

# TECHNICAL STRATEGY

## TRADING THE 3-DAY RSI MODEL

By Ed Carlson, CMT

The three-day RSI model is an extremely short-term trading model I created that presents the trader with a nice opportunity once or twice a month. Its goal is to find days when the market has become too stretched in one direction and there is a high probability of a "snap" back to the trend.

### BACKGROUND

The model uses Welles Wilder's Relative Strength Index (RSI) set to three days, rather than the 14 days that is commonly used. The three-day RSI is overlaid on both the S&P 500 Index (SPX) and the Volatility Index (VIX).

### SETUP

Buy signals are generated by a simultaneous move below 20 by the SPX three-day

RSI and over 80 by the VIX three-day RSI. Sell signals are given by the opposite setup (SPX three-day RSI over 80 and VIX three-day RSI under 20).

I normally use options to make these trades profitable as the period is short and the market move from this signal tends to be small. Using options, rather than index funds, can make for a highly profitable trade. I check my charts 15 minutes prior to the market close every day looking for this setup.

If the opportunity presents itself, I enter the order just before the close. Sometimes, the market will snap back before the close, and I exit a profitable trade that day. However, my normal game plan is to be out of the trade before the close on the following day.

### VERY SHORT TERM

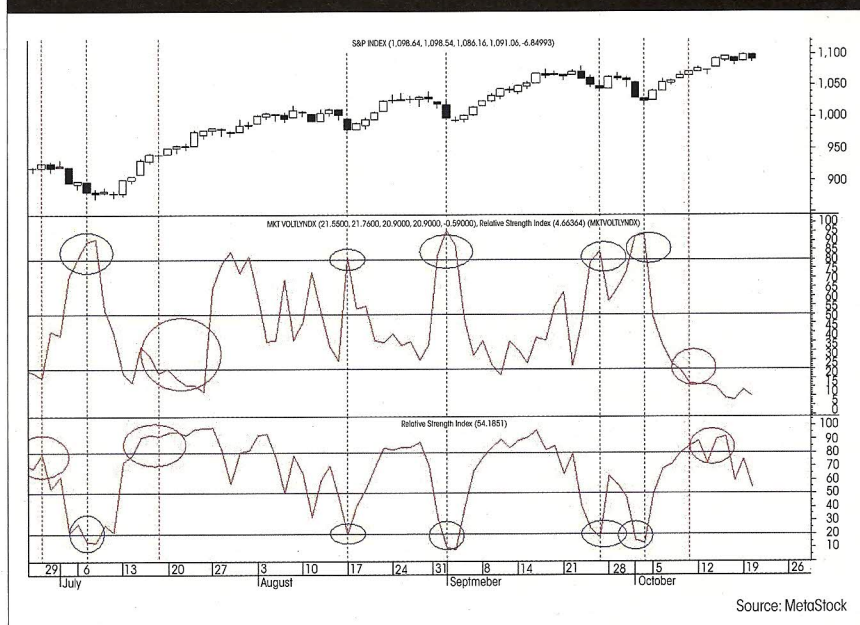
Despite the examples in Figure 1, it must be stressed that this is a short-term trading

strategy. By short term, I mean the holding period is one day, two at the maximum. Under no circumstances should a position taken from this model be allowed to turn into a longer-term holding. Not all trades are profitable, of course, but losses can be minimized by remembering the discipline to sell quickly.

Figure 1 shows, from top to bottom, SPX price, the VIX three-day RSI and the SPX three-day RSI. I have noted with ovals and dashed, vertical lines those days when the RSI indicators simultaneously exceeded the extremes noted previously. The chart shows not only the short-term nature of the model, but two failures as well.

The first failure (mid-July) could have been avoided through a filter I use. I watch the daily advance/decline line for breadth thrusts. I define a breadth thrust as a move exceeding 1.5 standard deviations over its 20-day moving average (Bollinger bands). This filter does not work in the opposite direction. That is, do not use a dip below the advance/decline line's lower band to filter out buy signals, as these are actually excellent buy signals in their own right! The other failure occurred in October ... a good reminder that no indicator is perfect.

FIGURE 1: S&P 500



Ed Carlson, the creator of the Carlson confirmation model, is an independent trader and consultant based in Seattle. Previously, he spent 20 years as a stock broker. He is a chartered market technician and hosts the Market Technicians Association Podcast Series (a weekly audiocast featuring interviews with recognized industry professionals). He manages a technical analysis blog directed at financial advisors at [SeattleTechnicalAdvisors.com](http://SeattleTechnicalAdvisors.com). Reach him at [ed@seattletechnicaladvisors.com](mailto:ed@seattletechnicaladvisors.com).