

How to Spot Overbought Stocks That are Due for a Drop

I just love getting questions and feedback from *Inside TradeSmith* readers. When I can cover the topics you want – or provide clarity on something I’ve covered before – it really helps me decide what to discuss in my next column.

Here’s one email I got that’s especially relevant to the latest market action:

The “Oversold” query of 10/31/23 got me thinking, has he given us a query for “Overbought” stocks? (Thinking that perhaps I should sell some of my overbought portfolio while it “reverts to the mean”). I’m enjoying your data-driven approach!

That’s a terrific question, and the answer serves as a timely topic for today’s column, considering how overbought stocks have become in general.

For my money one of the best ways to find overbought stocks is by using the relative strength index (RSI), a technical indicator we feature in *TradeSmith Finance*. Better yet, you can also use this widely followed indicator to spot oversold stocks, too.

Developed by J. Welles Wilder and published in his 1978 book, “New Concepts in Technical Trading Systems,” RSI has become one of the most popular technical indicators.

The RSI provides signals that tell investors to buy when an asset is oversold and to sell when it is overbought. It helps you to track the current and historical strength or weakness of a stock or index based on the closing prices of a recent trading period.

RSI is classified as a “momentum oscillator,” measuring the velocity and magnitude of price movements. In other words, it charts the rate of change in the rise or fall in price.

Specifically, RSI computes momentum as the ratio of higher closes to overall closes: stocks that achieve more or stronger positive closes have a higher RSI than stocks that have had more or stronger negative changes.

The RSI is most typically used on a 14-day time frame, measured on a scale from 0 to 100, with high and low levels marked at 70 (overbought) and 30 (oversold), respectively.

The trend in RSI, either up or down, reflects the trend in a stock or index. High and low levels (above 80 and below 20) appear less frequently but indicate stronger positive or negative momentum.

Wilder found that when RSI bottoms below 30 or tops above 70 it can provide useful buy or sell signals, respectively. Levels in between these extremes indicate the strength of trend, with the 50 level considered neutral.

Wilder also pointed out that divergences between RSI and price action can provide strong indications of a turning point, or a coming change in trend.

A bullish divergence occurs when price makes a new low, but RSI makes a higher low. And a bearish divergence takes place when price makes a new high, but RSI makes a lower high.

Armed with this understanding of how RSI works, we'll use the *TradeSmith* Screener tool to create our own overbought/oversold stock screen, using RSI along with some proprietary *TradeSmith* indicators.

The Screener is available to anyone with access to *Ideas by TradeSmith*. I'm also using our *Trade Cycles* indicators. (Note: my Screener may look a little different from yours since I have Platinum-level access.)

Setting up your Filters

Be sure you are signed in to *TradeSmith Finance*. Click on the **Invest** menu at the top, then the **Screener** tab. First you'll see a few pre-built *TradeSmith* screens that you may want to explore later.

For now, click on **+ Create new screener**, then **+ Manage Filters**.

- Under the **TradeSmith** section, check **Relative Strength Index**, **Cycle Conviction Level**, **Cycle Turn Area**, and **Cycle Period**.
- Next, under the **General** section, click on **Markets**.
- Then click the **Save & Close** button.

To give yourself a cleaner view, back on the **+ Create new screener** page, click the trash can icon to remove any filter line you don't plan to use.

Now let's review how the filter settings look within the platform.

Fine-tuning the Filters

The screenshot displays the TradeSmith Finance Screener interface. At the top is a navigation bar with links: Dashboard, My Portfolios, Markets, Invest, Options, My Services, Calendar, Pubs, and Baskets. Below the navigation bar is a 'Create new screener' section. On the left, there is a '+ Manage Filters' link with a green arrow pointing to the filter list. The filter list consists of several rows, each with a filter name, a value, and a trash can icon on the right. The filters are: Markets (value: S&P 500 (SPX)), Relative Strength Index (14) (value: 70, with a green arrow pointing to the 'more than' operator), Cycle Turn Area (value: Peak, Upcoming Peak), Cycle Period (value: Composite Cycle), and Cycle Conviction Level (value: High, Medium, Very High). At the bottom, there is a 'Display & Sort Results' section with 'Show top' set to 250, 'Sort results by' set to Rank, and 'DESC' sorting. At the very bottom are three buttons: 'Save As New', 'Save Changes', and 'Run Screener'.

TRADESMITH FINANCE

Dashboard My Portfolios Markets Invest Options My Services Calendar Pubs Baskets

← BACK

Create new screener

+ Manage Filters

Markets S&P 500 (SPX) +

Relative Strength Index (14) more than 70

Cycle Turn Area Peak Upcoming Peak

Cycle Period Composite Cycle

Cycle Conviction Level High Medium Very High

Display & Sort Results Show top 250 Sort results by Rank DESC

Save As New Save Changes Run Screener

- For Markets, I chose the large-cap **S&P 500 Index** to keep it simple, but you can select other indexes to include more stocks in your screen.
- Set the RSI to **more than 70** to find any overbought stocks in the index.
- Next, for added conviction, I included our proprietary *Trade Cycles* timing indicators. Here are my settings.
- For **Cycle Turn Area**, use the dropdown menu to select **Upcoming Peak** and **Peak**.
- Under **Cycle Period**, select the **Composite Cycle**, which is a blend of all the various timing cycles we track.
- And for **Cycle Conviction Level**, I chose **Medium**, **High**, and **Very High** – I excluded Low. That’s because I wanted a greater degree of confidence that the stocks on this screen would be at or near peak price trend.

RSI is a powerful and proven indicator on its own, no question, but by including our timing cycles, we can have more conviction that these stocks are at a possible overbought top and due for a trend change to the downside.

Now, be sure to save your work by clicking on **Save As New** so you can revisit this screen later. When I ran this screen, I found 95 S&P stocks that are overbought. Due to limited space, below is a screen shot of the top 10.

[Saved Screeners](#) (95 results)

☐	Ticker ▼	Rating	Health 📊	VQ%	Avg VQ%	VQ Ratio 📊	Volume	P/E Ratio	Trailing Divi...	Market Cap	Sector
☐	WBA Walgreens Boots	Bearish	1y+	24.19%	21.61%	11.93%	8,265,490	-7.47	7.21%	\$23.0B	Consumer Staples
☐	WAT Waters	Strong Bullish	3w+	22.51%	25.40%	-11.35%	214,905	30.26	N/A	\$19.7B	Health Care
☐	WAB Westinghouse Air	Strong Bullish	2m+	21.62%	27.60%	-21.67%	410,633	30.24	0.53%	\$22.8B	Industrials
☐	VRTX Vertex Pharmaceu	Strong Bullish	1y+	20.31%	40.25%	-49.54%	594,117	30.62	N/A	\$105.1B	Health Care
☐	URI United Rentals	Strong Bullish	6m+	31.03%	38.12%	-18.62%	488,406	16.80	1.02%	\$39.2B	Industrials
☐	UBER UBER TECH	Bullish	7m+	39.15%	42.98%	-8.91%	20,805,952	122.95	N/A	\$130.2B	N/A
☐	TRV Travelers Cos	Strong Bullish	1m+	17.49%	19.75%	-11.47%	1,020,704	20.11	2.08%	\$43.1B	Financials
☐	TRMB Trimble	Bearish	1y+	27.56%	35.07%	-21.41%	727,412	41.52	N/A	\$13.3B	Information Techno...
☐	TPR TAPESTRY	Strong Bullish	1y+	31.40%	31.91%	-1.62%	3,385,342	9.50	3.48%	\$8.6B	Consumer Discretio...
☐	TMO Thermo Fisher Sc	Strong Bullish	1y+	21.22%	21.99%	-3.48%	805,991	34.92	0.26%	\$205.4B	Health Care

Filtering for Oversold

Now, you can easily turn this stock screen on its head, so to speak, in order to quickly find *oversold* stocks. Adjust your settings like this:

- Set the RSI to **less than 30**.
- For **Cycle Turn Area**, use the dropdown menu to select **Upcoming Valley** and **Valley**.
- Stick with the same **Composite Cycle** period and **Cycle Conviction Level** of **Medium**, **High**, and **Very High**.

These settings should help add conviction that stocks making the cut are not only oversold per RSI, but they’re also at or near a valley low and expected to turn higher in price.

When I ran the oversold version of the screen, I found just one S&P 500 stock made the list.

Create new screener

+ Manage Filters

Markets ✕ S&P 500 (SPX) +

Relative Strength Index (14) less than 30

Cycle Turn Area ✕ Upcoming Valley ✕ Valley

Cycle Period ✕ Composite Cycle

Cycle Conviction Level ✕ High ✕ Medium ✕ Very High

Display & Sort Results Show top 250 Sort results by Rank DESC

Save As New Save Changes Run Screener

Saved Screeners (1 result)

☐	Ticker	Rating	Health	VQ%	Volume	P/E Ratio	Trailing Divi...	Market Cap	Sector
☐	AON Aon-A	Strong Bullish	1w+	17.61%	1,051,736	22.01	0.83%	\$58.0B	Financials

Using both versions of the RSI screener (overbought *and* oversold) in this way delivers an added bonus. It tells you at a glance that the S&P 500 overall is much more overbought today than oversold. And that's a useful market timing indicator on its own!

Mike Burnick's Bottom Line: In my own experience trading stocks for nearly four decades now, I can tell you that RSI is one of the most useful technical indicators. That's why we feature it in our Screener filters. And by saving and periodically running the above screens, you can see which stocks are overbought or oversold.

Happy New Year! And keep those emails coming, folks, at emailmikeburnick@tradesmith.com. Please include "Inside TradeSmith" in the subject line when you write in.

Good investing,

Mike Burnick

Senior Analyst, TradeSmith