

## Technical Indicators VIII: Stochastics

Contributed by Administrator  
Friday, 03 October 2008

Stochastic is an oscillator that determines where the most recent closing price is relative to its price range over a given time period.

It is one of the most popular oscillators that traders use in range-bound market.

The indicator involves two lines:

- %K
- %D which is a D-period moving average of %K

Where

- $\%K = 100 \left[ \frac{C - L_n}{H_n - L_n} \right]$
- C = latest close,  $L_n$  = lowest close over last n periods,  $H_n$  = highest high over last n periods

The most commonly used time period is 14, and the most common value for K and D are 5 and 3 respectively.

As you can see in the formula, %K measures where the closing price is in relation to the price range over n period of time. If the lowest close over last periods is 0, highest high over last n periods is 100, and the closing price is 75, then  $\%K = 75\%$ , which means the price is close quite close to the highest high.

## Applications of Stochastics:

### 1. Detect overbought/oversold levels

When Stochastic is over 80, the pair is considered to be overbought. If Stochastic is below 20, the pair is considered to be oversold. It works best in range-bound market. If the currency pair is in strong trend, the overbought/oversold levels offer limited value.

### 2. Crossovers

If the %K line crosses above the %D line, especially below the lower extreme of 20, a buy signal is generated. If the %K line crosses below the %D line, especially above the higher extreme of 80, a sell signal is generated.

In the above charts, six selling signals were generated in the range-bound period of EUR/USD. Notice that Stochastic may stay above 80 when the up-trend went strong at later stage.