#### Module 5- Chapter 3 – Stochastic Oscillator

The Stochastic Oscillator is a momentum indicator that was developed by George C. Lane in the late 1950s. It compares a particular closing price of a security to a range of its prices over a certain period of time. The oscillator's sensitivity to market movements can be reduced by adjusting the time period or by taking a moving average of the result.

#### What it is and what it shows

The Stochastic Oscillator provides readings that show the position of the current closing price relative to the high-low range over a defined number of periods.

The formula for the Stochastic Oscillator is as follows:

%K = [(Current Close - Lowest Low) / (Highest High - Lowest Low)] x 100

%D = 3-day SMA of %K

Usually, the Stochastic Oscillator is plotted as two lines:

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%K which is often referred to as the fast line

%D which is a moving average of %K and can be termed as the slow line

When the Stochastic Oscillator has values above 80, it's usually perceived as an overbought indication. On the flip side, a value below 20 might be seen as oversold. However, these thresholds can vary based on the asset's inherent characteristics.

#### How to trade it

The Stochastic Oscillator offers multiple ways for traders to interpret its readings:

Overbought and Oversold: When the Stochastic
 Oscillator exceeds 80, it can be seen as an indication that
 the security might be in an overbought condition.
 Conversely, a reading below 20 may indicate the asset is
 potentially oversold. It's important to remember that just
 because the Stochastic Oscillator enters overbought or
 oversold areas, it doesn't mean a reversal will occur
 immediately.

Example: If a stock has a reading of 85 on the Stochastic Oscillator, some traders might anticipate a potential bearish reversal, especially if other indicators confirm this sentiment.

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2) Bullish and Bearish Divergences: These occur when the price action of a security differs from the movement of the Stochastic Oscillator. A bullish divergence is formed when the security records a lower low, but the Stochastic Oscillator forms a higher low. Conversely, a bearish divergence forms when the security records a higher high, but the oscillator forms a lower high.

Example: If a stock's price creates a new low while the Stochastic Oscillator doesn't reach its previous low, this could indicate decreasing downward momentum and a potential bullish reversal.

3) Stochastic Crossovers: A crossover is one of the primary trading signals of the Stochastic Oscillator. A bullish crossover occurs when the %K value crosses above the %D line, signaling potential upward momentum. A bearish crossover occurs when the %K value drops below the %D line, indicating potential downward momentum.

Example: If the %K line (fast line) crosses above the %D line (slow line) and both lines are below 20, it might be considered a bullish signal by some traders.

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As always, it's essential to utilize the Stochastic Oscillator in combination with other technical tools and analysis techniques. This ensures a more holistic view of the market and betterinformed trading decisions.



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