

How to use the Stochastics indicator to invest in Forex?

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Stochastic is an oscillating indicator very commonly used in technical analysis. George Lane, the developer of this indicator, applied it for the first time late in the year 1950s and early 1960s.

This indicator is measured on a scale from 0% to 100% and determines the deviation of the closing price on the market, compared with normal levels of a period set by the trader. It is important that you know that this indicator is not recommended to be used in trending markets, since it is less effective.

Using the stochastics indicator

The main idea of how the stochastics indicator works is that you need to see clearly how this indicator determines what's going to happen in the market; an upward or downward trend, by looking specifically at the cross of the two indicator lines.

You can use this metric to calculate the levels of overbought / oversold levels (using the RSI indicator), also for finding points of entry at the intersection of lines and moving averages of the market direction and to identify points of divergence, with the aim of providing some weakness in the market.

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This indicator is composed of two lines:

1. The main line is called: % K

In the main fluctuation line (% K) tends to be more distinguished than the secondary line (% D), because it is more sensible. It is represented in the graphs as a compact line.

2. The secondary line is called: % D

%D is the moving average line of % K line. It is represented in the graphs as a dotted line.

There are 3 types of stochastics: Slow, fast and full.

1. Fast Stochastics: Line % K is not uniform, so it will not show any moving average. This type tends to provide an early indication of a turnaround in the market.

2. Slow Stochastics: Contrary to the fast % K line it is a bit more uniform, using three periods moving averages of the values of the line % K, so it is called a Fast Stochastics derivative. This type of stochastics provides more reliable trading signals.

3. Full stochastics: Allows you to use the two lines: % K and % D.

Estostastics 2As in other indicators, it is suggested that you make reference to the two lines between 20 and

80. These lines will serve to highlight potential overbought levels (above 80%) and oversold levels (below 20%).

The stochastics indicator provides 3 types of signals for trading in the Forex market:

1. Overbought/ Oversold: This signal occurs if the line passes over stochastics line of 80% and then the indicator goes back to the middle zone; the market should move in the same direction, which means a movement downwards. The same occur when the stochastics line passes below the line of 20% and then the indicator goes back to the middle zone; the market should move in the same direction which is an upward movement.

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What to do? You must wait until the crossing is given between the lines to confirm the signal.

2. Crosses: This signal occurs if the two lines cross the upper zone (above 80% mark) and then, the indicator goes back to the middle zone; the market should move in the same direction, which means a movement downwards. The same thing happens when two lines crosses the lower zone (below 20% mark) and then the indicator goes back to the middle zone; the market should move in the same direction which is an upward movement. These moments are regarded as the strongest signals.

What to do? In this case you should sell at the intersection of the lines % K and % D when they are above the mark of 80% and buy at the intersection of the lines % K and % D, when it is below the line of 20%.

3. Divergences: It is considered the most important signal because it can be useful for confirming signals.

It is divided into:

- Bearish Divergence: This signal occurs when new high levels or new maxim levels appear and tend to go higher in the market and their corresponding peaks are progressively smaller. This is a potential sell signal. I.e. Price continues to move up but stochastic indicator fails to do so

- Bullish Divergence: The bullish divergence occurs when the market shows new consecutive and new low levels, and the corresponding minima are progressively larger. This is a possible buy signal. I.e. Price continues to move lower, but stochastics indicator fails to do so.

What to do? In this case, you sell a bearish divergence and you buy if it is a bullish divergence.

What you should NEVER do?

- Never buy or sell unless both lines cross.
- Never buy or sell, if you find crosses in the boundary lines marked or in the middle of the two limits.
- Do not use this indicator in markets with heavy trends.

Remember that no investment is risk free and a stochastics indicator in Forex will help you most effectively when it is used in conjunction with other tools and indicators.

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