HOW TO
USE THE RELATIVE STRENGTH INDEX (RSI)

TCM
MARKET HACKS

DISCLAIMER

The contents of this document are for information and education purposes only. TC Markets Ltd is simply providing information on trading related concepts that is designed to broaden the readers trading horizons and should in no way be seen as investment advice. The reader accepts that trading of any kind carries a high level of risk and that a trader can lose more than they put in. All trading and investment decisions are that of the reader.

Relative Strength Index (RSI)

In this article we would like to introduce to you a widely used trading tool known as the Relative Strength Index, commonly referred to as the RSI. Developed by J. Welles Wilder, the RSI measures the ratio of up moves and down moves for the purpose of identifying overbought or oversold conditions.

The basic principle is that when the index breaks below 30 the implication is that the asset being analysed may be oversold and due a corrective bounce. Likewise, when the RSI is above 70 the asset may be overbought and may sell-off.

Unlike many technical indicators, the RSI is designed to be forward looking. I won't go into the mathematics behind this indicator as the objective of this article is to illustrate the application.

This is what it looks like on a chart. The shaded area at indicates neutral conditions on the RSI.

The RSI and Trading

The standard setting for the RSI is 14 periods. Although this can be adjusted, we prefer to keep things simple and use the standard 14 period for trade signals.

There are 2 main strategies for using the RSI:

1. To identify overbought and oversold conditions.
2. To identify divergence

Using NZD/USD and EUR/USD as examples, let's take a look at identifying **overbought and oversold conditions using the RSI**.

If price is rallying and the RSI moves above 70, this indicates that conditions are now overbought, and that price is expected to decline. In this instance, you would be on the lookout for confirmation that price has reversed to initiate a short position to profit from the decline.

Conversely, when price is trending lower and the RSI moves below 30, the indication is that the market is now oversold, and price may bounce. Should you get a confirmation in the price action you would be looking to by the market in anticipation of a move higher.

2. Divergence

As the word suggests, when it comes to Divergence, we are looking for the price action of the currency pair to 'diverge' from the action of the RSI. Typically, the price and the RSI move in tandem, so when this relationship breaks down it can signal a trading opportunity.

Divergence can be both bullish and bearish. on the chart below you can see AUD/USD is trending higher with a series of higher highs. Notice that during the same period the RSI started printing a series of lower highs. Price and the RSI have diverged.

As AUD/USD price peaked on the 25th of February 2021 it formed a higher high, at the same time the RSI produced a lower high signalling a **bearish divergence** and the market is about to sell-off.

By April, AUD/USD had sold off by close to 500 pips. If you had a bullish bias, you could have taken profit on any long positions held, or if you were bearish, you could have used this as a signal to sell the market and bagged a profit.

Let’s look at an example of Bullish Divergence on USD/JPY…

On this occasion USD/JPY is trending lower with a move from 113.75 to a low of 104.60. As price breaks lower the RSI makes a higher high - bullish divergence.

Using this bullish divergence as a potential signal that the market is likely to move higher, traders could buy the market in search of profit. If you were holding a short position this may be a good time to lock in some profit.

Application

We use Tradingview so will demonstrate on this platform.

- **Step 1** – When in Tradingview and on your chosen chart, click on the 'Indicators' icon in the toolbar.

- **Step 2** – Type RSI into the search box.

- **Step 3** – Select 'Relative Strength Index'.