David Steckler – Stochastics Pop

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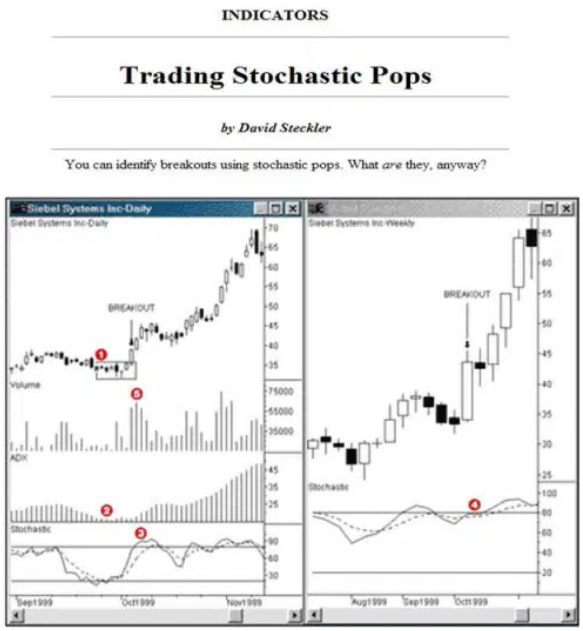
First and foremost my heartfelt thanks to David Steckler for his permission to reprint his original work of August 2000.


INDICATORS

Trading Stochastic Pops

by David Steckler

You can identify breakouts using stochastic pops. What *are* they, anyway?

(https://kitz3281.files.wordpress.com/2013/02/siebel1.jpg)

FIGURE 1: SIEBEL SYSTEMS. Just as SEBL breaks out of its consolidation, stochastics go over 70 and prices pop to twice what they were before.

A New Look at the Stochastic Pop

Many equity traders strive to identify stocks that are ready to break out and begin a sustained move higher in price. The difficulty lies in identifying which stocks are setting up to break out and determining when the breakout will occur.

One technique I like to use in identifying breakout setups is the Stochastic Pop. This situation arises when the stochastic indicator goes above the 70 to 80 level. Instead of reversing, however, the market tends to pop and momentum continues to rise.

Setup Conditions

I identify a Stochastic Pop setup when the following set of conditions occur:

1) Recent price action in a tight daily consolidation range;

2) Daily ADX below 20 (preferably below 15);

3) Daily stochastic %K above 70 (preferably above 80) and rising;

4) Weekly stochastic %K above 50 and rising;

5) Stock breakout on above average volume; and

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6) Bullish market conditions.

The Stochastic Pop is not a new technical indicator or technique. Jake Bernstein wrote about this phenomenon years ago. The setup conditions I added are refinements that increase the odds of success by requiring confirming signals from both the daily average directional index (ADX) and weekly stochastic signals. Keep in mind, of course, that the past performance of this strategy is not an indication of future success.

I utilize this methodology using daily and weekly charts to trade equities. I encourage the reader to experiment with different stochastic and ADX parameters, other time periods and/or other tradables.

The ADX indicator

The ADX indicator, developed by J. Welles Wilder, measures the strength of a trend but not the direction. The index uses a scale between zero and one hundred to rate the "trendiness" of a stock or commodity.

The ADX identifies whether the stock or commodity is moving directionally. However, it does not reveal what *direction* the stock is trending, only that it *is* trending. The stronger the trend, the higher the ADX value. A rising ADX value suggests that the present trend is gaining strength and the trend will continue, while a falling ADX value suggests the present trend is losing strength. A common interpretation of this indicator is that a stock or commodity is trending when the ADX passes through 30 and is rising.

(See, Star, Barbara [1999]. "How the Pros Use Average Directional Index," *Technical Analysis of* STOCKS & COMMODITIES, Volume 17: October, for more information on the ADX indicator)

The longer a stock trades in a narrow consolidation (congestion) range, the less trending motion it exhibits during the lookback period. Just as a strengthening trend is measured by an increasing ADX value, a weakening trend is measured by a decreasing ADX value. Backtesting revealed that when the ADX falls below 20, and particularly below 15, the stock has "non-trended too long" and is likely to soon break out of its trading range and initiate a new trend.

I look for stocks that have been "non-trending too long." The longer and narrower the consolidation range, the lower the stock's ADX value and the greater the likelihood that when a breakout comes, it will come hard and fast. Which direction this breakout takes and whether it leads to the start of a new trend requires the use of additional technical indicators.

The Stochastic Indicator

The stochastic indicator, also developed by Wilder, is a useful oscillating indicator that measures when a stock is overbought or oversold. Author David Lundgren identified three warnings issued by the stochastic that a trend is likely to change direction:

1) The stochastic %D rises to a level of 70 to 80 (overbought) or falls to a level of 20 to 30 (oversold); or

2) The stochastic %K – %D cross over each other from an overbought or oversold condition; or

3) A divergence between price and stochastic action (Ludgren, David [1993]. "Stochastic Indicators and Trading," *Technical Analysis of* STOCKS & COMMODITIES, Volume 11: March).

Note that my Stochastic Pop technique calls for the daily **%K** to rise to the 70 to 80 level, not the %D.

Bernstein observed that at times stocks would continue to rise even after the stochastic reached a level of 70 to 80. The key words here are "at times." Anticipating that a stock will continue rising merely because the stochastic rose to an overbought level, not only flies in the face of conventional analysis but also involves a leap of faith that prices will continue rising. How do you know that *this* time the stock will continue to rise? Observing a rising weekly stochastic concurrent with an overbought daily stochastic reduces some of this "FUD" factor (Fear, Uncertainty, Doubt).

The logic behind this is well known to technicians: "Trade in the direction of the primary trend." If the weekly trend is bullish and the daily trend is bearish, savvy traders may use pullbacks in the daily price to pyramid onto their original position. If the weekly trend is bearish and the daily trend is bullish, traders may use rising prices (particularly if they are on declining volume) to enter a short position, or may exit long positions as they sell into a bear rally.

Piggybacking a rising (but not overbought) weekly stochastic on top of an overbought daily stochastic dramatically increases in your favor the odds of a bullish breakout and a Stochastic Pop.

Put the Two Together and Wait for a Breakout

A stock with a low ADX value, a rising weekly stochastic, and an "overbought" daily stochastic is likely to be a breakout waiting to happen. I wait for the stock to start trading higher than the recent congestion-range high. If volume is strong, I enter the position on the long side. Let's look at an example.

Figure 1 shows both daily and weekly charts in candlestick format on Siebel Systems (SEBL). SEBL was selected for illustration purposes only and not as a recommendation. The daily chart is on the left and includes indicators for volume, ADX and stochastics; the weekly chart is on the right and includes the stochastic indicator.

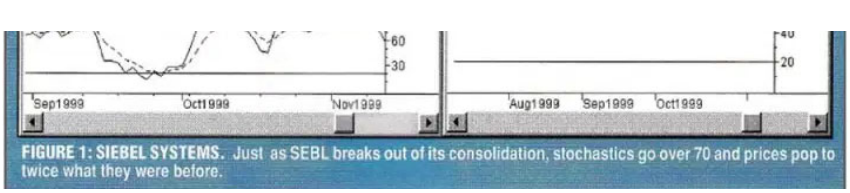

FIGURE 1: SIEBEL SYSTEMS. Just as SEBL breaks out of its consolidation, stochastics go over 70 and prices pop to twice what they were before.

(https://kitz3281.files.wordpress.com/2013/02/siebel-systems.jpg)

On the daily chart, note the area emphasized in the rectangular box and the indicators on those corresponding dates. SEBL exhibited a congested daily trading range, only one to two points wide, between September 27, 1999 and October 4, 1999 (setup condition #1). As a result, the ADX had declined and during these few days was reading between 16 and 18 (setup condition #2). At the beginning of this consolidation period, the stochastics were oversold.

On October 5, SEBL broke out of its tight trading range. On that date (see the down arrows), the stochastic %K had risen to 72.90 (setup condition #3). Volume was heavy that day at 5.95 million shares, almost twice the 50-day average daily volume of 3.06 million shares (setup condition #5).

On the weekly chart, the preceding Friday's (October 1, 1999, the down arrow), stochastic %K was at 68.35. The stochastic had turned down from an overbought signal a few weeks earlier and was dropping but by Friday, October 8, the stochastic turned upward and the %K closed the week at 78.47 (setup condition #4).

An aggressive trader applying the Stochastic Pop technique could have entered a long trade on Tuesday, October 5, the day SEBL broke out of its consolidation range. This approach utilizes the intra-week weekly stochastic value. Less aggressive traders could have waited until the end-of-week weekly stochastic resumed rising and entered the trade either on the close, Friday, October 8 or on the open, Monday, October 11.

Figure 1 shows that two weeks later, SEBL was trading about 10% – 15% higher than the entry date choices of October 5, 8 or 11. Within one month, it had climbed more than 50%.

Double Pops

The Stochastic Pop is a combination of daily/weekly signals. If we substitute the daily chart with a weekly chart, and the weekly chart with a monthly chart, we would have a weekly/monthly system that might foreshadow an impending major move. Since this is a longer-term signal, however, the timing may not be right for entering a trade. But what happens when both the daily/weekly and weekly/monthly setups occur simultaneously? On the rare times that this occurs, we have what I call the Double Pop.

The Double Pop uses the same setup conditions as the Stochastic Pop with one exception:

1) Recent weekly price action in a tight daily consolidation range;

2) Weekly ADX below 25 (preferably below 20);

3) Weekly stochastic %K above 70 (preferably above 80) and rising;

4) Monthly stochastic %K above 50 and rising;

5) Stock breakout on the weekly chart on above average volume; and

6) Bullish market conditions.

The Double Pop uses the same setup conditions as the daily/weekly signals, except that the weekly/monthly signal uses a weekly ADX value below 25 (preferably below 20) while the daily/weekly signal uses a daily ADX value of 20 (preferably below 15).

Cisco Systems (CSCO) fit this bill in October 1999. Figure 2 shows the daily chart on the left and weekly chart on the right, and Figure 3 shows the weekly chart on the left and monthly chart on the right. CSCO was also selected for illustration purposes only and not as a recommendation.

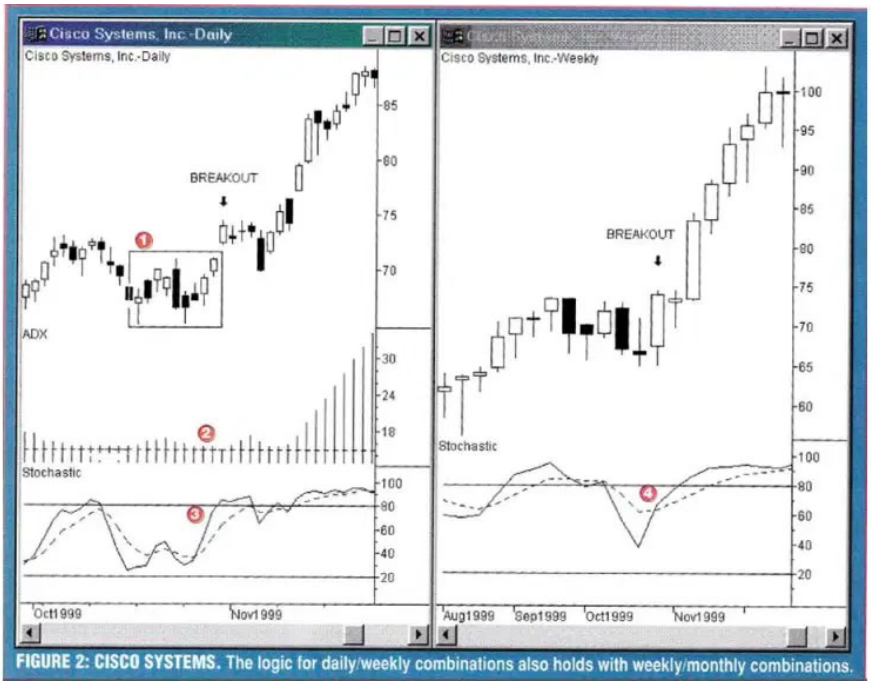

FIGURE 2: CISCO SYSTEMS. The logic for daily/weekly combinations also holds with weekly/monthly combinations.

(https://kitz3281.files.wordpress.com/2013/02/cisco-systems.jpg)

At the end of October CSCO was trading in a tight congestion range (setup condition #1), identified by the rectangular box. The daily ADX on October 28 fell to 14.27 (setup condition #2) and the stochastic %K rose to 74.90 (setup condition #3). The next day, the weekly %K rose to 66.01 (setup condition #4) and the stock broke out to a new high on 150% of the 50-day average daily volume (setup condition #5). A Stochastic Pop was born.

The following trading day, the weekly ADX had dropped to 22.80 (Double Pop setup condition #2)

and the weekly %K had risen to 77.37 (Double Pop setup condition #3). The monthly %K had risen to 91.47 (Double Pop setup condition #4). A rare Double Pop had occurred. CSCO broke out of its tight trading range on October 29, 1999 and closed that day at 74. Three and one-half months later, on February 11, 2000, CSCO closed at 130 15/16, a 77% gain.

Exit Strategies

For every trader and investor there are different investment goals and objectives, price or profit targets, time frame expectations, risk tolerances, and the like. Where should an exit be placed when using the Stochastic Pop technique? That is up to the reader. Some may be looking to capture a few points while others, a few dozen points. While the Stochastic Pop technique oftentimes returns a 25% to 50% gain within four to six weeks, no returns are guaranteed. Use an exit strategy and/or money management methodology that works best with your trading style.

Conclusion

Our goals, whether as traders or investors, are simple: Keep our money risk-free until the "golden opportunity" arrives to strike, strike when we expect stocks to move higher within a relatively short period of time, move money back to the sidelines when upward momentum slows or reverses, then wait for the next opportunity to arise and the cycle repeat. The less time our money is at risk in the stock market, the safer our money remains. The Stochastic Pop technique is yet another tool on our technical analysis workbench to help achieve these goals, keeping in mind that it may be considered an aggressive strategy not suitable for all investors or traders.

The PopSteckle

My Stochastic Pop technique was introduced to the Market Technicians Association in the fall of 1999. One of my MTA colleagues (with tongue firmly in cheek) promptly dubbed it the "PopSteckle", a play on the term Stochastic Pop and my last name. Matt Samojeden, president of the St. Louis Omega Users Group, was of invaluable assistance to me in writing the TradeStation code for the PopSteckle technique.

The code shown below is for a ShowMe study, a TradeStation 2000i feature that places a marker above or below a bar based on a conditional expression. It is common to use ShowMe studies to visually identify key price events in preparation for using the idea in a trading system.

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A trading system is more than just an entry strategy, it also includes both an exit strategy and stop loss strategy as well. Exits may be based on any number of conditions, such as achieving a pre-determined profit objective (dollars or percentage), the passing of a defined number of days or weeks, or the crossing of a moving average, and so forth. The choices are almost endless. Likewise, there are any number of different stop loss strategies you may choose to integrate in your system.

The PopSteckle ShowMe study is not in and of itself a back-testable trading system. The study code may be utilized as an entry condition in a trading system that may be back-tested. In order to back-test a system, the trader/investor must select entry, exit and stop loss strategies.

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The code is as follows:

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Inputs: ADXLev(15), DStocLev(70), WStocLev(50), ADXLen(14),
StocLenD(8),StocLenW(40),VolLength(50),VolFilter(true);

Condition1 = ADX(ADXLen) < ADXLev;

Condition2 = SlowK(StocLenD) > DStocLev and SlowK(StocLenD) > SlowK(StocLenD)[1];

Condition3 = SlowK(StoclenW) > WstocLev and SlowK(StoclenW) > SlowK(StoclenW)[3]; {Weekly Data setup}

Condition4 = Volume > 1.5*Average(Volume, VolLength); {Check for above average volume}

If condition1 and condition2 and condition3 and condition4 and VolFilter then plot1(High, "Setup");

{Volume Filter is Active with true as the setting}

If condition1 and condition2 and condition3 and condition4 and VolFilter = False then plot2(High, "Setup");

{Volume Filter is Inactive with false as the setting}

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The code uses fixed input values to look for a 14-day ADX below 15, an 8-day daily slow stochastic %K above 70, an 8-week (40-day) weekly slow stochastic %K above 50, and volume greater than 1.5 times the 50-day average daily volume. TradeStation's EasyLanguage allows the substitution of variable inputs in key indicator look-back settings in place of fixed input values, to allow optimization of the settings for back-testing purposes. I encourage the reader to experiment with variable inputs.

Entry setup condition number 3 in the beginning of this article explained that the daily stochastic must be above 70 and rising. ShowMe Condition2 is that today's daily stochastic value must be greater than 70 and greater than yesterday's stochastic value.

ShowMe Condition3 requires a bit of explanation. A weekly chart plotting end-of week bars ordinarily shows the weekly range, open and close ending on a Friday. Assuming a real-time data

feed, TradeStation 2000i plots the latest bar on a tick-by-tick basis even if today isn't Friday. All previous weekly bars are plotted on a Friday close only but the latest bar will be plotted regardless of the day of the week. On a Wednesday, for example, the weekly bar will be plotting and the end-of-day weekly stochastic value might be 55. Assuming the other entry setup conditions are met, that might be sufficient to trigger an entry signal.

If the PopSteckle code had used weekly bars to evaluate the weekly slow stochastic, historical ShowMe or trade system calculations would not show any signals for Monday through Thursday. ShowMe alerts or trades would only show on Friday if all the entry conditions were met. This code attempts to compensate for this limitation by equating one week with five days, hence the use of a 40-day stochastic as a substitute for the 8-week stochastic (StocLenW(40)).

Entry setup condition number 4 requires the weekly stochastic value to be greater than 50 and rising. ShowMe Condition3 requires that today's "weekly" stochastic value be greater than 50 and greater than the stochastic value three days ago.

Why three days? Chartists use longer time intervals to reduce the noise inherent in shorter time intervals. Weekly charts will not reveal daily price fluctuations intra-week. This three-day comparison period is intended to minimize the noise of the daily stochastic; my experience with using the PopSteckle technique is that if today's stochastic value is greater than the value of three days ago, then today's weekly stochastic is rising. I encourage the reader to experiment with other time intervals.

As part of testing this code I compared an 8-week stochastic with a 40-day stochastic on numerous charts. While not identical, values between the two were very close.

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ShowMe Condition4 requires that volume be much higher than the average daily volume. Heavy volume frequently accompanies a stock breaking out of a congestion range that continues higher in price over the following days or weeks. The volume condition may be turned on or off, at the reader's choosing.

Biographical Sketch

"David Steckler enjoyed 24+ years of experience as an investment counselor, helping clients design and manage portfolios that best met their investment goals and objectives. Before retiring he was a member and past president of the American Association of Professional Technical Analysts (AAPTA), and a member of the Market Technicians Association (MTA)."

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