Using the stochastic indicator to provide early warnings – By Paul Doggett

For over a decade I have demonstrated the beneficial application of my non-traditional application of the 55 day slow stochastic indicator. It can help traders fine tune their entries and exits. Most people only want to see examples of how its application may be used in entries and seldom do they wish to see how it can provide an early warning of a change in underlying momentum that often leads to a fall in a share price. I recently wrote about how it could have been used in the case of Bellamy's (BAL) and how it would have provided a warning to holders of the stock back in September 2016 when the stock was three times higher than the price it lingers at now, at the time of writing this article.

In this article, at the request of subscribers, I will again discuss how we can use the stochastic indicator to help us either exit or avoid stocks prior to suffering large falls.

Let's look at TPM. It was riding high at $12 and at the time of writing its share price was more than 50% lower. The TPM chart below shows three red circles. Circles A and B show the relationship between TPM's share price and the stochastic indicator. As underlying momentum and positivity towards the stock fell away, so too did the stochastic indicator. Once it fell below 80 on the signal line, it gives us a warning. Those who heeded that warning could have exited the stock above $11.50 prior to the dramatic fall that has since occurred.

This combination of price action and weakness in the stochastic indicator is not a fluke. It is not a one-off. We have seen it in our February 2017 trading update and we see it again here. It is a repeatable technical application that we can use time and again to gain an advantage in the market through an early warning of potentially impending danger.

I say 'potentially' impeding danger as we turn to Figure 2. In Fig. 2 we have the potential for danger as I will outline. Using my approach to trading and my application of the stochastic indicator, I would have exited MIN (were I in the stock) where we get price dip below the trend line in conjunction with the stochastic falling below 80 on the signal line (circled in blue). This means I would have missed the chance to get out at $13 (area circled in green), $2 higher than an $11 exit which is in the region of where I would have sold.

But MIN is now tracking sideways and the stochastic is weak. So if I owned the stock, I would have exited. If I am looking at buying the stock, I would wait. We do not want to suffer the same fate that share holders in both BAL or TPM.

Note again the critical relationship where the stochastic is strong (typically when it remains above 80 on the signal line for extended periods of time as indicated by the green circle), and the red circle where the share price tracks sideways as the stochastic weakens. We do not call MIN as either a buy or a sell at this point in time, given the technical information we have. We call it a sit and wait scenario. If the share price begins to fall we will see a corresponding fall in the stochastic indicator. If and when this happens, we can expect a decent retracement to occur.

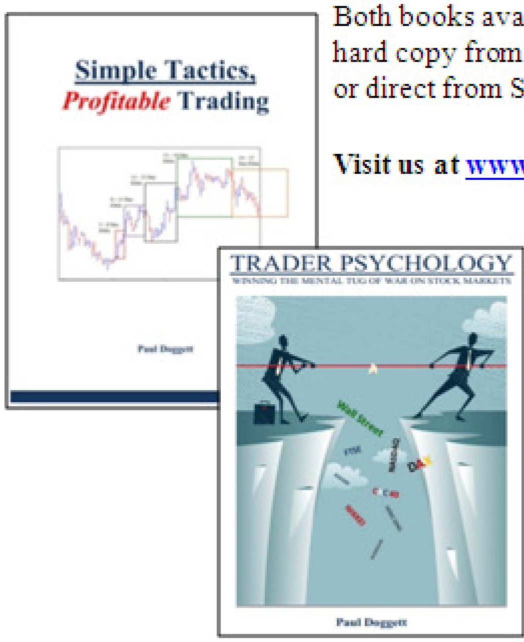
If on the other hand, the stochastic indicator rises above 80 on the signal line, we would expect and with good reason, the share price to break upwards from its sideways range. The breakout, if it were to occur would be a much stronger breakout and would more likely last longer if it has underlying momentum support as indicated by the stochastic.

This is how we apply the 55 day stochastic indicator in scenarios where danger and loss are the higher probability outcome and profit or a share price turn around are a lower probability outcome.

This article is based on the application of the stochastic indicator outlined in the book, Simple Tactics, Profitable Trading, available from www.stpt.com.au

POST SCRIPT:

Since this article was first published on www.stpt.com.au ,stock code MIN fell to an intra-day low of $9.15 in July (about $4.50 below the November peak and eight months after the divergence was first spotted in the charts shown in this article), before beginning its climb back upwards again.



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