Elliott Wave Theory

Quick Start Guide

Traders Day Trading .com

Learning about the Stock Market for Beginners &
How to Start Day Trading -
Successfully!

Preface

This eBook is an original publication from

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A trader's guide to

Learning about the Stock Market for Beginners & How to Start Day Trading – Successfully!

Visit us at our website to **learn more about Elliott Wave Theory** and much more.

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An Introduction to Elliott Wave Theory

What is Elliott Wave Theory

Elliott Wave Theory is a commonly used form of technical analysis that is applied to stock market charts for the purposes of **forecasting the future direction of prices**.

The Elliott Wave Principle is founded upon the concept that stock market price movements are not a result of the latest news headline, but are in fact a direct product of the mass psyche of the market participants.

How many times do we see the market **drop** on supposedly **'good' news**, or a stock's price **rise** on the announcement of some pretty disastrous results? Of course, the talking heads will always find an angle to explain away these discrepancies, 'results were not as bad as expected' or something similar, that is their job after all.

For a technical analyst it is not the **news** that matters, or even the numbers in those results, it is the **market's reaction** to them that is the only thing that matters. Applying Elliott Wave theory is the study of the stock markets price data in the search for recognisable patterns in the behavior of the markets prices. These price patterns can enable an Elliott Wave analyst to assess whether prices are likely to rise or fall - **ahead of the event.**

Elliott Wave Theory – an Invaluable Tool for Successful Trading

All technical analysis is based upon these **cycles of mass human behaviour** that is reflected in the movements of a stock's price. Elliott Wave analysis is unlike most other forms of analysis in that it is **possible** for an analyst to understand exactly where prices are within that cycle at any given point in time.

This **knowledge is invaluable** to traders and investors, as using other forms of technical analysis such as traditional support and resistance methods can tell traders where support is, but how do they know whether to expect that support to hold or break? Proper application of Elliott Wave Theory can help them **substantially** increase successful trade results by helping them to assess the probabilities of that support holding or breaking.

Successful trading is about **limiting risk** and reducing losses incurred from bad trades. By understanding where prices are in the Elliott Wave cycle, traders have a **unique tool** available to them in their efforts to find low risk and high yielding entry and exit points for their trading.

The Origins of the Elliott Wave Principle

The *Wave Principle* was developed in the 1930's by **Ralph Nelson Elliott** who had the view that:

> *"Because, man is subject to rhythmical procedure, calculations having to do with his activities can be projected far into the future with a justification and certainty heretofore unattainable."*

A distinguished accountant to trade, Elliott suffered from periods of ill health and at a time of historical stock market activity, spent much of his time studying the movements of the stock market to occupy his mind. He observed that the **markets often appeared to move in recurring and recognisable patterns**.

R.N. Elliott

Elliott studied the charts of a number of stock market indexes spanning 75 years at various degrees of time, from Yearly down to 30mins. What he discovered was that these patterns were **repetitive** and took the form of **interlinking 'waves'**. These waves then went on to develop into larger waves with similar patterns.

Robert Prechter Jr

RN Elliott's work remained relatively unknown until the 1970s when A.J. Frost and Robert Prechter Jr. published **Elliott Wave Principle** which is now widely regarded as **the definitive guide** to Elliott Wave Theory. It has since become one of the most popular and commonly used technical analysis tools.

Robert Prechter Jr. then went on to create the world's largest stock market forecasting service, Elliott Wave International (EWI).

Elliott Wave International's team of analysts provide forecasts for every major market in the world and through their **free to join, Club EWI** membership, offer an impressive range of very good quality educational materials such as videos, special reports, webinars...etc. Club EWI membership also gives you access to a **free Elliott Wave basics tutorial (50 pages)** which covers all the basics in more detail than we can in this "**Elliott Wave Theory – Quick Start Guide"** eBook.

The Elliott Wave Theory Basic Principle

We have all heard the phrase 'one step forward and two steps back' to describe a situation where we feel as though we are going nowhere, or achieving nothing.

R.N. Elliott's observations were that as the market progresses, prices tend to **ebb and flow** in wave like moves. Impulsive, flowing moves would consist of **5 waves** followed by an ebbing back, in a more corrective period where prices seem to struggle to get anywhere, and consisting of **3 waves**.

Each wave then develops within part of a larger cycle. The complete cycle is composed by those 2 parts and each cycle is part of an ever expanding matrix of **interlinking cycles** of various degrees of trend.

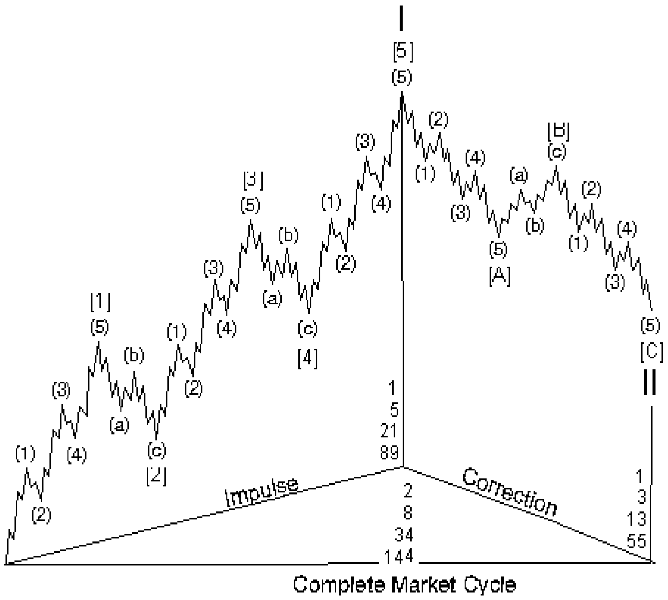


Chart Courtesy of Elliott Wave International

In the basic wave formation, **impulsive waves** are labelled with the numbers 1,2,3,4,5, and **corrective waves** are labelled with the letters a,b,c.

As we can see in the chart above, impulsive waves will **gain** a lot of ground whereas in corrective waves, prices tend to **struggle** to get anywhere. Corrective waves are more of a sideways consolidation or range bound move that occurs when the market wants to hold on the price levels that have been gained.

It is important to remember that these charts are showing 5 waves up and 3 waves down as in a positive market, but impulsive waves can also occur when markets are declining. An impulsive move in a **declining market** will take the form of **5 waves down and 3 waves up**.

Impulse Waves

Impulse Waves

Impulse waves are **powerful moves** composed of 5 sub waves that drive the market in the direction of the larger trend. Within the larger impulse wave, the 5 waves subdivide into 5,3,5,3,5 formations and are labelled 1,2,3,4,5.

Waves 1,3 and 5 are the impulse waves and are powerful, driving moves which are interrupted by the waves 2 and 4 which are **corrective** and consolidating phases, creating the wave like structure.

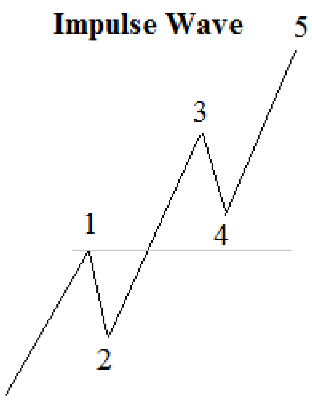
An impulse wave itself, always **subdivides into 5 waves** to a lesser degree, so the important factor for an Elliott Wave analyst in recognising that the trend has reversed, is to be able to count 5 waves in the internal sub divisions of the move.

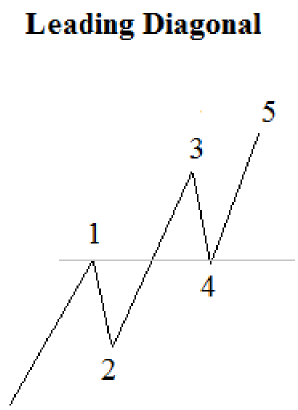
Wave construction is always the most important factor in **wave recognition** so let's have a closer look at the subdivisions within an impulse wave.....

Wave 1 (Impulse)

First waves subdivide into 5 smaller waves and can be either, slow and steady, grinding away and relentlessly moving against the trader convinced the previous trend is still underway, or they can be **sharp and decisive** blowing those traders out of the water.

First waves can also take the form of a **Leading Diagonal** which involves an overlap of waves 2 and 4 but these must still subdivide into 5,3,5,3,5 structures.





Impulse Waves

Wave 2 (Corrective)

Second waves subdivide into 3 smaller waves and are often **sharp and deep**, retracing much of the gains of wave 1.

Within second waves, many traders are still convinced that the previous trend is still in effect. Generally speaking, second waves will be very deep and are most likely to retrace much of the first wave if that was a slow grinding move. Very sharp and powerful first waves can lead to a very shallow wave 2.

Wave 2s **never** retrace more than 100% of wave 1. If prices move beyond the origin of wave 1, it is a clear signal to the Elliott Wave analyst that his analysis is wrong.

Wave 3 (Impulse)

Third waves subdivide into 5 smaller waves and are typically the **largest and most powerful wave**. These waves occur on high volume and are broad ranging with mass participation as the new trend becomes clear. Wave 3s are **never** the shortest impulse wave and are the most likely to extend.

Wave 4 (Corrective)

Fourth waves subdivide into 3 smaller waves and are often very **complex moves**. These tend to be sideways and range bound moves frustrating bulls and bears.

Wave 5 (Impulse)

Fifth waves subdivide into 5 smaller waves and are **distribution phases**. These usually display a weakening of the trend in prices, breadth and volume. They can be long and drawn out phases as the market **tops or bottoms,** but at times they can be very sharp 'spike' like moves.

Fifth waves can take the form of an **Ending Diagonal** and involves the overlap of waves 2 and 4 but they differ from a Leading Diagonal which can appear in the wave 1 position, in that they subdivide into a 3,3,3,3,3 construction.

Corrective Waves

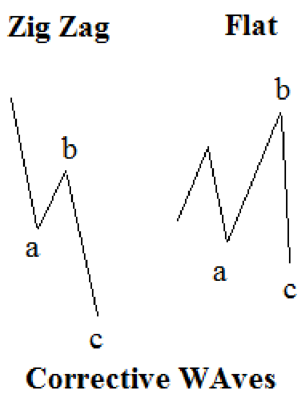
Corrective Waves

Corrective waves retrace part of the previous trend but never move beyond the origin of the previous impulse wave. In other words wave 2 never breaks the **origin** of wave 1 and wave 4 never breaks the **origin** of wave 3.

Waves 2 and 4 within an impulse, and A,B,C are corrective waves

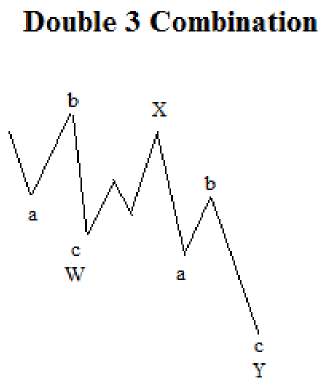
The different types of corrective waves are a **Zigzag, Flat, Triangle** or a **Combination**.

Wave	Structure	Labelling
Zigzag	5-3-5	a,b,c
Flat	3-3-5	a,b,c
Triangle	3-3-3-3-3	a,b,c,d,e



Combination Waves

Combinations can occur when a corrective wave has not met its price target or needs to **extend** in time. Typical combination waves are **double 3's** or **triple 3's** where a combination of zigzags or flats, are joined together by an **'X' wave.** 'X' waves are 3 wave corrective moves.



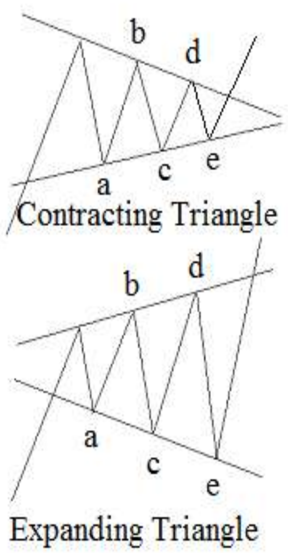
Double 3's are labelled W,X,Y each of which can be a zigzag or a flat. W and Y are two 3 wave moves connected by the X wave.

Triple 3's are labelled W,X,Y,X,Z each of which can be a zigzag or a flat. W,Y and Z are the Three 3's connected by the Two X waves. The **final wave in a combination can also be a triangle**. E.g. A very shallow double 3 (WXY) could consist of a Flat (abc) for W and a Zigzag (abc) for X, ending in a Triangle (abcde) for Z.

Elliott Wave Triangles

Elliott Wave Triangles

As with all Elliott Wave identification, the internal wave formation is the most **important** factor in identifying Triangles in Elliott Wave Theory. **Triangles** subdivide into 3,3,3,3,3 and are labelled a,b,c,d,e. In other words, each internal wave subdivides into a 3.



It is important to remember that **Elliott Wave triangles** are not determined by shape, contracting price action in a converging triangular shape does not necessarily mean that it is an Elliott Wave Triangle.

A very common mistake we have found is that most of the formations that we see purported by analysts to be an Elliott Wave Triangle are not actually valid. We believe that this is through **wishful thinking** rather than through reasoned analysis.

An Elliott Wave Theory Triangle is a particularly **special feature** as they can only appear at certain points in the cycle. This means that they can be extremely good guide in **confirming** to the technical analyst where we are at that particular point in the cycle. The reliability offered by the price action following these patterns can lure to the analyst to see what he wants to see rather than what is actually there.

"What we see depends mainly on what we look for." *(John Lubbock)*

Triangle Positioning in Elliott Wave Theory

A genuine Elliott Wave Triangle will only appear in the charts in certain positions within the cycle. They always occur in a position **prior to the final wave** in a move or as the **final wave** within a combination as mentioned earlier.

- Wave 4
- B wave
- X wave (final X wave in a Triple 3)
- Final wave in a Combination

Elliott Wave Theory and Fibonacci

Fibonacci number Series

R.N Elliott himself wrote that **"The Fibonacci Summation Series is the basis of The Wave Principle."**

So what is the Fibonacci Series, the series is 1, 2, 3, 5, 8, 13, 21, 34, 55, 89, 144.....

Each number is the sum of the **previous two** numbers. E.g. 1+2=3, 3+2=5, 5+3=8...etc... If you compare the number sequence and refer back to the chart on page 6 of this eBook, you will start to get an idea of the **relevance of Fibonacci** within Elliott Wave Theory.

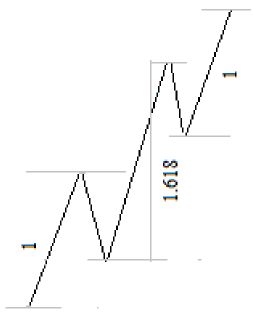
Fibonacci Ratios

Fibonacci ratios are derived from the sequence of numbers and the **most important** one is of course the **Golden Ratio** which is 0.618. The Golden ratio appears in many forms throughout the natural world and the importance of the Fibonacci ratios within stock analysis is very clear to see too.

There are many ways to apply Fibonacci studies to technical analysis and we also look for **Fibonacci ratio relationships** between the related waves in a cycle. Here are some common ratios to look for....

- Wave 3 to wave 1 – 1, 1.618, 2.618, 4.236...
- Wave 5 to wave 1 – 0.5, 0.618, 1, 1.27, 1.382, 1.618...

When one of the impulse waves extend, there are some **common relationships** to look for and an example of this can be seen in these charts.



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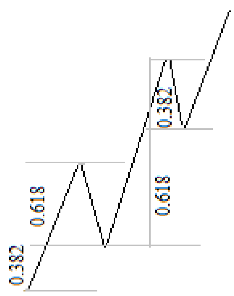

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Common **retrace ratios** for corrections are

- Wave 2 – 0.616, 0.786
- Wave 4 – 0.382, 0.5
- B waves – 0.5, 0.618, 1.00, 1.27

Wave 2s are often sharp and deep. In an ideal world they would **retrace 0.618 or 0.786** most of the time. Wave 4s tend toward a shallower retrace and will often find **support at the 0.382** level of wave 3.

B waves are generally less consistent and tend to vary in length more.

Applying Elliott Wave Theory

Applying Elliott Wave Theory

As with any other form of technical analysis, it is essential to remember **why** you are using Elliott Wave Theory in your analysis of a chart, it is not our wave count that is the most important factor, it is always the **profit or loss** derived from using our Elliott Wave analysis that should be the **only thing** that matters.

Appling Elliott Wave theory is only a **means to an end** so it is essential that a trader does not get drawn in to the popular game of trying to force his preferred wave count into price action in an attempt to be seen to get it right.

Top 10 Tips for Applying Elliott Wave Theory Profitably

1. **Always** observe the Elliott Wave rules
2. **Always** consider the Elliott Wave guidelines
3. **Always** be quick to accept when your analysis is wrong
4. **Always** use stops losses
5. **Always** consider the alternative wave counts
6. **Always** use Fibonacci in conjunction with your Elliott Wave analysis
7. **Always** consider a potential trade entry in multiple time frames before entering
8. **Always** remember which time frame it is that you are trading in
9. **Always** have a trading plan
10. **Always** try to gauge current sentiment to evaluate whether it confirms the analysis

Human behaviour is firmly embedded and reflected in the movements of stock market prices, so we must always endeavour to take a step back and try to **separate ourselves from the crowd**. This is best achieved by considering all current, valid wave counts and observing live price action to try to gauge which wave, prices are most likely to be forming.

Elliott Waves evolve, these waves then evolve into larger waves so it is important not to get too far ahead of ourselves by anticipating moves that may never take place.

Test Your Knowledge – Elliott Wave Theory

Q1. How many waves does an impulse wave subdivide into?

A1.

Q2. What is the maximum retracement level for a wave 2?

A2.

Q3. Who is considered to be the leading authority on Elliott Wave Theory?

A3.

Q4. What is the most important Fibonacci ratio?

A4.

Q5. How does a triangle subdivide?

A5.

Q6. What is the most important factor in wave recognition?

A6.

Q7. What is the next number in this Fibonacci sequence 5, 8, 13, 21, ?

A7.

Q8. Which impulse wave is never the shortest?

A8.

Q9. How do we label a 3 wave zigzag?

A9.

Q10. Could a wave 2 be a triangle?

A10.

How did you do? Check your answers to see how well you did at the Traders Day Trading .com Elliott Wave Theory answers page.

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