

STOCHASTIC OSCILLATOR



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What Does the Stochastic Tell You?

A stochastic oscillator is a **momentum indicator** comparing a particular closing price of a security to a range of its prices over a certain period of time.

It is used to generate overbought and oversold trading signals, utilizing a **0-100 bounded range of values.**



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Key Takeaways

- A stochastic oscillator indicator is used for **generating overbought and oversold signals**.
- Price on a scale of 0 to 100, with measurements **above 80** indicating that an asset is **overbought**.
- And measurements **below 20** indicating that it is **oversold**.
- Stochastic oscillators **measure the momentum** of an asset's price to determine trends and predict reversals.



Understanding the Stochastic Oscillator

Stochastic oscillator charting generally consists of **two lines**: one reflecting the actual value of the oscillator for each session, and one reflecting its three-day simple moving average.



Because price is thought to follow momentum, the **intersection of these two lines** is considered to be a **signal** that a reversal may be in the works, as it indicates a large shift in momentum from day to day.

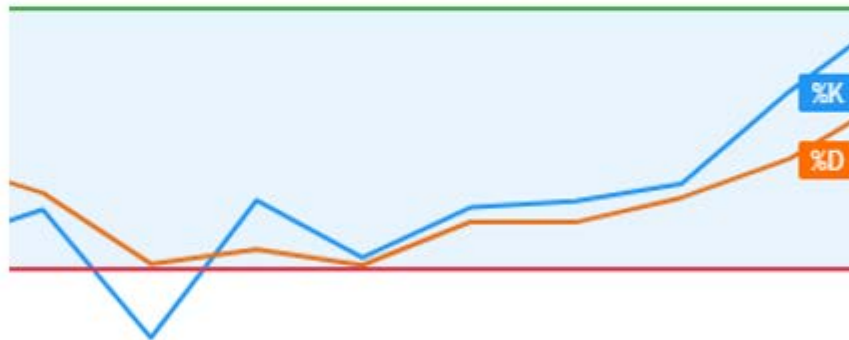
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Understanding the Stochastic Oscillator

Divergence between the stochastic oscillator and trending price action is also seen as an important reversal signal.

Notably, **%K** is referred to sometimes as the **fast stochastic indicator**.



The **"slow" stochastic** indicator is taken as **%D** = 3-period moving average of %K.

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Limitations the Stochastic Oscillator

The primary limitation of the stochastic oscillator is that it has been **known to produce false signals**.

This is when a **trading signal** is **generated** by the indicator, yet the price **doesn't follow** through, which can end up as a losing trade.

During volatile market conditions, this can happen quite regularly. One way to help with this is to take the price trend as a filter, where signals are only taken if they are in the same direction as the trend.

