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Use Stochastics to Get into and out of Gold Positions

HOW TO SPOT BUY AND SELL SIGNALS FOR GOLD

Stochastics can be used as a centrepiece for buying and selling gold futures whether you are a short or long term trader. Stochastics will signal changes in the momentum of the price of gold. Used in combination with fundamental analysis and other technical tools stochastics will add an additional dimension to your trading.

➔ The author began trading gold in 1983. At that time he worked for one of the biggest commodity trading companies in the world. In his early days as a trader he went to his boss to point out an interesting chart pattern developing in the gold market. The pattern showed that the price of gold was about to move higher. Not only was there a bullish price pattern on the chart but the gold price was closing each day at or near the highs of the trading session. His boss looked at the chart, listened to the rationale. He then poured a cup of cold coffee over that chart. "Only fundamental supply and demand analysis will tell you when the price of a commodity is going to move. Fundamentals are telling me lower – charts don't mean a thing". Needless to say he did not buy gold at that time. However he did learn a valuable lesson. You see, as the price of gold moved higher during the following days, he knew that chart patterns sometimes will signal a coming price move in any market.

THE ROLE OF FUNDAMENTAL AND TECHNICAL SIGNALS

The ultimate guide to the long-term price direction of any commodity is its supply compared to its demand. The boss was not wrong about that. When it comes to the gold market, supply and demand data is readily available. A curious investor can quickly find data on annual production, annual consumption and total above ground stockpiles on the internet. Look at whether production or consumption is rising or falling compared to past years. Is the cost of producing an ounce of gold rising or falling? The answer to this question will shed light on the fundamental state of the gold market. You should use fundamental knowledge to determine a basic price bias – will the price of gold rise or fall in the future? However, fundamental knowledge alone is not enough to make money buying and selling a commodity like gold. This is particularly true when it comes to shorter-term trading.

For ten years now the gold market has moved higher. Figure 1 illustrates the long-term bull market move in the price of gold. Those technical signals that the boss ignored could have made him lots of money on the road to higher gold prices. Even when a market trends for a long period of time it rarely goes up or down in a straight line. Close attention to technical signals will enable you to profit. Those profits can be more substantial than catching an entire move. There are always price corrections even in the most powerful long-term trends. It is important to use technical signals in order to decide when the right time to buy or sell is. There are so many technical tools in use

F1) TEN YEAR MONTHLY GOLD CHART

The long term trend of the gold price has been higher.
Source: www.tradesignalonline.com

today but the author has one favourite when it comes to buying and selling gold, the stochastic oscillator.

WHAT ARE STOCHASTICS?

The stochastic oscillator is a technical momentum tool. It measures whether a market has the momentum to continue a trend or whether that trend is running out of steam. The stochastic oscillator compares the closing price of gold for a particular period of time to its price range for a given period of time. When the gold price is moving higher the price tends to close each period near the highs of the period examined. Conversely when the gold price is weak the price tends to close near the lows of a particular period. There are two types of stochastics that traders use, fast and slow. In a market like gold the slow stochastic is preferable because the fast stochastic gives too many false buy and sell signals.

Use the stochastic for one period in combination with a price range or moving average that measures three times that period. This method works for any time period whether it is monthly, weekly, daily or even for intraday trading. For example, a 30-minute moving average versus a 10-minute stochastic chart provides very profitable buy and sell signals for short-term traders.

STRATEGY SNAPSHOT

Strategy name	Slow Stochastic Setup
Strategy type	Trend following, momentum based
Time horizon	Any
Setup	Long or short
Entry	In combination with fundamental analysis and other technical tools. Entry when moving average (MA) crosses in overbought or oversold territory
Stop-loss	When moving average crosses again – discretionary based on other technical and fundamental signals
Take Profit	When moving average crosses again – discretionary based on other technical and fundamental signals
Trailing stop	N/A – discretionary
Exit	Discretionary
Risk-and money management	Discretionary
Average number of signals	Depends on time horizon – greater for short-term trading least for long-term trading

THE IMPORTANT THINGS TO REMEMBER ABOUT STOCHASTICS

When it comes to stochastic oscillators, a reading above 80 will signal that the gold price is in overbought territory. A reading below 20 will signal that the gold price is in oversold territory. Be careful though, the price of gold can remain overbought or oversold for long periods of time. That is why it is so important to use the moving average in order to provide signals where buying or selling makes the most sense.

It is when the stochastic crosses the moving average that the trading signal flashes to take action or to buy or sell. When the moving average crosses and is below the stochastic use this as a signal to buy. When the stochastic reads under 20 signalling that the price is oversold the buy signal works best. When the moving average crosses and is above the stochastic use this as a signal to sell. When the stochastic reads over 80 signaling that the price is overbought the sell signal works best. Figure 2 shows how a stochastic oscillator provides effective buy and sell signals on a weekly chart. Figure 3 highlights the stochastic oscillator on a 30-minute chart.

STOCHASTICS ARE ONLY PART OF THE PICTURE

It is important to remember that the stochastic oscillator is not a be all and end all tool. Just as the author's boss missed an opportunity by not paying attention to a technical signal, traders can't afford to ignore all signals – technical and fundamental.

There are always price corrections even in the most powerful long-term trends.

Use a multi-step process when it comes to trading gold. Decide on your overall directional price bias using fundamental analysis. Once you decide on an overall direction, your opening trade should always reflect that bias. Wait patiently for the correct technical signal. Stochastics is not the only technical tool to rely on but it is a powerful tool for a number of reasons. As a momentum indicator it signals a shift in trading activity which often portends a reversal in price direction. And, Stochastics are used by so many technical traders that the signal itself often can create a self-fulfilling prophecy. When it comes to selecting the right time to take a profit or cut a loss on a gold position Stochastics is a powerful tool.

Pay attention to Central Bank gold buying or selling.

F2) WEEKLY GOLD CHART WITH SLOW STOCHASTIC

The oval indicates a buy signal as the slow stochastic is at or below 20. The moving average crosses below the stochastic. The rectangle indicates a sell signal as the slow stochastic is at or above 80. The moving average crosses above the stochastic. The initial buy signal (oval) was followed by a sell signal (rectangle). In each case the buy signal came at midpoint price of $1600 and the sell signal came at midpoint price of $1700.
Source: www.tradesignalonline.com

SPOTTING BUY AND SELL SIGNALS WILL IMPROVE YOUR GOLD TRADING

Whether you are new to trading and investing or you are a seasoned professional use all of the tools at your disposal. A combination of fundamental and technical analysis will leave no stone unturned. Keep up to date on all of the fundamental supply and demand data out there. Make yourself aware of changes in the fundamentals so you don't get blind sighted. Watch for production shortfalls or increases. Pay attention to Central Bank gold buying or selling. Try to stay abreast of increased or decreased demand for gold from different parts of the world. Any fundamental changes can cause sudden and sharp movements in the price of gold. When you determine your directional bias, use stochastic oscillators to help pinpoint the best areas to buy and sell. This technical indicator has made and saved the author tons of money since he started trading gold back in 1983, almost 30 years ago!

F3) 30-MINUTE GOLD CHART WITH SLOW STOCHASTIC

The slow stochastic provides potentially profitable signals for the short-term trader. There are plenty of instances when the stochastic rises above 80 and falls below 20 with a cross of the moving average. The cross signals selling and buying opportunities. Shortterm traders should not rely solely on stochastics. Stochastics in combination with other technical tools are useful to trigger short term buying or selling opportunities. Source: www.tradesignalonline.com