

Trend lines

Aren't they things you draw on price charts?

Well, yes they are but that doesn't mean you can't use them in other areas also...

Actually, trend lines on RSI can often provide you with break signals much earlier than signals from the price chart. Let's face it trends are trends wherever they are seen. If you consider the basic definition of a trend you will see that trend lines can be placed on trends on plots other than price.

An uptrend is where there is a consistent move higher and where successive lows are moving higher and successive highs are also moving higher. Once one of the lows has been broken it will warn of a reversal in the trend.

Equally, RSI can develop in trends with the same requirement – that in an uptrend successive lows and highs are both moving higher. A downtrend will be the opposite.

Let me show you two examples.

In this 5-minute chart of AUDUSD there are two very clear examples.

To the far left it can be seen that RSI formed a bearish divergence on the final peak in the Aussie in which the RSI peak was lower than the previous one. From there price proceeded to develop in a downward move where subsequent price highs moved lower together with the lows which also declined.



Towards the end of this move we can see that we could have drawn a trend resistance line across the RSI peaks. Following the final low (although at that time we could not be sure it was the final low) we see that the correction high still formed a lower high. However, following that the next price low failed to reach new lows.

Soon after that point RSI broke above the trend resistance line. The bar when the break occurred did not confirm a price break higher but remained within the recent range. Since a trend resistance line couldn't be drawn we would have had to relied upon the breach of the last swing high which occurred at a higher level 7 bars after RSI broke above its resistance line.

From that point price rallied higher retaining a sequence of higher highs and higher lows. Equally RSI also saw swing highs move higher along with swing lows in RSI. Towards the top of the trend we would have been able to draw a trend line below the RSI plot. However, once again there was no price trend support that could be broken.

Just as in the first example, we would normally have to wait until we saw breach of the prior swing low but this was a long way below the peak. By drawing a support line below RSI we can see that the line was breached just 5 bars after the actual trend high and following that a good counter reaction lower carried price down for a deep correction.

Here is a second example:



This second example shows the daily chart of the Euro against the U.S. Dollar as it rallied to the 1.3851 high. If we attempted to draw a support line under this rally the points are not really accurate and thus it is difficult to be certain of what constitutes a break lower. IN addition, by the time what appears to be a break occurs price has reversed quite some distance.

Now, during the price trend higher we see that RSI has been making new highs and new lows – the correct definition of a trend and we can also draw a support line under the major RSI lows. Towards the end of the price rally we can see that the highs in RSI did not match the additional price highs, thus forming a divergence. This is a warning that the upward momentum in price is slowing down and could potentially cause a reversal lower.

We would normally look at the most recent price low but this is also a long way down and as such it is difficult to place a break level that would confirm the uptrend is complete. However, what does happen is that soon after the bearish divergence with three lower RSI peaks against three higher price peaks the RSI breaks below its support line.

Quite clearly this has provided us with an excellent signal of price reversal at a very early stage.

Therefore, when using RSI, don't just think of overbought and oversold – which are actually far more risky trades – think of whether RSI has been trending and see where the trend lines are breached – they can give excellent early signals.

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