RSI

Spotting Overbought & Oversold Conditions — Lesson Explainer

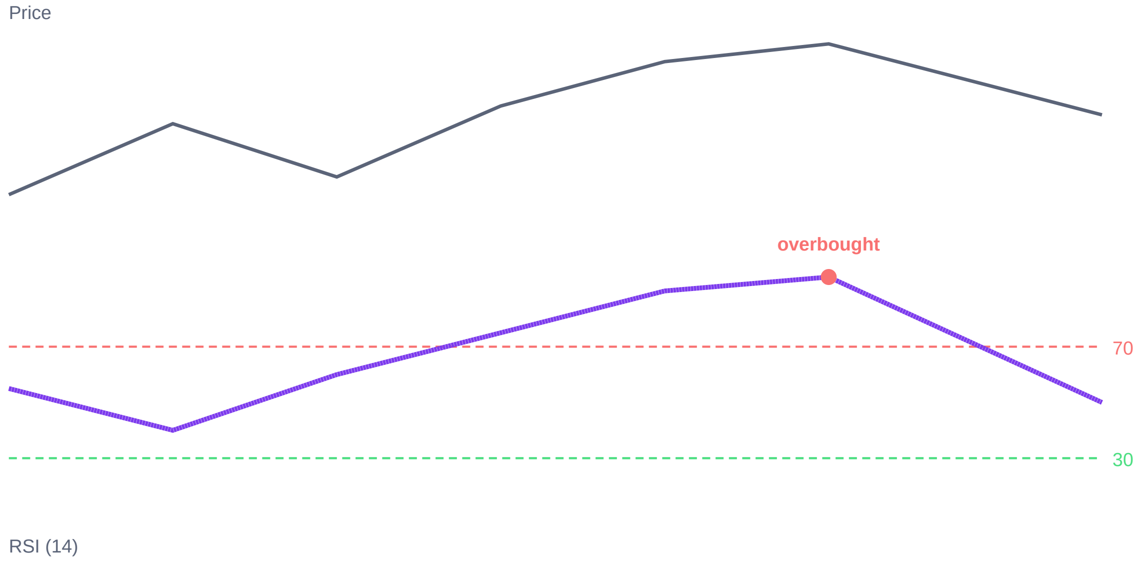
The Concept

The Relative Strength Index (RSI) is a momentum oscillator that compares the size of recent gains to recent losses, plotted on a scale of 0 to 100. It's typically calculated over a 14-period lookback.

RSI above 70 suggests an asset may be overbought - a pullback or pause becomes more likely. RSI below 30 suggests oversold - a bounce becomes more likely. These are guidelines, not hard rules.

Formula: RSI = 100 - (100 / (1 + RS)), where RS is the average gain over the lookback period divided by the average loss.

RSI Alongside Price



5 Things to Know About RSI

1. 70/30 are guidelines, not laws - a strong trend can keep RSI pinned above 70 (or below 30) for a long stretch.

2. Divergence is often more useful than the level itself - price making a new high while RSI makes a lower high is a classic warning.

3. Shorter lookback periods react faster but whipsaw more - 14 is the standard balance.

4. RSI works best paired with trend context - an oversold reading in a healthy uptrend pullback differs from one at a real breakdown.

5. RSI is a momentum tool, not a valuation tool - it says nothing about whether a stock is cheap or expensive.

4 Things to Check When Reading RSI

• Check for divergence first - compare RSI's recent peaks/troughs to price's.

• Read it with the trend - in a strong uptrend, treat dips toward 40-50 as the zone that matters.

• Don't trade the first touch - wait for RSI to actually turn back before treating a 70/30 cross as confirmation.

• Pair it with support/resistance - an oversold reading at a known support level is a stronger combination.

> **Worth knowing:**
> RSI describes recent momentum, not the future. A stock can stay 'overbought' for weeks in a strong trend, and an 'oversold' reading can keep falling further. Use it alongside trend and volume, never in isolation.

Quiz — Answer the questions, then check the key on the next page

1. What does RSI measure?

A. The company's price-to-earnings ratio
B. The total trading volume over a period
C. The size of recent gains relative to recent losses, on a 0-100 scale
D. The distance between support and resistance

2. What does an RSI reading above 70 traditionally suggest?

A. The stock is definitely about to crash
B. The asset may be overbought - a pullback or pause becomes more likely
C. The company has high debt
D. Trading has been halted

3. What is "bearish divergence" in RSI?

A. When RSI and price both make new highs together
B. When RSI is exactly 50
C. When volume falls to zero
D. When price makes a new high but RSI makes a lower high

4. Why can RSI stay above 70 for weeks during a strong uptrend?

A. 70/30 are guidelines, not hard rules - strong trends sustain overbought readings
B. RSI can only go from 0-70, never higher
C. It's always a data error
D. Overbought readings automatically reset every Friday

5. Avg gain 2.4, avg loss 0.5 - is RSI closer to overbought or oversold?

A. Oversold (RSI near 20)
B. Exactly neutral (RSI = 50)
C. Overbought (RSI well above 70)
D. RSI cannot be calculated from this information

Answer Key

1. What does RSI measure?

Correct answer: C. The size of recent gains relative to recent losses, on a 0-100 scale

RSI compares average gains to average losses over a lookback period (typically 14) to produce a single 0-100 momentum reading.

2. What does an RSI reading above 70 traditionally suggest?

Correct answer: B. The asset may be overbought - a pullback or pause becomes more likely

Above 70 is the classic overbought zone - a signal to watch for exhaustion, not a guarantee of an immediate reversal.

3. What is "bearish divergence" in RSI?

Correct answer: D. When price makes a new high but RSI makes a lower high

Bearish divergence is often considered more informative than the raw overbought/oversold level.

4. Why can RSI stay above 70 for weeks during a strong uptrend?

Correct answer: A. 70/30 are guidelines, not hard rules - strong trends sustain overbought readings

RSI reflects recent momentum, not a countdown timer - a strong enough trend can keep it pinned in overbought territory.

5. Avg gain 2.4, avg loss 0.5 - is RSI closer to overbought or oversold?

Correct answer: C. Overbought (RSI well above 70)

RS = 2.4 / 0.5 = 4.8; RSI = 100 - (100 / (1 + 4.8)) ~ 82.8 - solidly overbought.