Momentum Oscillators

Timing is always key when trading and technical analysis provides a method of probabilities that helps you choose the right time to get into a trade. Technical analysis works most of the time, but not all of the time. That's why we have exit strategies. But, today I'm going to show you some technical tools that help you decide when to get into a trade. They're called momentum oscillators.

RSI, MACD and Stochastic Indicators: These are momentum trading tools that were designed to show when a stock is overbought or oversold.

There are numerous oscillators in technical analysis; however, the ones above are three of the most commonly used oscillators.

RSI = Relative Strength Index

Let's start with the RSI. The RSI (Relative Strength Index) is a moving average that oscillates between a low of 20 and a high of 80 with a midpoint of 50. (See chart below.) The RSI average can be adjusted to represent the moving average you consider best for the particular chart interval you are looking at.

Without making this too difficult to understand, most traders use a 5 or 7 day RSI when looking at a daily chart because the markets are open 5 days per week and this gives a trader a snapshot of the weekly average of price movement for that chart.

If you're looking at a weekly chart, many traders switch to a 10 - 14 day RSI. The differences between a 5 or 7 and a 10 or 14 day moving average are negligible in my opinion. I use a 5 day for my daily charts and a 10 day for my weekly charts.

When the RSI reaches the higher point of 70 or above (See arrows on chart below), that indicates that the underlying security is overbought and should correct back down soon. Inversely, if the RSI is at a low point of 30 or lower, that would mean that the underlying security is oversold and an uptrend reversal should begin soon. These securities will oscillate up and down during any given time frame, thus the name 'oscillators'.

The mid-point for an RSI chart is 50% or the number 50. Again, if the RSI trends above the mid-point, expect a reversal down and if it trends below the mid-point, expect a reversal back up.

MACD = Moving Average Convergence/Divergence

The mid-point of the MACD is '0' with a high of +30 and a low of -30. When the price of a security approaches the high point of +30, then the security is considered to be overbought and you will typically get a reversal to bring it back down to neutral territory or below. (See arrows in chart below)

Likewise, if the security approaches the low point of -30, that would mean the security is oversold and you would expect a reversal back up in price.

The MACD can also show divergence in the underlying security pricing structure, as shown in this example above. You can see how even though this chart of the S&P shows new highs and an uptrend, the MACD shows a divergence or downward trend line in the opposite direction of the chart pattern. This represents a potential for a reversal to the downside soon.

Stochastic Oscillator = Momentum indicator that uses Support and Resistance levels.

The theory behind a Stochastic Oscillator is that in an upward-trending market, prices tend to peak near their high or resistance level, and during a downward-trending market, prices tend to bottom near their low or support level.

Stochastic oscillators also use the number 50 as the midpoint with a high of 80 and a low of 20, just like an RSI oscillator. The difference is that a stochastic oscillator uses a minimum of 2 different moving averages and tends to peak at price resistance and bottom at price support.

All of these oscillators give a trader similar information and I personally use the RSI and the MACD oscillators only.