

There's an old saying that if you trade headlines, you'll end up selling newspapers.. "Traders open their wallet before they open their mouth" Alan always preaches. That is where technical analysis and especially stochastics come into play. How many times have you seen the market moving sideways and we start to see prices move one way and "BAM!" they reverse? That is an indication that traders are all betting on the market going the same direction. In other words, there are too many traders on one side of the boat. Markets are mean reverting, so it is common to retreat from the extreme to the average.

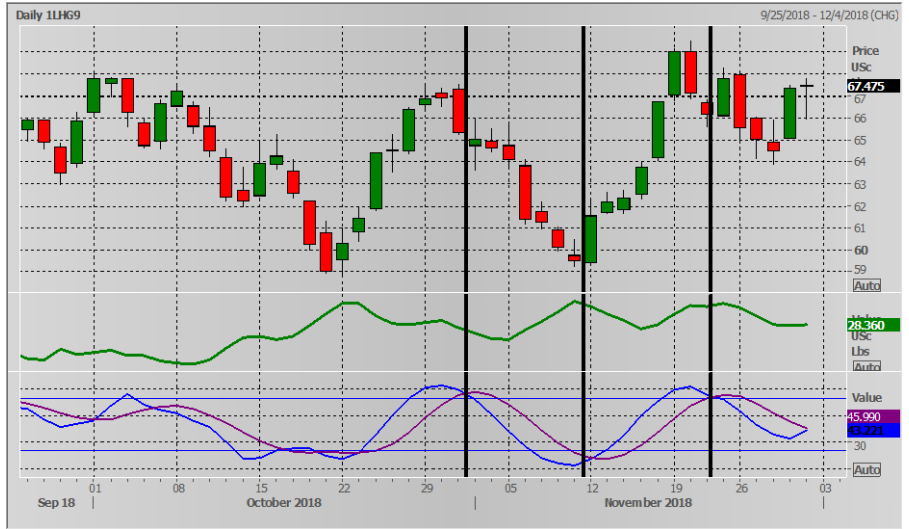
As some of you may know, there's two types of markets (besides the bull and bear markets). And those are trending and non-trending. One rule of thumb when it comes to applying stochastics to your technical analysis is that they are not very reliable in trending markets. The way we measure a trend in markets (other than visually) is by using ADX, or Average Directional Index. Normally, when ADX is rising, a signal of a trend, we shift toward using trend following tools like MACD. When we are not in a trending market, we typically look towards using RSI and Stochastics. Both RSI and Stochastics are oscillators that tell you when the market has gone too far in one direction. When a market had gone too far, they reach "overbought" or "oversold" conditions. For this Chart School we are focusing on Stochastics.

There are three types of stochastics including raw, fast and slow. We typically use the slow stochastics, which smooths the data. The raw and fast stochastics are often choppy and not easy to read. The slow stochastics consist of two lines, %K and %D. The %D is a moving average of %K, typically a 5- day. The %K is a formula of highs and lows, which your software should calculate for you. The %K and %D are then plotted on a chart from 1-100 to signal the current market situation (too bullish, too bearish, neutral). In the overbought scenario, the market is too bullish and can be identified when the stochastics are over 80. Oversold is when the market is too bearish and is suggested by stochastics values under 20. It is then, when the market is below 20 or above 80, that we look for a buy/sell signal. The signal occurs when the %K and %D cross each other while in overbought/oversold territory. If they cross while oversold, it is a buy signal and a sell signal when the market is overbought.

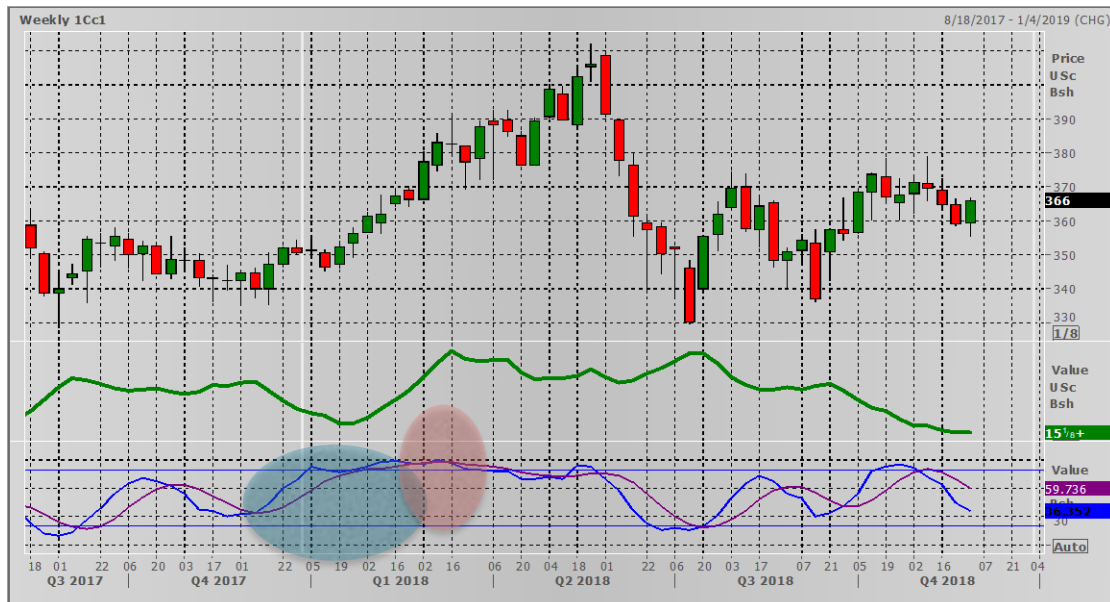
Typically, we use a 7-period stochastics, with a 4-period smoothing and a 5-period smoothing for %D. However, there are also ways to optimize your stochastics. It should not be used to give you the signal you want, but the one you need! Sometimes you have to change lengths of the Stochastics depending on the underlying price cycle. To optimize stochastics, you count the cycle low to low by checking 3 complete swings and averaging to get the cycle length. You then set the stochastics to that length and see if it turns near the correct spots. If a cycle length is long, i.e. a 45-week cycle in cattle, you can divide by a whole number (5 to get a 9-period length) to shorten up the stochastics to get a faster response. A quote from George Lane says. "Stochastics are not predictive. If it signals before the turn, you don't have it set up right."

Parameters	
%K Periods:	<input type="text" value="7"/>
%K Averaging Periods:	<input type="text" value="4"/>
%D Method:	Simple <input type="button" value="v"/>
%D Periods:	<input type="text" value="5"/>
Interval:	(Default) <input type="button" value="v"/>

The February Lean Hog chart below shows a pretty good example of when to use stochastics. ADX (green line) does show a slight trend going on, but it is not high enough to disregard stochastics. We see that the market was overbought in late October, when stochastics indicated a sell signal on Nov 1. Obeying and following that signal would have been good for a \$5-6 gain if you went short. The market turned bearish and was soon oversold. The stochastics buy signal on November 12 would have been prime time to get out of your short position and go long. Following a bullish turn, on about November 19, stochastics became overbought and crossed on 11/23 (The right most black vertical line) indicating a sell signal. Stochastics are now bearish but turning neutral after Thursday's large gains.



That was a very ideal situation for using Stochastics. The next example of the weekly continuous corn chart is not. In early 2018 (the blue circled section) Stochastics were nearing overbought territory. By the time there was a cross to indicate a sell signal (red circled section), ADX (green line) was showing a strong up-trend. That made the sell signal invalid or at least suspect, and thus sent stochastics to what we call pegged. Since stochastics cannot go over 100 or under 0, in a strong trending market being oversold/bought will a lot of times look like the trend needs to reverse. However, when stochastics become pegged they will act like a maxed out speedometer, bouncing off 0 or 100 until the trend runs out of momentum (MACD is the best indicator for those strong trends).



Those previous examples are just a couple of ways to follow Stochastics. One other way you can use them is via a divergence. A divergence is when the market makes a new low but the stochastics cross isn't as low as the prior swing and vice versa. The March 19 soybean chart below illustrates that. Back in late August/early September, the market was oversold and showed a buy signal. ADX (green line) was rising indicating a trending market, which may have caused some hesitation to obey the buy signal. A few weeks later, the market went back to near oversold and showed a cross not as low as the prior one. The market

however, made a new low, which signaled a bullish divergence. Somebody sold at a new low and didn't have any followers, which explains the stochastics not going lower. That second cross would have given you the actual buy signal.



“You trade the news you lose!” That is one reason we look to technical indicators for a hint of how to look at the market. A couple important things to remember are 1) that Stochastics are to be used, not to get the results you want but the ones you need. Don't set up your chart to be bullish just because you feel bullish and vice versa. Stochastics work best in a non-trending market to signify when traders are too bullish or too bearish for that time and place. Keep these steps in mind when setting up/looking at your charts!

Austin Schroeder

There is a risk of loss in futures and options trading. Past performance is not necessarily indicative of future results.
Copyright 2018, Brugler Marketing & Management LLC. All rights reserved.