

# The RSI PRO: The Core Principles

The Basics

Paul Dean

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## INTRODUCTION

This is an introductory book to trading **The RSI PRO Forex Trading System**. It is not meant to cover all of the nuances of the system but to give the trader interested in this system the basic information without having to spend a great deal of money. The basics of **The RSI PRO Forex Trading System** are simple. They involve understanding **4 RSI Trading Signals** that appear on RSI, the Relative Strength Index. These signals can be manually located on any RSI chart on any charting package for any financial instrument including equities, commodities, etc.

The Complete RSI PRO Forex Trading System includes: **The RSI Fundamentals: Beginning to Advanced, The RSI Paint Indicator, and The RSI PRO Forex Trading System, Trading Examples Vol.1.**

The Core Principles for this system include the following:

1. Understanding and locating Reversals (and divergences)
2. Understanding the RSI Range
3. Understanding Range Shifts
4. Understanding Momentum Type 1, Momentum Type 2 and Momentum Type 3
5. Understanding The Levels of Success

With these Core Principles any trader can be successful trading Forex. This is a standalone method of trading Forex. It can be done with no other additional indicators. It does not need moving averages, trendlines, Fibonacci Ratios, Chart patterns or any price action theory.

The intent of this book is to take you through these Core Principles so that you can understand the system and how it works. To make this eBook helpful to a wide range of people it will contain several sections that may or may not relate to you. Please feel free to skip over them; however, as most of them are short and to the point, you may want to read them as they provide valuable information. The topics we discuss are listed below.

Why Forex?

Why RSI?

Trading is Decision-Making

In-depth Introduction to RSI

The RSI PRO Forex Trading System and the Andrew Cardwell method

The 4 RSI Trading Signals

RSI Range and Range Shift

RSI and Momentum

The RSI Paint Indicator

The Income Trading Method

# CHAPTER 1

## Why Forex?

Many people are turning to other methods to make income outside of what is considered their normal jobs. The recession/depression has made many people re-evaluate how they will deal with the future. This is true of people who have counted on the equity markets to be their main investment vehicle over the past 30 or 40 years.

There are a number of things to consider when looking at new ways to generate income. Google “home-based jobs” and you will get over 250 million hits. All kinds of opportunities present themselves. Hey, this is America!

One thing that many people are turning to is the Forex market. It has grown at a rapid pace since the advent of the computer and online trading. One of the greatest features is the idea that you don't have to go to work to make money, or that you can buy an automated trading system to trade for you. While this may sound good, just like any business it takes time to learn, it takes time to run, and unfortunately very few people do it without tending the store. Automated systems are not going to make you money over the long run. I will not go into that subject now but if you are interested you can read several articles on this topic by me at [EzineArticles.com](http://EzineArticles.com).

Forex is the name given to the Foreign Exchange Market where currencies are exchanged everyday between individuals, institutions, countries, and hedge funds. The spot market, which is where individuals trade, there is a turnover of \$1.4 trillion each day. The entire Forex market moves 4\$ Trillion each day, an incredible sum of money and each day/year it gets larger. Our objective here is to help you get started. But first, let's list a few of the benefits that trading Forex can have for you.

### Benefits

- This business has no customers to deal with.
- No phone calls in the middle of dinner or the middle of the night.
- There are no products to sell.
- No inventory to keep and move.
- No maintenance and no building or employees
- No boss.
- You can do it from your home or any place in the world
- You can trade 24 hours a day 5 days a week
- You can learn to trade for a relatively small amount of money
- You can practice for free with demo accounts offered by online brokers
- You can open a live account with as small as \$100
- No one can tell you can't do it because you don't have experience or the right degree.

- There are no commissions to pay as brokers charge traders on the spread when they enter a trade.
- You are in full control of your trade.
- You don't have to research companies as in investing in equities.
- There is no bull or bear market as currencies are traded in pairs and can be traded in short or long.
- There is no one to call to place a trade and no one to call to exit, everything is done on your computer or mobile phone.
- And you can go on vacation anytime you want with no problems to take care of "back at the office."

It sounds like it's almost too good to be true. But for less money than most businesses, a little discipline, patience, and persistence; just about anyone can understand the principles that make money and the rewards are potentially greater. Another nice feature is that you don't have to quit your day job (or night job) to start.

Skill in trading takes time to develop. If you start with the right books and trading method you will be ahead of the game. With a little work and several hundred dollars anyone can educate themselves. It is not necessary to plop down \$5,000 to \$6,000 or more to learn to trade. In fact many places that "educate people in Forex" are only giving a broad overview of trading. When the trader is finished, it is like being handed a box of tools.

*"This is a hammer, you use it to pound nails. This is a screwdriver, you use it to put screws in wood. This is a level, etc."*

You have the box of tools but you still do not know how to trade. Going to med school doesn't make you a doctor, working in a hospital makes you a doctor.

If you are not disciplined, you will need to develop that skill. You will need to understand what discipline is and what it isn't and then work to keep the undisciplined characteristics out of your trading. An example, is hitting a baseball. Good hitters have pitches they try to stay away from. They also know that there are good pitches, better pitches and best pitches. They have learned this over time and the good hitters make the pitcher throw as many pitches as possible so they get the most opportunities to hit the pitch they want. That is discipline. Good hitters don't chase bad pitches, and Forex traders do not chase bad trades.

Patience and persistence go hand-in-hand. It takes time to learn anything new. You need to have the patience to study, practice and absorb what you are learning. Many traders learn enough to begin trading in a few months, some take longer but regardless of the amount of time you need to get a "feel" for what you are doing. In sports they say that the game is *slowing* down for a player. When you don't know what you are doing things happen fast. As you become better, they slow down and it takes persistence to understand what is happening so that you don't get discouraged and quit.

There are many ways to free yourself from working for someone, to make extra money or replace your current income. Forex is one of those methods. Because it is a global market and because more and more people are involved, the potential to make money only increases.

## CHAPTER 2

### Why RSI?

I recently wrote an article for EzineArticles.com that I posted at LinkedIn. The title was, [Why RSI, the Relative Strength Indicator, Surpasses All Other Momentum Indicators](#). The article caused quite a debate among some well-known Forex trader/authors but the essence of what I wrote was true. Here is how the article begins.

*“Whether you are a seasoned trader, or a brand new trader, learning the key concepts of the RSI, Relative Strength Index, is perhaps the most important thing you can do to advance your trading career.”*

I realize that is a bold statement and I understand why some people would want me to prove that it was true but having traded Forex for 3 solid years along with researching everything about it, as if I were writing a PhD dissertation, I am unaware of any trading indicator that does so much. I have studied nearly every major trading concept and used them in the live market and nothing including Elliott Wave Theory, Fibonacci Ratios, Gann, Chart Patterns, price action theory, or any combination of these works better in particular for all people. Certainly there are people who develop methods that work well for themselves but not for others.

Elliott Wave is a perfect example of a subjective trading system. David Aronson, Evidenced-Based Technical Analysis, calls it a “*tale*”.

*“The power of a good story may explain the enduring appeal of the Elliott Wave Principle, one of technical analysis’ more grandiose conjectures.”* A conjecture is more a proposition than a fact; “*a conclusion deduced by surmise or guesswork*” according to Merriam-Webster Dictionary.

Aronson goes on to say, “*The Elliott Wave Principle, as popularly practiced, is not a legitimate theory but a story, and a compelling one . . . any sufficiently flexible model can fit a prior set of observations with perfection.*”

You don’t need EWT or any other indicator to trade reversals. We do teach methods that will aid in your decision-making in our more advanced book but the core ideas are all here in this eBook.

I will list a few of reasons here why RSI is such a powerful indicator for trading:

- **RSI concepts are simple to learn for beginners but advanced enough for use by experienced traders** – Being an advanced trader does not mean you have more tools, i.e. indicators, lines, etc. on your charts. It means you have more understanding and can remove your fair share of pips from the market.

- **Because RSI measures momentum** – momentum is perhaps the most important factor in trading. If you understand momentum you are 90% of the way home.
- **RSI is a leading indicator not a lagging indicator** – There is much discussion about this because RSI uses information from past periods to make decisions at the present. This is exactly what any other trading theory does even those that say they are just making “at-the-moment” decisions. Also, it is well documented that news, for example, is not absorbed by the markets all at the same time meaning that past information can be helpful in current trading decisions.
- **RSI is part of every trading package** – The Relative Strength Index is part of every charting package, many of them free so finding reversals and divergences is available to all traders. Metatrader 4 is an excellent trading tool to download and use and is offered by many different online brokers for free.
- **RSI is simple to understand and easy to read** – There is no need to load your trading screen up with multiple trend lines, moving averages, Fibonacci, etc. While we do use channels to define major and minor trending, RSI PRO does not require that you use any other indicator to become proficient as a trader.
- **The signals used on RSI (The 4 RSI Trading Signals) are objective because they are algorithmic** – This is one of the most important factors in trading, whether the signal to trade is algorithmic or whether the trader decides where he/she thinks it should/could/would occur. The signal is an alert for the trader to make a decision of whether or not to trade and they should not be subjective. They should be the same for me in Florida and the same for Damien in Australia, Anthony in San Francisco, Ales in the Ukraine.
- **RSI can be statistically studied in order for data that is important to future trades including momentum times, RSI levels, and which of the 4 RSI Trade Signals are producing the most profits (pips)** – We are developing a system here that has real data behind it so that we know where the best signals come and when. Our statistical data is updated each week and is available at [www.youlearnforex.com](http://www.youlearnforex.com).
- **RSI signals allow for accurate entry with a low risk of drawdown** – the value here is that with less risk the trader can use a larger position size for the trade. A 1 lot trade going 100 pips is \$1,000. If the risk is doubled at entry the position size must drop to half the lot size and the profit is only \$500.
- **The RSI PRO Forex Trading System has a specific target on each trade** – we discuss this in the Levels of Success but the basis of the system and the statistical studies is that each RSI reversal trade has a specific target based on the set up of that trade.

In the pages that follow we will show how all of this information works together to put you into position to trade successfully.

We will talk more about RSI in a moment but before we do let's take a minute to talk about what trading is really all about.

## Chapter 3

### Trading is Decision-Making

Trading is simply a process of decision-making. How you do it and the tools you use to make those decisions are critical.

Actually the best indicator for trading Forex is our mind but when we use our mind to make decisions we develop tools to help us decide what we will do, how we will do it, when we will do it. The purpose of The RSI PRO Forex Trading System is to give you the tools to make good trading decisions.

As discussed earlier, some trading tools can lead us astray. We discussed the Elliott Wave Theory but there is no statistical data that shows counting waves actually works. Yes, there are times that you will get trades right but the same could be true of flipping a coin. The point is if our trading decision becomes interpretative at the point of the trade then our decision-making becomes much more complex.

What kinds of decisions do you make when you trade? Here are just a few.

1. The currency pairs you are going to trade.
2. The time you are going to trade.
3. The system you are going to use.
4. What your signal will be when you trade.
5. Where will you place your entry?
6. Where you will place your stop loss?
7. Will your stop loss be hard or soft?
8. Will your stop be tight or loose and how will you decide?
9. What will your position size be?
10. What is your target?
11. What other factors will I take into consideration before I enter?
12. What consideration will I take while I am in the trade as to my exit?

Those are just some of the decisions we make and within each of those decisions are multiple other decisions. We try to take these in logical steps but that doesn't always work so tools become important for us to be able to reorganize our decision process when something happens we did not expect.

Traders email me every day with questions that tell me their decision-making process is still in a stage of infancy. Give me a choice between a trader with sound decision-making and a good system and bad decision-making and great trading system and I will take the sound decision-maker every time.

Trading is not just getting into lots of trades and making lots of pips. If I had a system that guaranteed me 5 pips everyday or every time I traded, I would be a billionaire in short order. Because we can't guarantee that, we have to deal with uncertainty and this means we have to deal with risk and dealing with risk means we have to make decisions - good decisions.

The best way to illustrate this is to think of a baseball player at bat. He is trying to hit the ball but he is not going to swing at every pitch. He knows the pitcher and the pitcher and the catcher know him. The pitcher knows what pitch he wants to pitch and the batter knows what pitch he wants to hit. If he can, the batter will wait the pitcher out for the pitch he wants. All kinds of discipline, patience and decision-making go into this conflict.

The batter knows his best pitch. However, he also knows he may not get that pitch. He may get what he considers a good pitch or a pitch that is better than good. He would like to get his best pitch and he hopes he makes a good swing at it.

At You Learn Forex we have a tool called The Trader's Map. This tool helps a trader with the "conditions" of the trade he/she is about to take. It is in a quadrant and there are Good, Better, Best and Worst conditions for a trade. The Trader's Map is a decision-making tool.

Forex traders would do well to think of trading as waiting for the right pitch or finding some other metaphor they can use to compare their trade decision-making to. It will help them a great deal.

## CHAPTER 4

### In-Depth Introduction to RSI

Welles Wilder created RSI, which is defined as a momentum indicator that measures the market's current price relative to the price for a certain period of time, typically 14 periods. You can probably search all day on the Internet and read every book in the library and bookstore and not come up with anything different on RSI but the following:

*“Most readers of the Swing Trader are familiar with RSI or the Relative Strength Index. The calculation of this indicator compares the average of up and down closes over a specific time usually 14 periods (a period can be an hour, day, week etc). RSI works primarily as an oversold/overbought indicator. A stock is oversold when it reaches the 30 level or goes below it. It is overbought when RSI exceeds 70. Stocks can stay oversold or overbought for long periods of time. Therefore, if RSI has crossed the 30 or 70 "boundary", no action should be taken until it has re-crossed it in the opposite direction. For example, if RSI falls below 30, do not buy until the indicator has come back above that level.*

*As with many overbought/oversold indicators, an important signal is given by bearish or bullish divergence. Bullish divergence occurs when RSI approaches 30 and begins to rise even though price continues to decline. That tells the trader the momentum of the decline is decreasing. Bearish divergence happens when RSI approaches 70 and the indicator begins to decline even though price is rising.*

*The 50 level is also important in RSI analysis. That is where the up vs. down closes in the indicator are in equilibrium or balance. Crosses below 50 indicate a weakening of the stock and those above 50 signify strengthening.”*

That was from StreetAuthority and typical of what you will read on the subject. If you decided to trade RSI based on this information you would lose money. Most traders who use RSI today don't use it as a method of trade entry. Instead they are still going by the same old “wrong” conclusions set forth by Wilder. To be a good RSI PRO trader you will need to understand some of these areas so we will present them below.

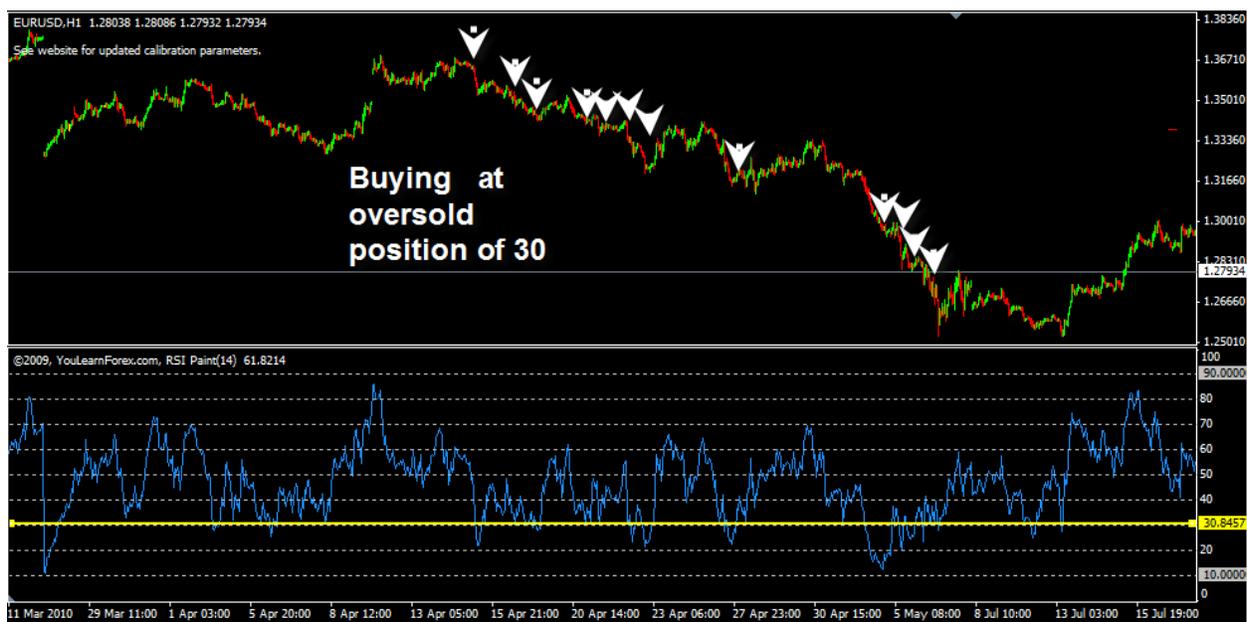
#### A measure of overbought and oversold

Many traders use the indicator to determine whether price at a particular location is overbought or oversold however Wilder never presented this concept in his book. Even still, this seems to be the predominate use of the indicator. Unfortunately traders who have used this concept to enter and exit the market have not had successful results.

Overbought and oversold are very relative terms. The idea for being overbought, for example, would be impossible to graph on a chart as it has to do with the irrational emotions of buyers.

Cardwell himself shows how the concept of overbought and oversold is flawed but for some reason in his analysis of trades, he continues to use it. He and Constance Brown have used a non-fixed RSI in an attempt to achieve better results in determining overbought and oversold but it is an elusive idea and it would seem that they of all people would understand this as Andrew Cardwell is the recognized expert on RSI.

Overbought and oversold are very simple to disprove. Place a horizontal line on your RSI chart at 70 RSI, considered overbought. Now scroll back through prices and notice how long RSI can stay at the level and how often it falls to 30 RSI, considered oversold, and price will still be moving up. The same experiment can be done for oversold conditions.



Here is an example of times RSI hit 30 (yellow line) where the standard definition of RSI would be to buy. The trader using this information would fail dramatically as price just continues to fall. This is a misunderstanding of RSI as we know it today.



Here we see the opposite mistake, selling when prices reached 70 RSI. Price continues to move upward.

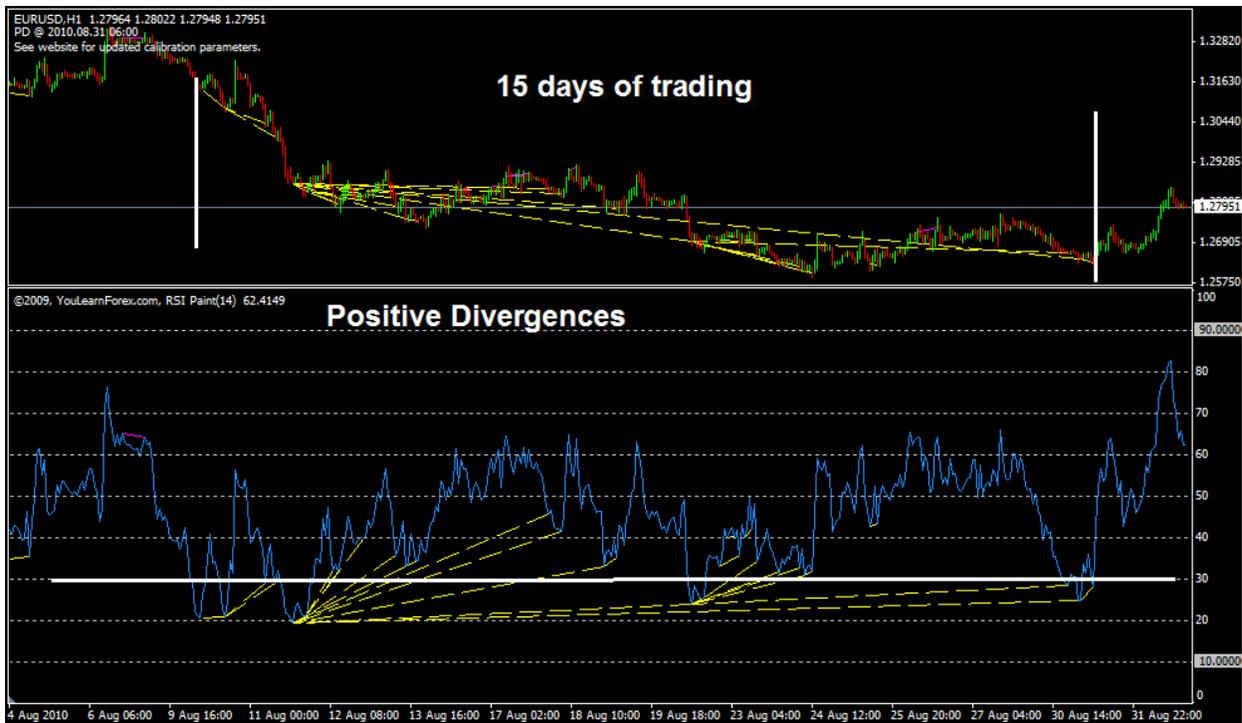
Can you find places where price dropped when it reached 70 RSI, yes? Can you find places where price shot up when it reached 30 RSI, yes? Did either have anything to do with overbought and/or oversold? No.

Okay, the next time someone tells you that a price is overbought and/or oversold remember what you learned here. Never again make a decision that is based on overbought and oversold.

### Positive and Negative Divergences

Wilder's methodology was more centered on divergence between the oscillator and price, in particular after what he called a, "... good directional move" which was in his mind, "a very strong indication that a turning point is near."

Divergences however do not reverse prices in only a small percentage of places. Divergences as we will learn are retracement signals in a trend.



*“Bullish divergence occurs when RSI approaches 30 and begins to rise even though price continues to decline. That tells the trader the momentum of the decline is decreasing.”*

All of the yellow dashed lines are Positive (Bullish) Divergences on price yet price continues to drop. This is 15 days of trading or 3 weeks on an hourly chart. The white horizontal line is on 30 RSI where according to the instructions above, price should begin moving upward. We will learn that Positive (Bullish) Divergence is in fact a retracement signal, not a reversal signal and we will identify it as Momentum Type 1.



*“Bearish divergence happens when RSI approaches 70 and the indicator begins to decline even through price is rising.”*

Negative (Bearish) Divergences behave in exactly the same way except in the opposite fashion. If the initial idea of RSI was right, price would be falling, not rising.

Although I can find places where divergences reverse the trend they are very few and would not be the basis of good decision-making. Now, when someone tells you, or you read that a Bullish Divergence has formed and to trade the currency pair long, take it with a grain of salt.

### Andrew Cardwell and Reversals

The most significant thing to come from RSI was something Andrew Cardwell a student of Welles Wilder found, reversals. Wilder went on to create a number of other indicators but Cardwell stayed with RSI and discovered Reversal Signals. These Reversal signals are the center point of Cardwell’s trading system and they are utilized by other top traders. Constance Brown devotes a chapter to them in her book, Technical Analysis for the Trading Professional (\$55.00). The book is required reading for the advanced portion of the CMT examination.

She discusses it again in a chapter in, Breakthroughs in Technical Analysis (\$60.00), by David Keller, in a chapter on Price and Time.

We will look at Reversals later in more depth but there are two lessons here. One has to do with sticking with something until you learn something new about it. Cardwell apparently did just that and found a signal that others had missed.

Second, some trading indicators may be created for one thing but end up being more helpful in other ways. In both of these cases we should make sure we give everything that we use in Forex to trade and perhaps take a moment to think “out-of-the-box” to see how else a trading tool might be used.

Now it's time to take a brief moment to look at The RSI PRO Forex Trading System and what we know of Cardwell's method.

## CHAPTER 5

### The RSI PRO Forex Trading System and the Andrew Cardwell method

I am often asked how The RSI PRO Forex Trading System differs from Andrew Cardwell's RSI trading method. I have talked to Cardwell several times via the phone but we did not discuss his trading system. At one point we discussed a joint venture and I sent him my eBook (first edition) to read and comment on but he never reciprocated by sending his to me.

My first book on RSI (RSI Fundamentals: Beginning to Advanced) sold for \$49.99 and his total system was about \$10,000 at the time; since he has reduced it to about half. He never responded to my book so I do not know if he didn't like it, didn't read it or something else. We have exchanged emails on several topics but he has never told me anything regarding his system.

At the time I knew about reversals and how he incorporated some filters from two videos I had purchased online that he did around the 90s.

Initially when I began trading using his methodology about three years ago from my cobbled research, I thought the system was the best system I had found in all of my research on Forex trading. However, after using it for two years with mixed results and not wanting to pay over \$10,000 to get his mail-order course, I set out to make the system my own and make it better.

The crux of my system is the reversal signal that he discovered and which we will discuss later. There were several things that presented problems however; not every reversal made money. In other words, losses if you trade every reversal because some reversals come in steps like stepping stones that lead to the top of a hill. It is the last steps that provide the profit. So, the crucial thing that needed to be done was to eliminate as many of the "false" signals as possible. I will discuss some of the differences between the two systems below.

#### Moving Averages

One in particular filtering rule is the use of moving averages that must cross before entry is taken with a reversal signal. This did not make sense in that if you are using a leading indicator, RSI, for your signal and you are confirming it with a lagging indicator, moving averages, than there was no reason for the leading indicator. It does not take a great deal of research to show how this causes problems. A signal can occur and price could move 100 pips before there was a confirmation of the moving averages and just as the confirmation took place the moving averages could cross back (loss of momentum). Then of course you would be constantly fiddling with the moving averages for different markets and time frames. **Moving averages are not part of my system in the way Cardwell uses them.** I do explain the use of a single moving average in

RSI Fundamentals: Beginning to Advanced but in terms of mean reversion which is significantly different than moving averages that cross and delay a decision. In that case you are not trading reversals but moving averages.

### Overbought and Oversold

There seemed to be a contradiction in whether to use RSI as overbought and/or oversold or to not use it. Cardwell points out the fallacy of overbought and oversold but then designed a Composite Index that removed the static range of RSI in hopes of having a more reliable method of determining overbought and oversold. He must believe it works because he sells this index as part of his system. The trader interested in doing this can simply alter the typical RSI indicator inputs box and uncheck the “fixed minimum” and “fixed maximum” boxes and get essentially the same affect, saving them several hundreds of dollars.

I decided to remove this contradiction completely from The RSI PRO. The RSI PRO does not make any decision on overbought or oversold as the term is meaningless in regard to RSI and what it measures.

### Target Projection

One of the initial things I liked about Cardwell’s system was his target projection method. Very few trading systems provide a way to determine the target before the entry is made.

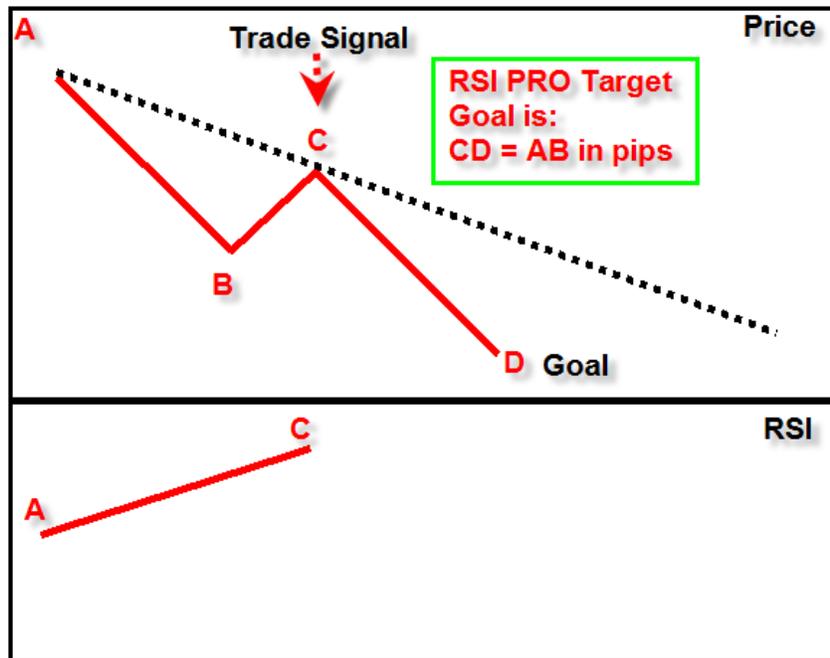
The reason this is so helpful is that it allows the trader to then determine how much risk he/she will take in order to reach that goal. Position size in trading is important to reaching ones goals; sooner rather than later.

It became apparent after a period of time that perhaps the target method was not correct. Yes, the target was hit occasionally but how often? There was no real way to know until I created The RSI Paint Indicator with the help of trader/programmer David Moser and RSI PRO trader as well. Once we had that tool we were able to create a second tool that downloads over 20+ pieces of information on each reversal and divergence signal. Running tests on the Cardwellian target projection method for reversals showed a very small percentage reach their targets. This leads us to a 4<sup>th</sup> reason The RSI PRO is different.

### Statistical Data

Before we created our download tool I felt we needed to determine our method of success for The RSI PRO system, or the projected target for each reversal trade. In that way we could determine the success rate for our system. I will briefly discuss that here.

The chart below is what is called the Target Projection Chart for each RSI Reversal trade.



The schematic here is for a Negative Reversal. The top of the chart is what price would do when a Negative Reversal formed. The angle formed by ABC is price moving downward from A to B and then moving upward B to C. The signal for the reversal would occur when price reached C and when the C on RSI was higher than A. There are 4 possible goals for this trade which are described by levels.

<p><b>Good Level 3</b></p> <p>Signal is made at C and price exceeds D but does not reach D before exceeding A.</p>	<p><b>Better Level 2</b></p> <p>Signal is made at C and there is a drawdown but the drawdown does not exceed the price at A; Price proceeds to D where AB in pips = CD in pips.</p>
<p><b>Best Level 1</b></p> <p>Signal is made at C and there is no drawdown; price proceeds to D where AB in pips = CD in pips.</p>	<p><b>Worst Level 4</b></p> <p>Signal is made at C but price does not exceed D before it exceeds A.</p>

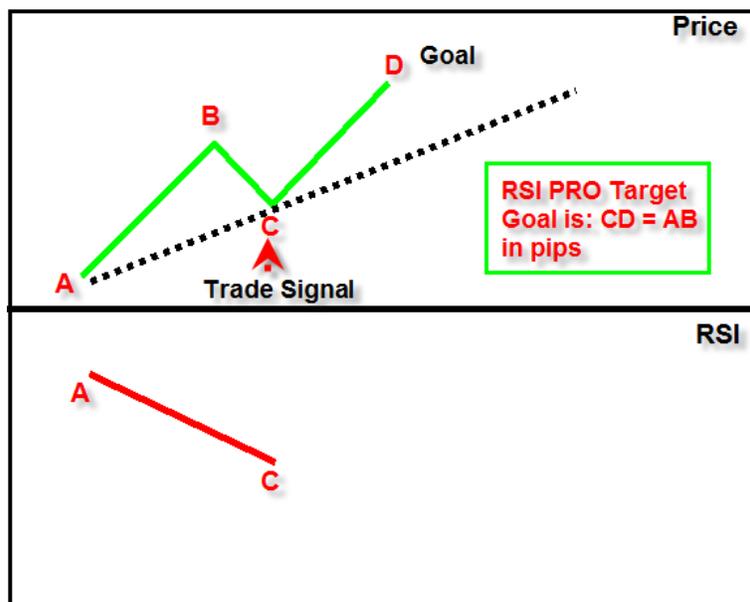
Obviously Level 1 is **Best** as there is no drawdown and there is a good chance there was significant momentum.

Level 2 is **Better** but not Best because it does the same thing as Level 1 but has some drawdown and is not stopped out.

Level 3 is **Good** because the pips gained exceed B before turning back and taking out A.

Level 4 is **Worst** because the signal is created and the trade is immediately taken out at A.

As you can see, A is failure. The opposite would be true of a Positive Reversal which is shown schematically below.



These are just some of the major differences that would set The RSI PRO from the Cardwell method and as most traders would conclude, they are significant differences and improvements.

## CHAPTER 6

### The 4 RSI Trading Signals

We have discussed in part the 4 RSI Trading Signals but we will go into more detail now.

What are the 4 signals?

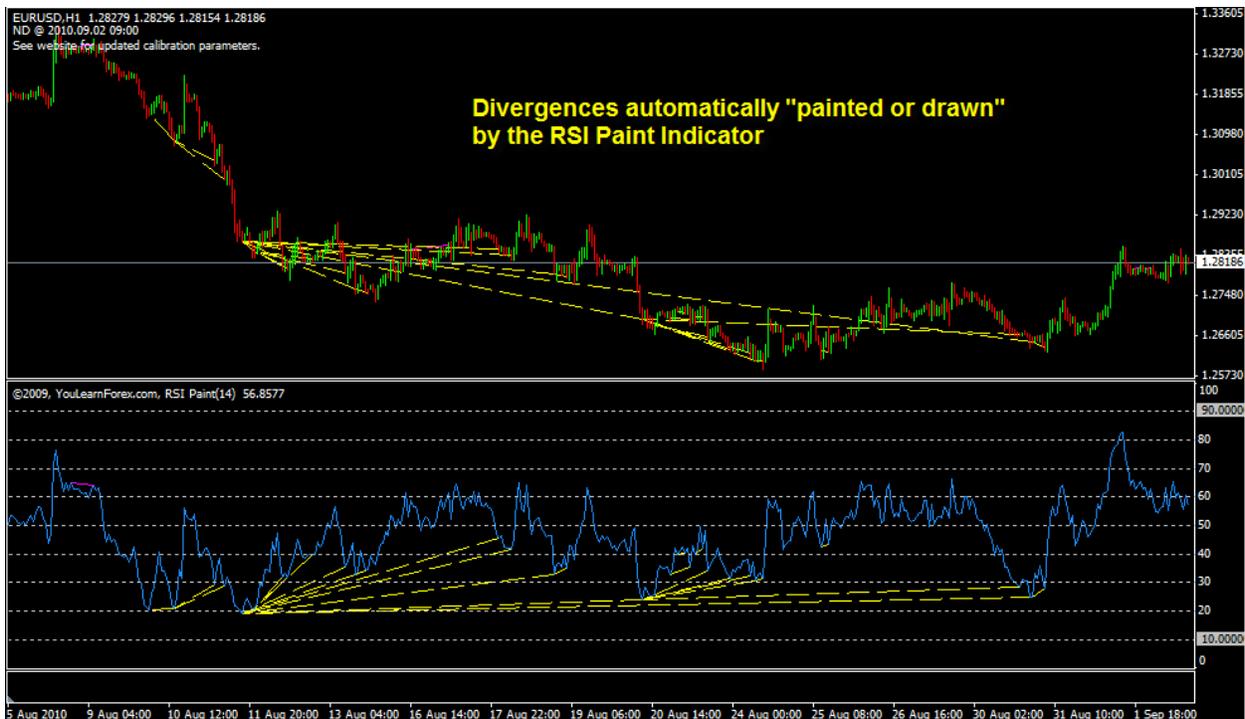
1. **Positive Divergence** – RSI is higher at point 2 but price is lower. This occurs along the valleys of the RSI.
2. **Negative Divergence** – RSI is lower at point 2 but price is higher. This occurs along the peaks of the RSI.
3. **Positive Reversal** – RSI is lower at point 2 but price is higher. This occurs along the valleys of RSI.
4. **Negative Reversal** – RSI is higher at point 2 but price is lower. This occurs along the peaks of RSI

Below are examples of each. The first example will be a single instance and the second will be using the RSI Paint to show how many can occur in

#### Bullish or Positive Divergence

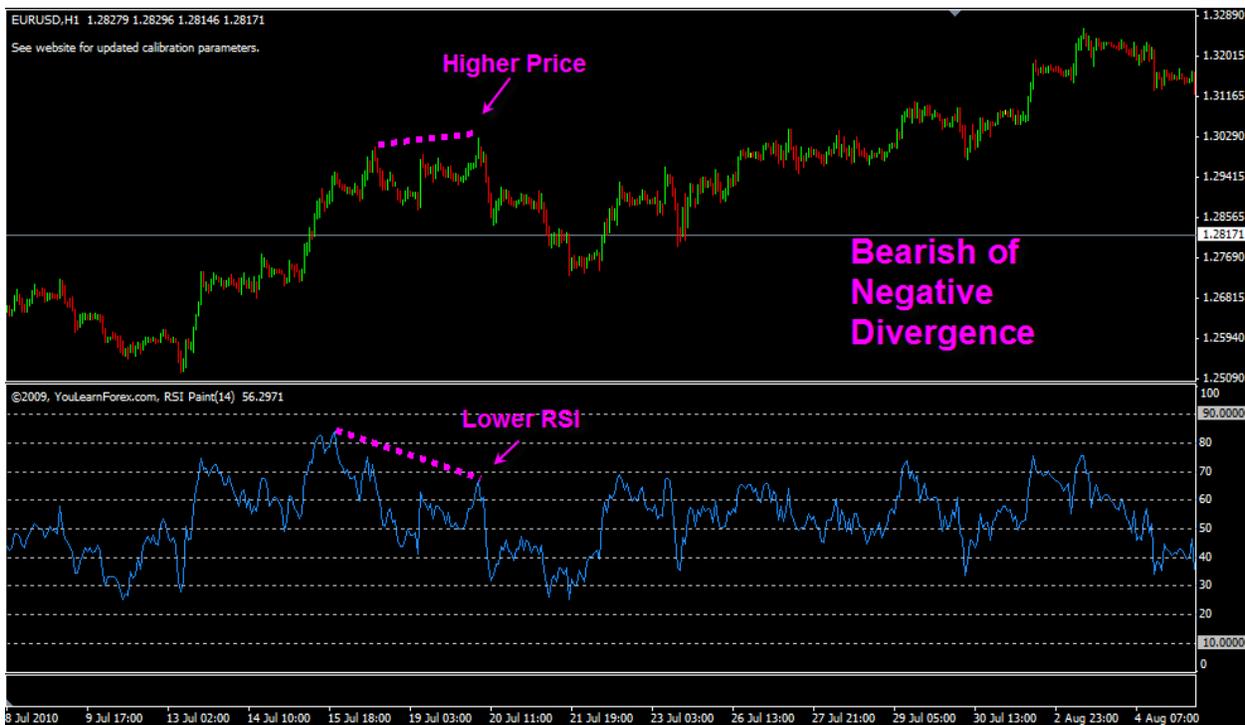


Manually locating and drawing divergence

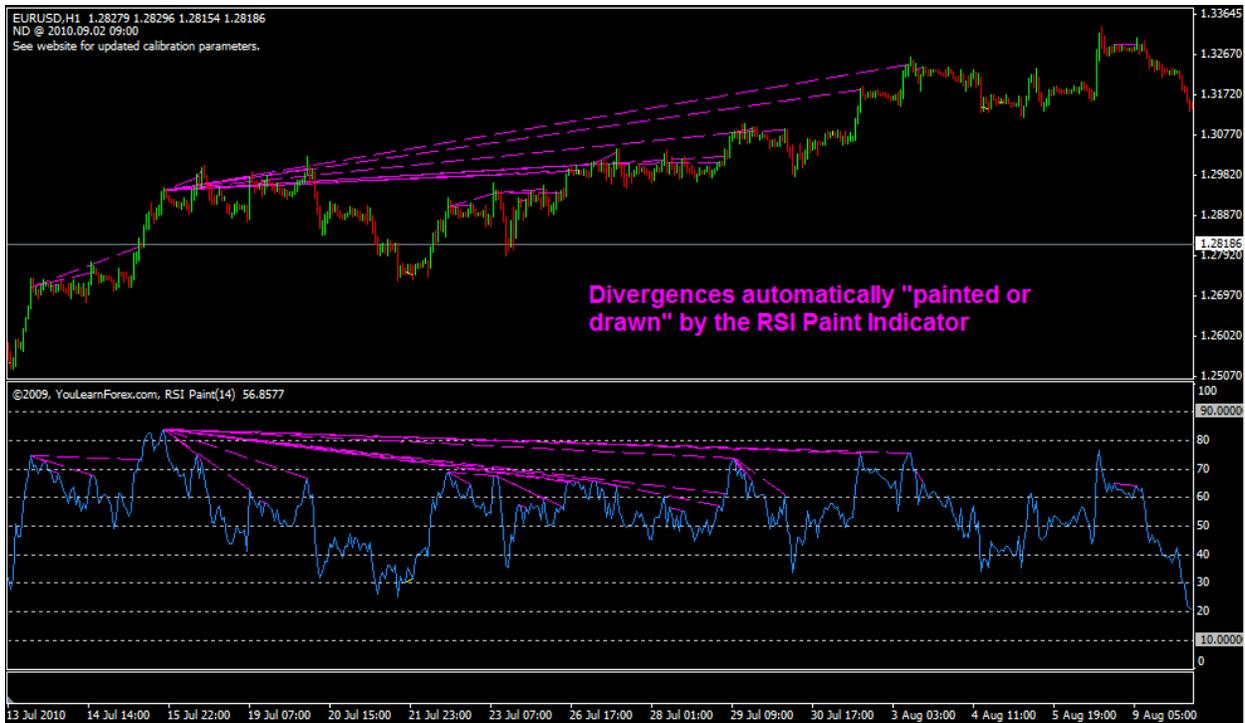


The RSI Paint locating and drawing Divergences

### Bearish or Negative Divergences



Manually locating and drawing divergence



The RSI Paint locating and drawing Divergences

### Bullish or Positive Reversal



Manually locating and drawing divergence

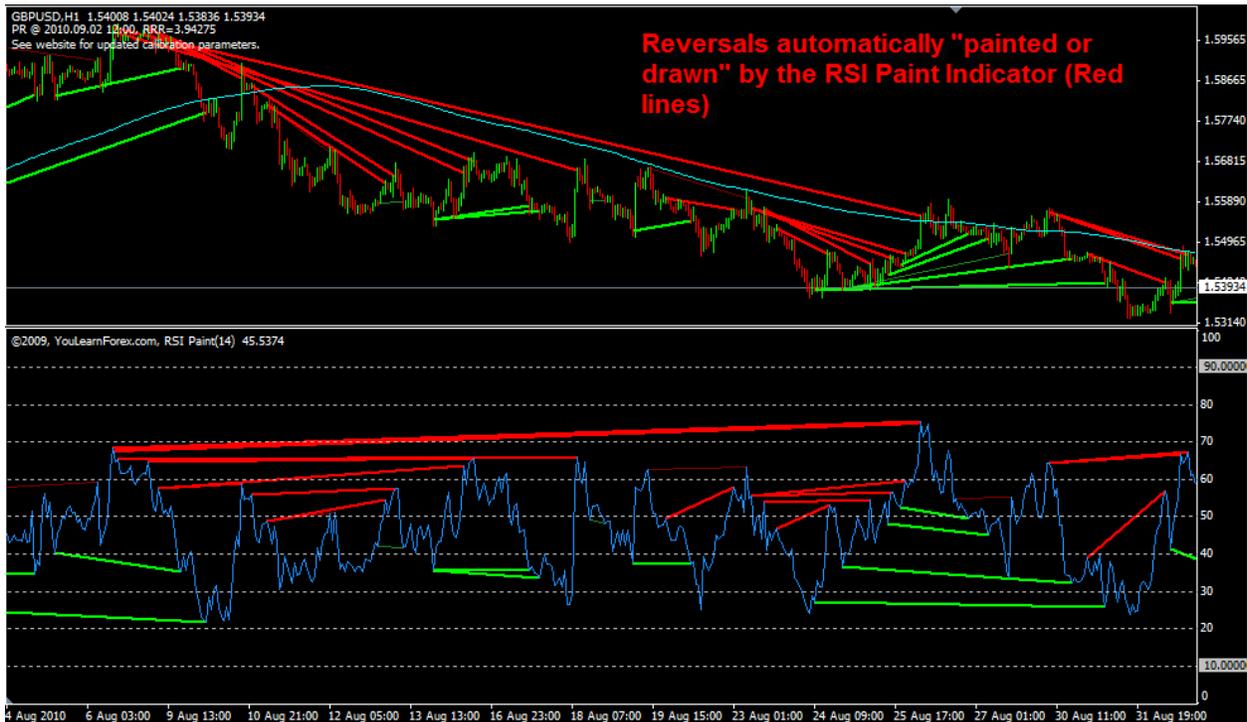


The RSI Paint locating and drawing Divergences. This drawing includes all the other signals as well showing how many signals can occur on one trading chart.

### Bearish or Negative Reversals



## Manually locating and drawing divergence



The RSI Paint locating and drawing Divergences. This drawing includes all the other signals as well showing how many signals can occur on one trading chart.

What is the best way to find divergences and reversals if you are doing it manually?

### **Here are some of the Key Points about these signals:**

1. Typically divergences are hard to trade as they most often occur counter to the trend and it is not my recommendation until you are well-seasoned in this trading method. One reason is that divergences occur most often when a trend is retracing. This is why divergences lead to reversals, they are not the signal themselves for reversal.
2. Positive divergences lead to Negative Reversals; Negative Divergences lead to Positive Reversals.
3. There are many signals that occur as shown by the examples above. Although we will discuss the RSI Paint Indicator later on, it wasn't until we decided to create our own indicator in MT4 to locate all of the divergences and reversals on RSI that we realized how many there were.
4. The cumulative RSI signals give a graphic representation of what price is doing. After you have traded this system for a while you will most likely be able to look at RSI charts with the RSI Paint Indicator and tell what is happening on price.
5. Because the main momentum is with the trend, anything counter to it will not have a lasting effect. Divergences are the signal that will counter the trend the most and

indicate that price is resting and that new reversals are on the way. However, because they run counter to the trend, they become "alerts or clues" so-to-speak for the more stronger reversal signals.

6. Positive (bullish) Reversals or Negative (bearish) Reversals are the signals that allow traders who use RSI to generate profits as they provide entry points that move with the existing trend. This allows traders who are trading with the trend good entry and exits points.
7. When price is moving in a downtrend Negative Reversals predict the continuation of the trend while Positive Divergences are the signals that run counter to the trend. Typically when price has been moving down as a result of a Negative Reversal signal, it will eventually rest and retrace and a Positive Divergence will form. This retracement may be a good place to exit the trade or to take profits. This will depend somewhat on the trading style you adapt; short-term, long-term, or somewhere in between. Then, the trader waits to for additional Negative Reversals as the trend continues.
8. An uptrend would be just the opposite with Positive Reversals pointing the way to trade with the trend and Negative Divergence as the counter trend signal.
9. Statistical data shows that when the trend is moving downward the greatest number of successful trades will be Negative Reversals and in an uptrend, Positive Reversals.
10. Although we teach traders to look at the "context" of price using channels in RSI Fundamentals: Beginning to Advanced, the channels are not what determine a trade. They can and are part of the decision-making process but it is the location of the 4 Signals that traders should focus on first.
11. There is no need to draw Fibonacci Ratios or trend lines or to look for chart patterns. In fact, we discourage those things because they are subjective methods of trading not objective.

If you do not have the RSI Paint Indicator which draws all divergences and reversals for you you can still locate them with on your RSI chart and use the Metatrader tools to draw them.

Now when you look at a blank trading chart you will know what to do. Begin plotting from right to left the signals that are in front of you. As you do they begin to tell a story; the story of momentum which we will discuss shortly.

Now we're going to look at two important concepts of RSI: RSI Range and RSI Range Shifts.

# CHAPTER 7

## RSI Range and Range Shift



This is a concept that can make you a great deal of money. When price is trending up RSI ranges at higher RSI levels than when price is trending down. Here price is moving up on the left side of the chart and RSI is ranging between 80 and 30 RSI. On the right side of the chart RSI is ranging between 60 and 20 RSI, almost 20 points lower on the downtrend. These ranges will vary slightly from time frame to time frame but you will see the difference because there is a shift in range.

Notice where the yellow arrows goes from 80 RSI to 20 RSI. Price has begun to go lower but the downtrend move has only begun (you wouldn't know that then). After the yellow arrow however price did not recover to 60 RSI and the dropped again to 20. When RSI started dropping at the 60 RSI peak we would have been looking for a Reversal signal in order to enter the market.



Here is the same chart as above with the Reversal drawn in and it occurred right on that exact point where RSI recovered to 60 RSI after the yellow arrow. This trade dropped 600 pips in the next 10 days.

## CHAPTER 8

### RSI and Momentum

You may think that you have learned the essence of the RSI PRO Forex Trading System and for the most part you have but there is another nugget of gold here. It is called Momentum. I am capitalizing it because it is crucial to trading successfully in particular if you are planning to do any short-term trading.

Here is a comment from Matthew Clements, editor of The Technical Analyst magazine on RSI. *"The Relative Strength Index (RSI) is perhaps the most popular of all technical oscillators, in that it provides an easy-to interpret indication of possible market turning points and trend strength."*

What he has just described is Momentum. Turning points and trend strength are caused by Momentum. If there is no Momentum change causes turning points and trend strength.

First of all, what exactly do we mean by Momentum. There are many people who talk about Momentum and everyone has a little different definition. Let's decide what it isn't and then we will decide what it is.

It's not volatility. Often when I say we want to trade momentum people say, "Oh, news trading." But that is not Momentum. Volatility is erratic price behavior that can be caused by noise which can be caused by the plethora of automated trading systems attacking each other, buying and selling, or it could be price shooting up or down and then whiplashing once, twice or three times as a result of news. *Volatility is not Momentum*

It is not waiting for price to narrow down in a tight range and then breakout. That is a breakout strategy that needed Momentum, it does not define Momentum. In most of these strategies the trader either brackets the trade or tries to guess which way the trade will go and often there is no certainty of timing. If there is not sense of when or why then there is not Momentum. It would be like having a car with no accelerator and waiting for someone to bring one, then you would have Momentum. *Breakout is not Momentum*

Then traders talk about the Market Sentiment. Market Sentiment is a good term and comes close to our meaning however typically it is tied in with long-term strategies like COT and other fundamentals. Trade pundits often say that a currency pair is likely to this or that because of the market sentiment at the time but the market isn't doing this or that yet. *Market Sentiment is not Momentum*

One thing we know is that Momentum must be there at the time of trade. In particular if the strategy wants to maximize position size which reduces risk. Momentum reduces the drawdown so that the risk, stop loss, can be tightened on the trade.

## **Momentum drives price**

When a trade is entered regardless of how the signal was determined, Momentum must be present to carry the trade to its goal just as there must be an engine in a car that responds to the accelerator when it is pressed. Momentum is caused by traders entering into the market in overwhelming force in one direction over the other. There is no Momentum when prices are not moving. Momentum usually follows a news release. The price movement at the news break is not Momentum.

## **Momentum lowers risk; increases profit**

When the trade has Momentum at the time of the trade then there is less risk. RSI is a Momentum indicator but not all trade signals have the right kind of Momentum. That is because there are three kinds of Momentum. We will define them in a moment.

Momentum, when it is present will typically have an almost **zero** risk level. RSI reversal signals, for example, in trades where Momentum is present have drawdowns of 10% or less regardless of time frame, often they do not drawdown at all. This can be statistically validated as far back as 10 years of reversal signals. Take this situation. If you have a 300 pip range of risk and a 300 pip target then only 30 pips is required with the right kind of Momentum to take that trade. This allows the trader to increase the position size of the trade.

What does this mean in terms of dollars? If you trade 1 lot at 10% risk and you make your target of 300 pips, your profit is \$3000 on the above example. However, if you take a 30% risk position and reduce your position size by 1/3rd then your profit would only be \$1,000. As you can see this is significant to a traders, year-end bottom-line. This is true regardless of whether you are trading for 10 pips or 1000.

## **Momentum can be seen**

Typically Momentum can be seen visually on a chart almost immediately. In contrast many trades that have no Momentum, or no hope of Momentum, sit for long periods with no movement. This is often seen when a trade is placed in the Asian Trading period on many currency pairs. Michael Marcus describes in Market Wizards how trading large positions with tight stops and times of high market momentum was one of the best strategies he employed and he is considered to be the all-time top currency trader.

This is why RSI is so crucial as a trading indicator and as a method of entry into markets - it measures Momentum.

## **What kind of Momentum does it measure?**

After trading the RSI for over 3 years I began to see that there was more than one type of Momentum occurring on the RSI chart. It was then I began to identify the kinds of Momentum

and what it meant when I was watching a currency pair. Remember earlier I said that the signals on RSI were clues or alerts to what price was doing.

Momentum can be separated into three areas; Momentum Type 1, Momentum Type 2, and Momentum Type 3.

Momentum Type 1 can be found in the form of divergences. Divergences are signs that a trend is slowing and forming a retracement. They are retracement Momentum and seldom reversal Momentum.

Momentum Type 2 is continuation Momentum. This Momentum is found in the form of reversals that tell the trader when it is best to re-enter the trend. Momentum Type 2 is the more powerful of the two but just because you have a Momentum Type 2 signal, does not mean that it is time to trade.

Momentum Type 3, or market Momentum needs to be in place to drive the trade through to the intended target, in particular when trades are shorter in duration. In longer trades, Momentum Type 3 may occur at different periods of time to accentuate the length of the trend. But for success to occur, there must be a Market Directional Force in the direction of the reversal that you are choosing to trade.

Many things cause Momentum Type 3 and much can be learned about when it will occur.

Here is a list of things that create Momentum: Remember, Momentum is the river that begins to flow with force outside the whirlpool. Do not mistake the whirlpool for Momentum. Just because you have a reversal at the time of a news announcement, does not mean that price will go in that direction. The market will need to spin that information around (volatility) before it lets it go into the river. Once you know that direction then it is time to enter.

For example, if you are trading on a day when there is economic news at 8:30am and at 10:00am EST then you should wait until the news settles. That may be at 10:15am, 10:30am, 10:45am or 11:00am. On days when there is no 10am news then you should wait for the Dow.

You will be surprised at how much more consistent you will be.

Scheduled News can create Momentum but there is no certainty in which direction therefore the trader waits, the gambler throws in his stake.

Unscheduled News can have the same affect but you will often miss it. This is an opportunity to wait for the "burst" of Momentum to "blowout" and catch the trade as it returns to stability. This is a very easy way to make money.

Statistical data can be gathered to determine which hours of the day trade best for a particular currency and time frame. This data is compiled and is available at the Member Area on a weekly basis.

Being ready and in position is half the battle.

## CHAPTER 9

### The RSI Paint Indicator

#### What is the RSI Paint Indicator

- The RSI Paint Indicator is a standard RSI that you will find on any trading chart. We have programmed this indicator to “paint or draw” all divergences and reversals automatically. The advantages are several.
- Each of the 4 RSI Trading Signals is in a different color which makes identification easy.
- The MT4 trading platform allows the trader to be alerted whenever a signal is created at the moment is created.
- The signal is automatically sent to the computer screen and it can also be sent to an email address or to a cell phone.
- The 4 RSI Trading signals create a pattern that allows the trained RSI PRO trader to make accurate predictions.
- The RSI Paint Indicator easily switches between time frames re-drawing the 4 RSI Trading Signals for that particular time frame in seconds.
- The RSI Paint Indicator can be put on as many currency pairs as required.

In the method we have shown here the RSI PRO trader can trade drawing the signals manually. This can be tedious however and not the best use of time. In particular when the trader would like to move from one time frame to another or to know at a particular time what signals might occur on multiple currency pairs.

There are over 20 inputs which can alter the look of the RSI Paint Indicator.

- It draws all divergences and reversals or eliminates one or the other.
- Price lines that correspond to the 4 RSI Trading Signals can be draw or removed.
- The Risk Reward Ratio determines which signals are bold allowing the trader to determine which signals he/she is most interested in.
- The period can be altered; the default is 14.
- Comments are provided in a mouse over of the reversal and divergence signals with important data (RRR, RSI levels, Price levels)
- The number of periods can be selected

## CHAPTER 10

### The Income Trading Method

Do you have a goal for how much you would like to make each day, month, or year in Forex? Maybe you think if you just find the right system, everything will take care of itself?

Having a goal of how much to make each day can be very important to your success. What would you like to make every day? To determine that, you will have to decide how much time you will spend and the type of trading system you will use. Are you planning to trade Forex to provide income on a daily and weekly basis or are you planning to use it as part of a long-term investment?

**Your trading style is an important factor in trading Forex.**

One of the things I like about Forex is that it is a powerful moneymaking opportunity. Like him or not, George Soros made \$1 billion in one day trading against the British Pound. In other words, you can make a great deal of money in a matter of minutes but to do it you have to have experience and knowledge.

Some traders shoot to make 100 pips in one day, or 25 or 50. I think that is the wrong philosophy. I think the trader should look at his or her equity and decide what type of increase they would like to see each day and then find the trade, based on their trading methodology, to meet that goal.

I have used the Income Trading Method as one of my trading methods for some time and it works nicely. Here is the idea. Place a balance in your trading account say \$3,000. Your goal is to make 10% each day without risking 5%. Whatever you make, you take out of your account and then start over again the next day. At any time you can increase the size of your base equity.

With \$3,000 you would be trading 1 standard lot and risking no more than 15 pips. If you do not have trade for a particular day you don't trade. Compromising your trading principles or pressing for a trade will not work. There will be days that you lose and there will be days you will not trade.

There will be days however when you win small, normal and big. In the end your goal is to capture 10% each day without risking more than 5%.

Now if your risk is 15 pips as it is here then you will look for momentum trades that allow you to enter with a Reversal signal that gives you that possibility. It will make you more conservative. Rather than ask yourself how many pips you will place as your stop before or after you enter you will have this as a criteria as part of your decision-making.

If Momentum carries you to the 10% mark and then tails off, exit the trade and call it a day. Walk away. If Momentum carries you to more than 10% watch for the right time to exit (when Momentum is dying).

I have seen accounts doubled in 9 days, 20 days and 40 days. The key is consistency however. Don't let success make you take bigger risks.

## **Conclusion**

There are a number of subjects we have not discussed here. Our purpose was to present The Core Principle of the RSI PRO Forex Trading System. If you would like to see the additional information offered in RSI Fundamentals: Beginning to Advanced you can go to the website and click on the Table of Contents. The eBook is roughly 6 times larger than the eBook with subjects that are covered more in depth and additional subjects that fall outside of The Core Principles but are helpful in making the best decisions you can as a trader.

I trust that you have found this eBook to be helpful. Please feel free to email me your questions, opinions and comments and happy trading!