Wavespeak

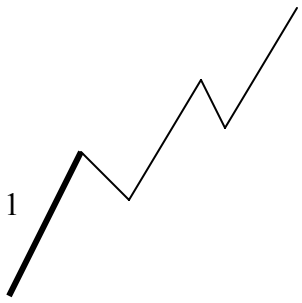
The Quick and Short of Elliott Wave Theory

Let me start by saying the study of Elliott Wave is not a quick and short endeavor. The details of this theory have been the result of nearly three quarters of a century of hard work, and such labors will continue into the future. But it is this hard work that makes the Wave Theory what it is; by far the most accurate and consistent stock market forecasting strategy ever. Wave Theory's reach expands much further than the stock market. It is found in commodity prices, fashion trends, political trends, and any other arena that is subject to a herd mentality and a prevailing social mood. In any case, I will do my best to explain the theory in a simple and straight forward manner as it applies to the stock market. If when you are finished with this short (and certainly incomplete) explanation of the theory and you want to learn more, I strongly suggest doing so; it is truly an exceptional study. I have listed a few books at the end of this tutorial that will greatly assist you in your quest to learn more. Finally, please read the entire tutorial before deciding this is too confusing. While the initial concepts seem complex, I think it will make sense as it comes together.

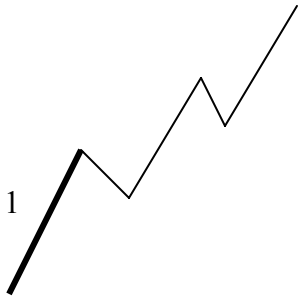
The Basics

In the 1930's, Ralph Nelson Elliott found through his studies that price patterns in the stock market produced a limited number of definable patterns that would occur at an infinitely small and infinitely large scale over time. This is best described visually:

Example A)



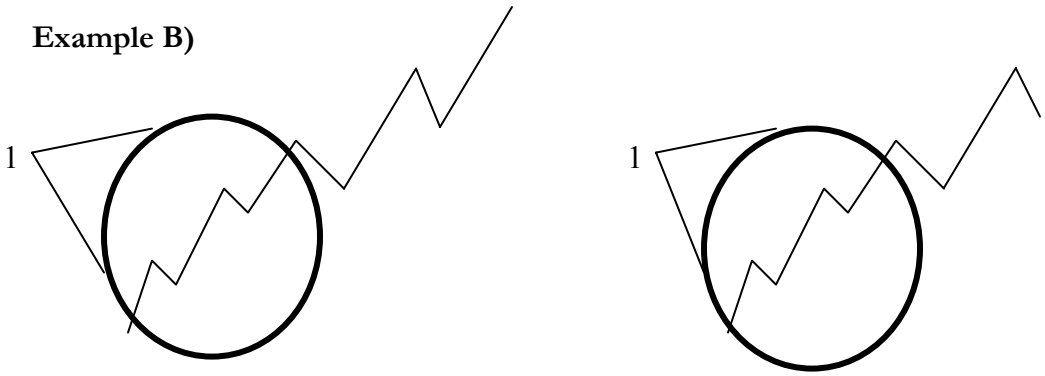
1-Minute Chart



Monthly Chart

Although the above price charts appear to be identical, they are quite different, at least in scale. The first chart details a few minutes of price action, while the second chart took a few months to create, but a similar pattern has developed. Now let's take a magnifying glass to the two lines I have labeled "1" above:

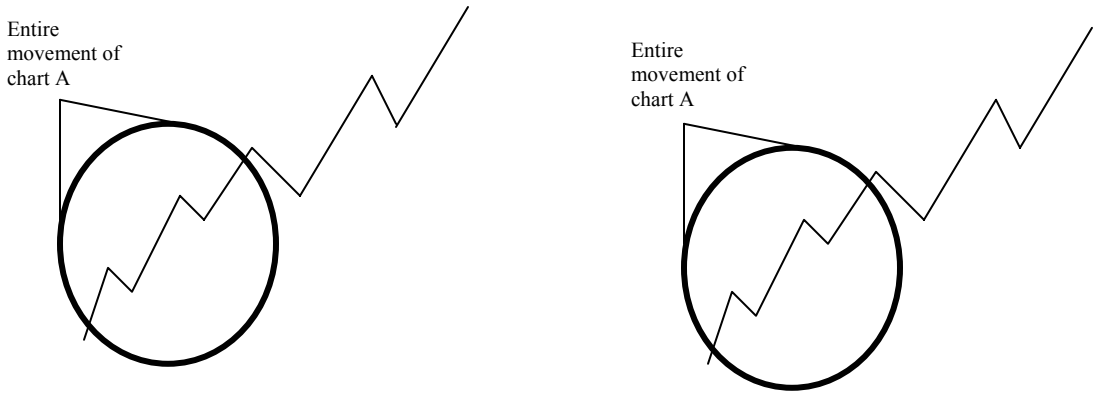
Example B)



1-Minute Chart Monthly Chart

By taking a closer look, we see that a smaller version of the entire pattern is found in "1". So, each "leg" of this uptrend takes on the same form as the pattern as a whole. Conversely, the entire pattern shown on the charts in Example A are only the first "legs" of a larger advance:

Example C)



1-Minute Chart Monthly Chart

The purpose of this lesson is to point out that the same patterns occur at infinitely small scales and infinitely large scales. But these aren't random patterns. They have distinctions that make them identifiable and predictable. This is what we discuss next.

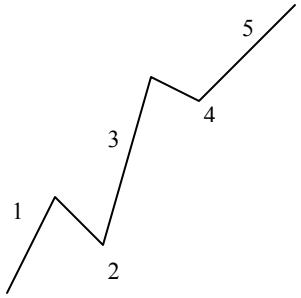
Wave Patterns

In Wave Theory, there are two different kinds of waves: impulsive waves and corrective waves.

Impulsive Waves

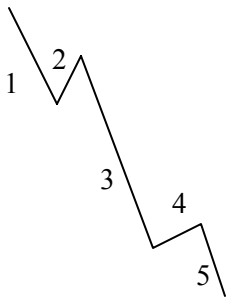
Impulsive waves are the price moves that make a trend. These waves play out in five moves, three that move with the trend, and two that go against the trend, as shown below:

Example D) Up Trend



As you can see, waves 1, 3, and 5 are up-trending waves, moving with the overall trend. Waves 2 & 4 separate these up-trending waves, and correct a portion (but never all) of the upward movement. As discussed in the first lesson, you will find a smaller five-wave pattern within wave 1, a smaller five-wave pattern within wave 3, and the same for wave 5. Even deeper, within each of the five waves that make up wave 1, you will find five waves as well. This process continues to smaller and smaller scales.
The entire five-wave pattern makes up the impulse pattern. The above chart shows how this looks in an uptrend. The same impulse pattern appears in downtrends as well:

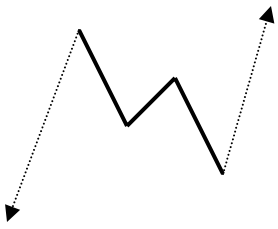
Example E) Down Trend



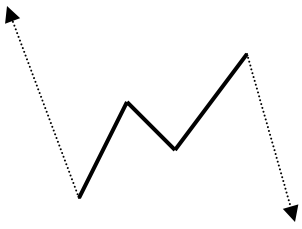
Corrective Waves
Corrective waves are the waves that go against the trend. They separate impulsive moves, and can take numerous forms. The four main categories are:

1) Zigzag ; A zigzag moves sharply against the dominant trend:

Larger trend is up:

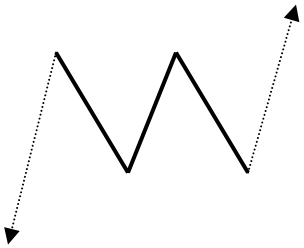


Larger trend is down:

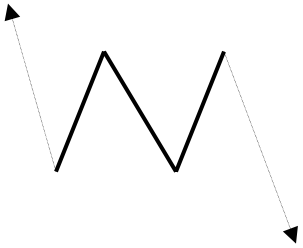


2) Flat; A flat moves mostly sideways:

Larger trend is up:

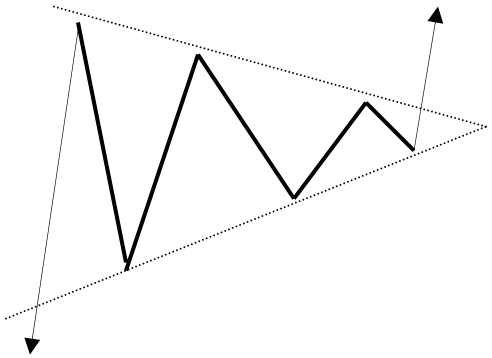


Larger trend is down:

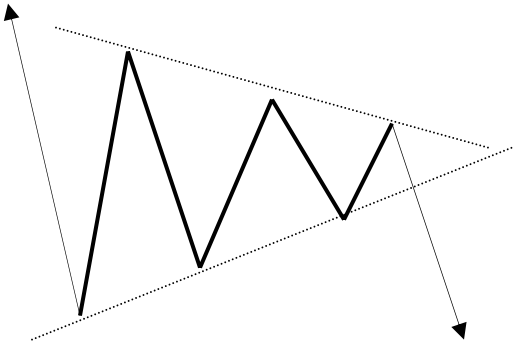


3) Triangle; A triangle consolidates tighter and tighter:

Larger trend is up:

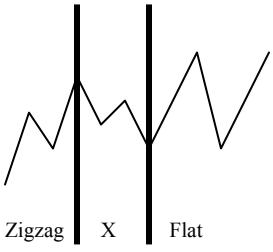


Larger trend is down:

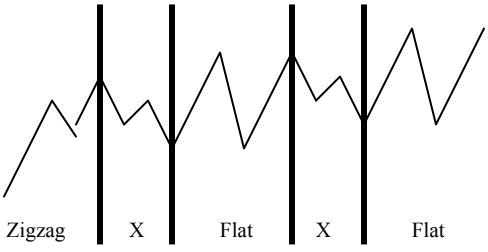


4) Double or Triple Three: This is a combination of any of the corrective moves above. They are separated by a three wave move called X:

Double Correction:

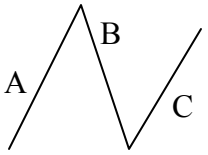


Triple Correction:

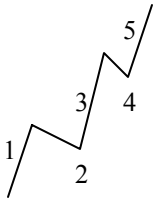


This can obviously become quite complicated, and it gets more so. For example, there are four variations of triangle patterns: Ascending, Descending, Contracting, and Expanding. These details are not important to the new student. The most important thing to remember is that these corrective waves are very different from impulsive waves. For one, they are choppy and overlapping. That is to say, if you were to draw a horizontal line across a corrective wave, the wave would touch the horizontal line in many places; it overlaps itself. The other major difference is that corrective waves unfold in three waves (except in the case of a triangle, which has five *overlapping* waves), while impulsive waves unfold in a non-overlapping five waves:

Corrective Wave



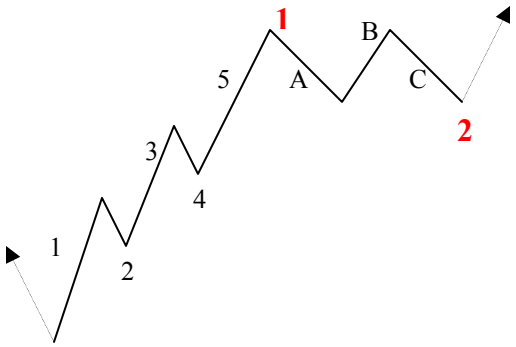
Impulsive Wave



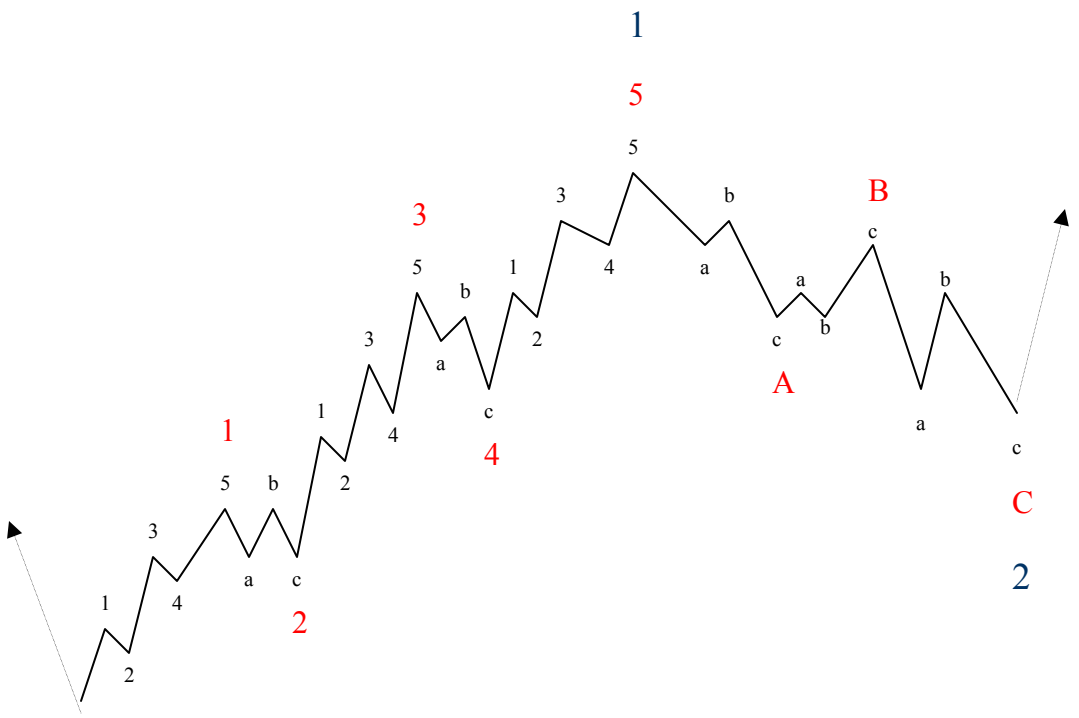
You may also notice that I have labeled the waves differently. Corrective waves are labeled ABC, one letter for each wave, while impulsive waves are labeled 12345, one number for each wave. When labeling a double correction, you use ABCXABC and ABCXABCXABC with a triple correction. A triangle is labeled ABCDE. When you are referring to a wave, the appropriate terminology is to say "Wave A", "Wave 3", etc.
The point of this lesson is to be able to identify the differences between impulsive and corrective waves. Impulsive waves are waves that move with the larger trend and are comprised of five waves. These waves are labeled with numbers. Corrective waves move against the larger trend, and are comprised of three waves (except triangles), and are labeled with letters. Now we will attempt to put the two together.

Together at Last

Combining an impulsive wave with a corrective wave gives us the following chart:



As discussed above, this chart could be a one-minute, hourly, daily, weekly, or monthly chart. These patterns can be found at all scales. The black wave 1 on the chart above, which is an impulsive wave, is made up of five waves. Wave 2, which is a corrective wave, is made up of 3 waves. Wave 3 is made up of five waves, and so on. Further, the entire 5 wave sequence above is also only wave 1 of a larger degree, as shown by the red 1 above. It becomes more complicated when looking at corrective waves, but that lesson is for those who wish to learn more about the Wave Theory. Now here is a chart with more detail:



The above is termed a **wave count**. This pattern continues indefinitely, and even better, is predictable. Now, here are a few rules that help with forecasting.

The Unbreakables

Wave counts, such as the one above, must adhere to certain rules. These rules are a great help when trying to maintain your own wave count, because if any of them are broken, your count is invalid, and the real wave count must be determined. (Note: The price movement of every index in every single minute of every month of every year is accountable for using these methods. If a rule is broken, it is telling sign that the count is different than what you had thought it was). The rules are as follows:

1) In an impulsive move, wave 4 can not overlap wave 1. That is to say, the low of wave 4 can not breach the top of wave 1 (in an uptrend, vice versa for a downtrend).
2) Wave 3 of an impulsive move is never the shortest wave of the five-wave sequence, and is often the longest impulsive wave.
3) The rule of alternation; Expect alternating patterns in virtually all wave movements. That is to say if Wave 2, a corrective wave, is a zigzag, expect Wave 4 to be a flat, triangle, etc.

4) "The Right Look"; This rule is somewhat subjective, but states that wave counts must have the right look to them, something that develops over years of practice.

These rules help keep the chartist in check when trying to determine where a market is in the wave count. If a rule is broken, it can safely be said that a different wave count is underway. These rules, along with other methods listed below, make forecasting with the Wave Theory an incredible success.

Other Forecasting Tools

Aside from labeling price patterns to determine where the market is headed next, there are other aspects of this theory that assist in the forecasting process.

Fibonacci Retracements

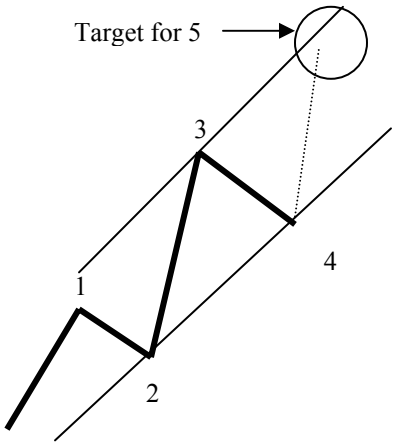
The most important supporting forecast tool, Fibonacci retracements, has volumes of text covering the subject and the mathematics behind it. So this will certainly not cover all that one needs to know to truly understand the idea, but here's the short of it. Leonardo Fibonacci, born in 1180, was the greatest mathematician of his time. He created a sequence of numbers based on breeding rabbits (huh?). The Fibonacci sequence begins with 1, 1, 2, 3, 5, 8, 13, 21….up to infinity, whereby any number is the sum of the two previous numbers. These numbers have amazing implications throughout nature, as well as social behavior. To make a long story short, the deeper into the sequence you get, the ratio of any two adjacent numbers gets closer and closer to .618. This is the golden ratio, which is found in everything from the length of your finger to the swirl of galaxies far away. From this ratio, other ratios are derived;

.236
.382
.5
.618
.786
1
1.618
2.618

These ratios are found all over the stock market indices. For example, wave 1 at any degree is often retraced in wave 2 by one of the above ratios. So if wave 1 was 100 pts in length, we might expect wave 2 to be 38.2 points, or .382 of 1. You have to see it to believe it. In my work, I find more often than not that the retracement of a wave is by one of the above percentages. Thus, a target for the move is created. Further, waves that move in the same direction are often linked by a Fibonacci retracement. For example, wave 1 and wave 5 are often either 61.8% of the other wave or equal in length. This tool is more powerful than you can possibly fathom until you see it with your own eyes; it is truly incredible. Fibonacci has many more applications in the markets, such as time relationships between peaks and troughs, but it is a full study in itself, and the above will have to suffice for now.

Channel Lines

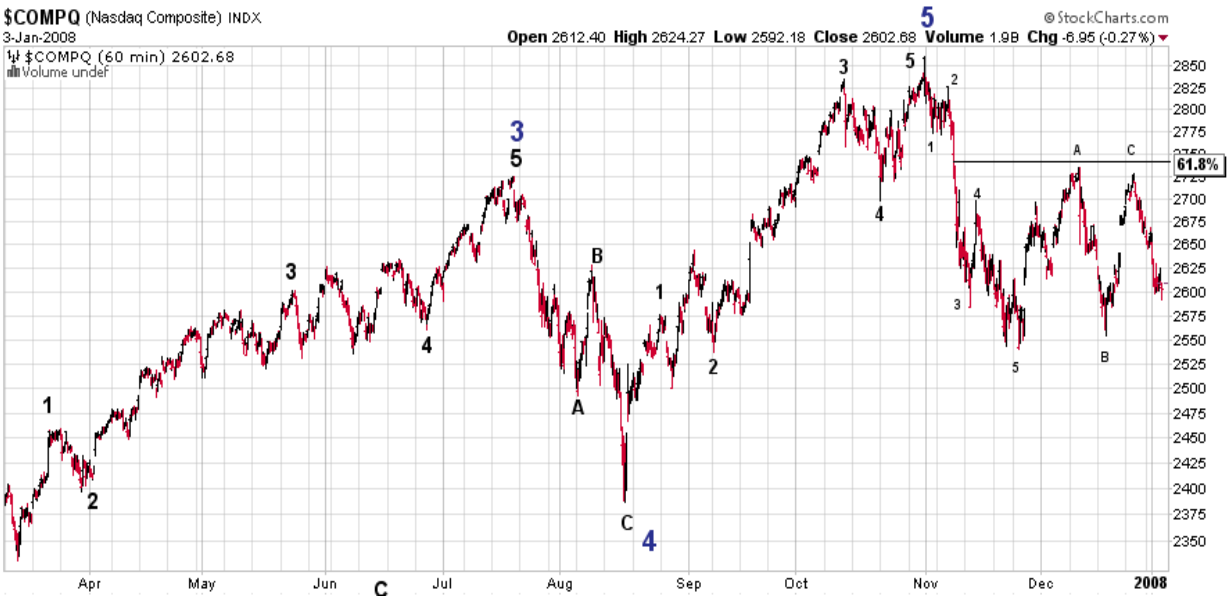
The other major forecasting tool used in Wave Theory is exceptionally simple. Channel lines are very useful when forecasting where a wave 5 will terminate before a new trend begins. This is done by connecting the end points of wave 2 and 4, and drawing a parallel line at the end point of wave 3:



This is a very simple and very effective method for forecasting the end of a move and the proceeding reversal. In conjunction with Fibonacci retracements and wave counts, this is by far the most successful method of forecasting ever known.

The Reality

This is more than a theory that only works in a vacuum. This method has forecasted the biggest turns in modern stock market history and will continue to do so in the future. Below is a chart of the NASDAQ. The Wave Theory has forecasted and can successfully account for all of the action that has occurred over the past three years:



Each wave subdivides into the appropriate number of component waves, and all rules are adhered to. Certainly, a theory that has the forecasting ability to see all of this occurring before it does is truly exceptional.

That's all, Folks!

The above text is my best attempt at summarizing the Elliott Wave Theory in a short and concise manner without leaving out any crucial components. However, this is just the beginning. Hey, no one ever said it would be easy! A theory with this much success and predictive ability is worth its weight in gold and then some. If you desire to learn more about the theory, I strongly suggest checking out the following books in order of what I consider to be the most important:

1) The Elliott Wave Principle – Bob Prechter and A.J. Frost
2) Mastering Elliott Wave - Glenn Neely and Eric Hall
3) Conquer the Crash – Bob Prechter
4) The Wave Principle of Human Social Behavior – Bob Prechter

Otherwise, I hope this text will at least help you understand what "Elliotticians" are babbling about when talking market. Good Luck!

Ryan Henry
Practicing Elliottician