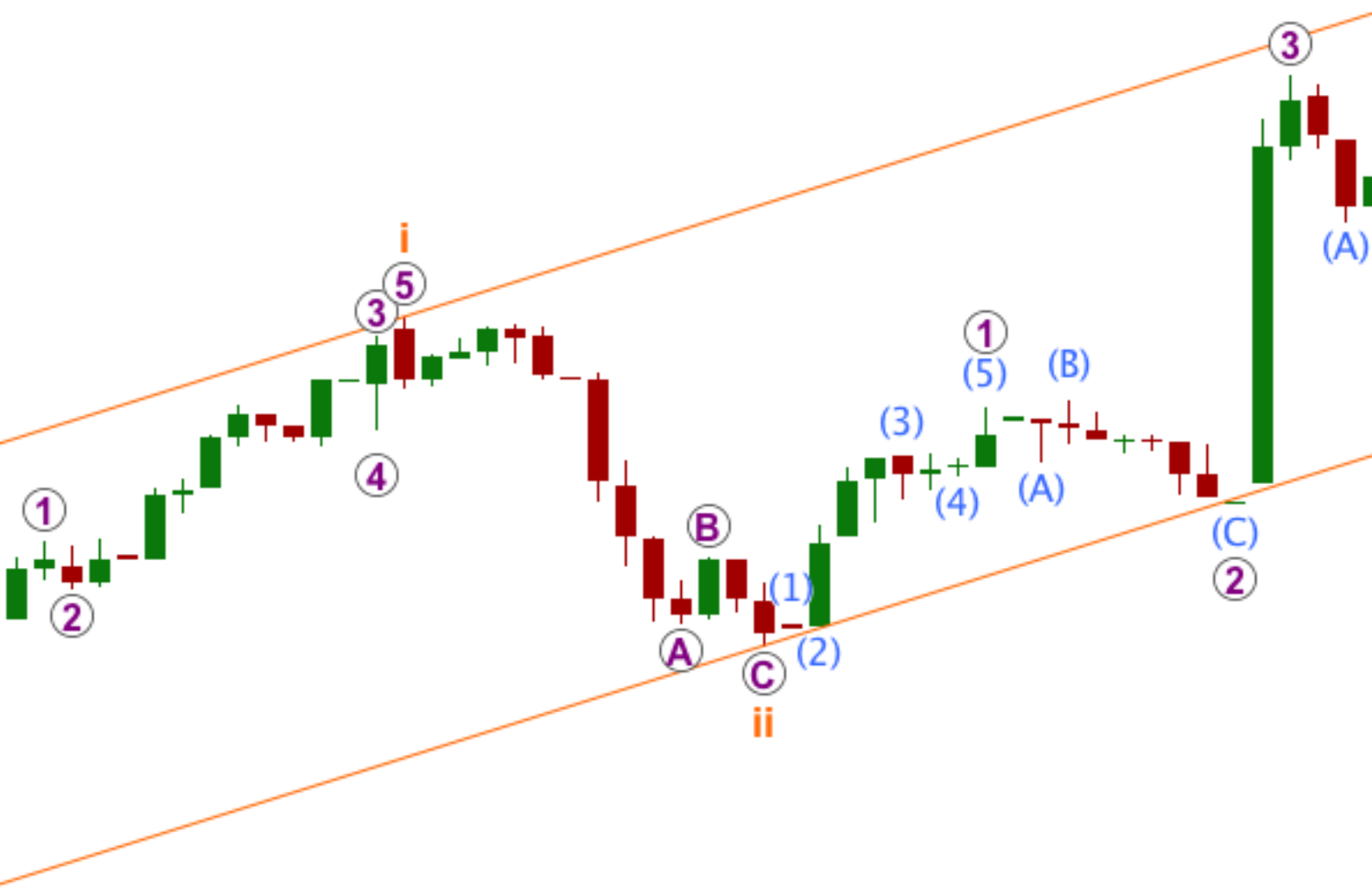
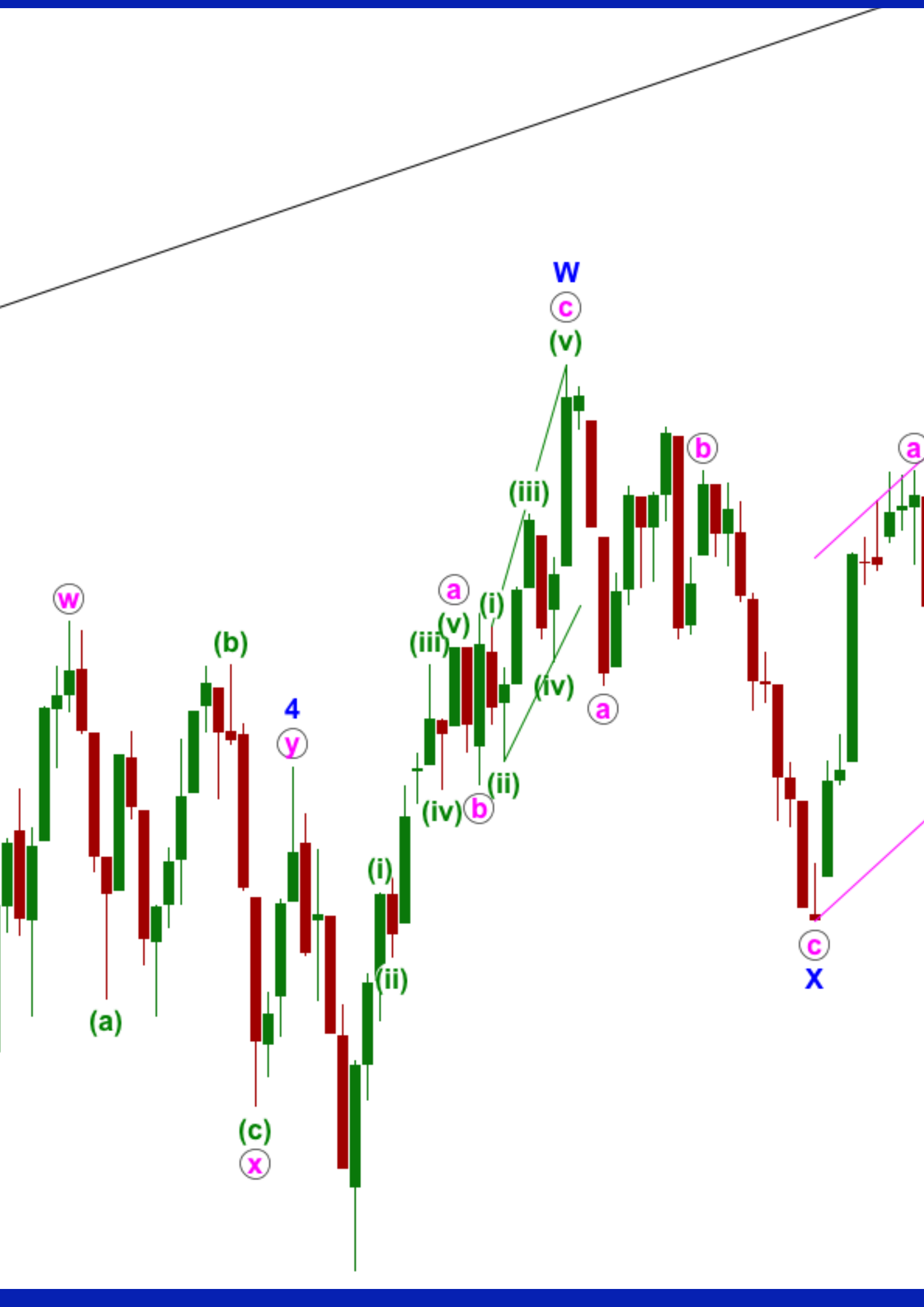
Elliott Wave Stock Market

MONEY WAVE

& Other Stock Market Trading Secrets


i
5
3
4
1
2
B
A
C
ii
(1)
(2)
(3)
(4)
1
(5)
(B)
(A)
(C)
2
3
(A)

Contents


W
c
(v)
(iii)
(i)
a
(v)
(iii)
(iv)
b
(ii)
(iv)
a
b
a
w
(b)
4
y
(i)
(ii)
(a)
(c)
x
c
X

Introduction

This ebook reveals the secret that the Stock Market is not random and instead it is patterned.

Because the market follows identifiable patterns, if we can identify which pattern is unfolding we are able to predict the next direction. This enables traders to be on the right side of the market more often than not, and increases the likelihood of profits.

This ebook goes even further and shows some simple technical techniques which can be used to increase the probability of knowing which direction the market is moving.

Elliott Wave

The rationale behind why Elliott Wave works:

Nature is not random. It is patterned. We see the same basic pattern in the plant and animal kingdoms. For example, within Animalia we see many variations of a central backbone with four appendages as limbs, and a single head.

Within this basic structure there is much variation between different species.

Humans are a part of nature and this is why we follow a natural pattern.

The stock market moves because human beings make it move. Humans are a social species and group together. Groups of humans follow repeated patterns of behaviour, swinging from optimism to pessimism and back again.

The stock market is an indicator of the social mood, and on a chart of the stock market we can see where the human group is within the pattern.

The stock market is not random. If it were then traders would have no more success than the flip of a coin. If the stock market were truly random then no one would be able to consistently profit from trading it.

But people do. When we know what are the patterns which unfold within the stock market, then we are able to identify where it is within the pattern and identify what direction in which it should move next. This is the secret to Elliott wave and why it works.

In the 1930's Ralph Nelson Elliott formulated the Wave Principle after studying charts of the Dow and its predecessors. He identified the basic pattern which he saw repeating at all scales, and he identified several patterns within the pattern. R N Elliott published his discovery in a work titled "Nature's Law."

In the 1970s A J Frost and R R Prechter Jnr discovered R N Elliott's work and published what is now used as the definitive guide to all students of Elliott Wave, the "Elliott Wave Principle."

This Ebook is not meant to be an alternative text to "Elliott Wave Principle" and any traders who decide to use this principle as a tool in their decision making kit would do well to purchase a copy of the standard text.

The Basic Pattern - Fractals

The basic pattern is five waves up, followed by three waves down.

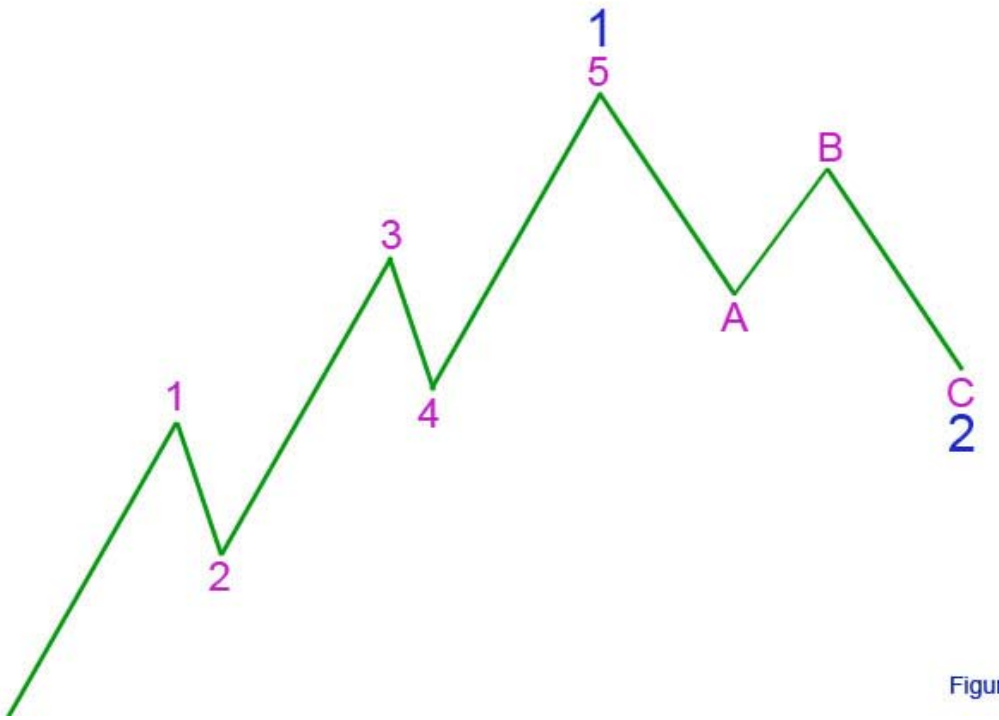


Figure 1

This basic pattern allows for overall forwards movement.

When we are in a bull market the movement will be upwards. When we are in a bear market the movement will be downwards.

Within this basic pattern the waves are numbered 1 to 5 for the movement that takes price in the direction of the main trend, and labeled a-b-c for the movement that takes price against the main trend.

Within the numbered waves it is waves 1, 3 and 5 which move price most strongly in the main direction of the trend. These waves are termed “actionary.”

Waves 2 and 4 move price against the main direction of trend and so they are termed “reactionary.”

The lettered waves are termed corrective. Within the a-b-c movement the trend (in a bull market) is downwards. Waves a and c are actionary, they move price in the direction of trend. Wave b is reactionary. The whole movement together, a-b-c is reactionary and corrective.

This pattern builds upon itself to create larger versions of the same pattern:

ELLIOTT WAVE STOCK MARKET MONEY WAVE

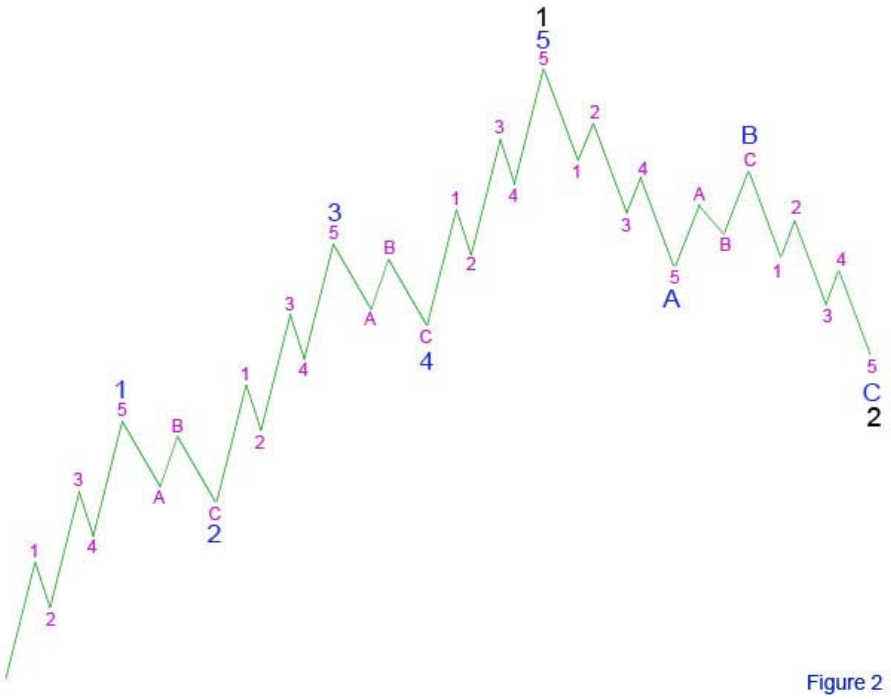


Figure 2

At each time frame of a chart; monthly, weekly, daily, hourly and 5 minute, you can see fractals of the same patterns repeating. I have even watched live charts tick movements and seen this same five up three down pattern repeating on the smallest time frame.

Elliott wave uses “degrees” of labeling to identify fractals. Your personal trading style will depend upon which degrees of wave you will trade. For long term investment you would be using weekly and monthly charts. Day traders want to see movements on hourly and five minute charts.

As a general guideline for stock markets, degrees at minute and above offer good trading opportunities for most traders. Trading wave degrees at minor and intermediate will suit most mid term traders. Day traders would trade wave degrees at minute and below. Long term investors would trade degrees at interme-

diate and primary. Figure 3 illustrates the colour and nomenclature for labeling different wave degrees.

label example	wave degree	time period	colour
(I)	Grand Supercycle	generations	Dark Purple
(I)	Supercycle	multi decade (about 40-70 years)	Olive Green
I	Cycle	one to several years	Teal Green
(1)	Primary	a few months to a couple of years	Maroon
(1)	Intermediate	weeks to months	Black
1	Minor	weeks	Blue
(i)	Minute	days	Pink
(i)	Minuette	hours	Green
i	Subminuette	minutes	Orange
(1)	Micro	minutes	Purple
(1)	Submicro	minutes (very few)	Aqua
1	Miniscule	seconds to minutes	Red

Figure 3

13 Corrective Patterns

When not to trade is just as important as when to trade.

Corrective patterns are found within the basic pattern in waves 2 and 4. Corrective patterns of one larger degree make up the complete A-B-C correction which follows after a five wave impulsive movement upwards.

Corrective patterns are very difficult to analyse and so very difficult to trade. Price tends to move in choppy, overlapping movements and the trend is unclear.

One big difference between professional traders and occasional traders who lose all their money, is the trades the professionals DON'T take. Corrective movements of low wave degrees seen on hourly charts are not good trading opportunities.

Trying to trade these movements involves a greater risk of significant losses.

The biggest reason why corrections are hard to trade is there is so much variation within them. There are 13 possible corrective structures and it is only by very careful attention to subdivisions of each wave, and rules and guidelines, that an analyst may be able to identify which structure is unfolding. The correct structure is often only known at the very end of the movement.

The 13 corrective structures are: zigzag, double zigzag, triple zigzag, three types of flat, double flat, triple flat, three types of triangle, double combination and triple combination. Figure 4 shows the basic structure of these different types of correction.

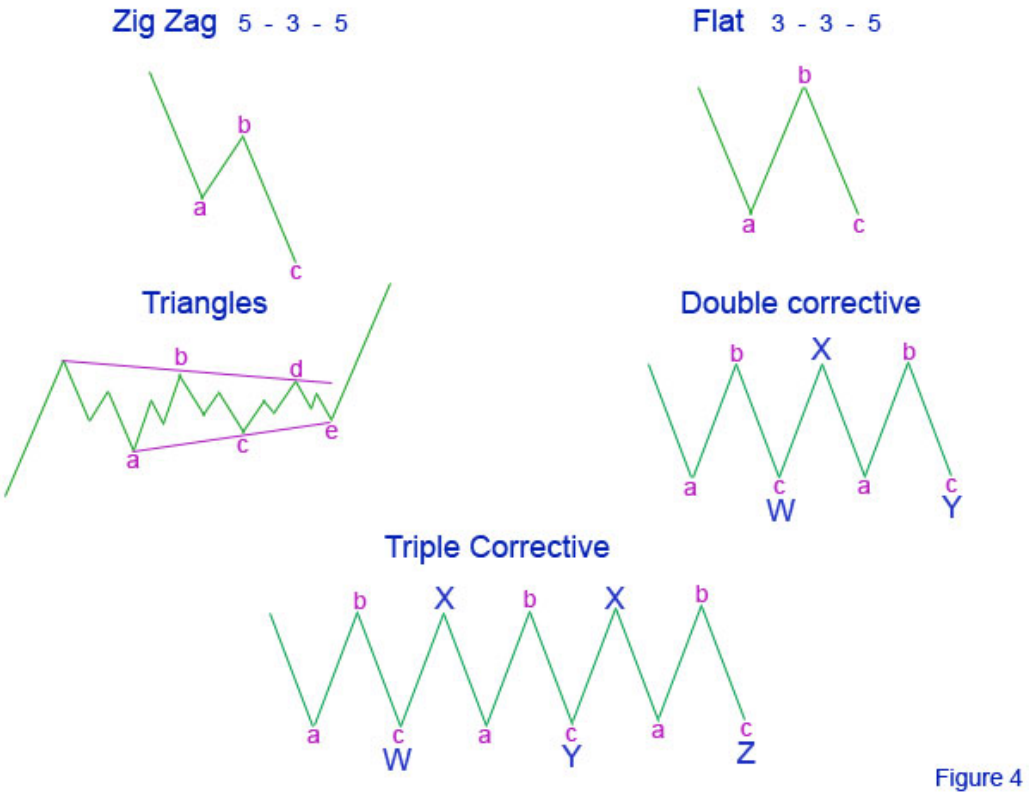


Figure 4

The core rules for each type of correction are outlined below. For a full listing of all rules and guidelines we refer to “Elliott Wave Principle” by Frost and Prechter, 10th edition, pages 86 to 91.

Zigzags.

There is only one type of zigzag and it must subdivide into 5-3-5. Wave A must subdivide into a five wave structure, wave B a corrective structure, and wave C must also subdivide into a five wave structure.

Apart from the subdivisions the only core rule which must be met by a zigzag is B may not move beyond the start of A.

Zigzags are very common and simple structures. They often fit well in trend channels.

Flats.

There are three types of flats: regular, expanded and running. The most common type is an expanded flat.

Figure 5 shows the basic structures. These diagrams are for corrections within bull markets. For bear markets the structure is reversed.

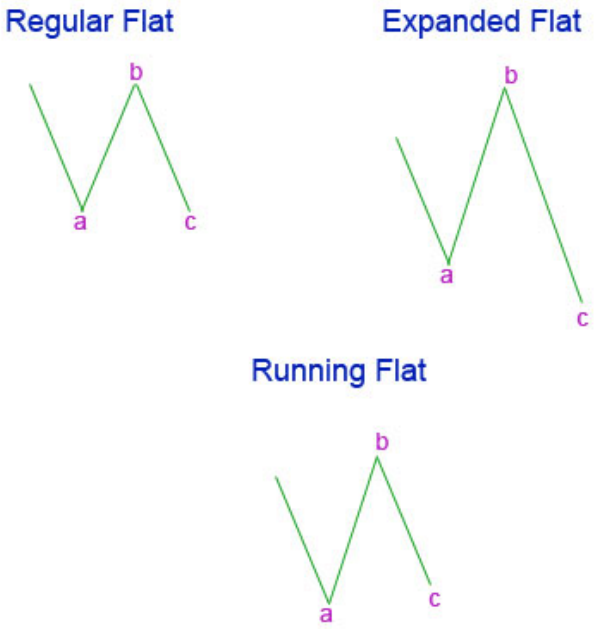


Figure 5

The biggest and crucial difference between a zigzag and a flat is the subdivision of the A wave. In a flat wave A must subdivide into a three wave structure (usually a zigzag). Wave B must retrace at least 90% of wave A. Wave C must subdivide into a five wave structure.

Expanding flats are very common, regular flats are uncommon, and running flats are rare.

Triangles.

There are three types of triangles: contracting, barrier and expanding.

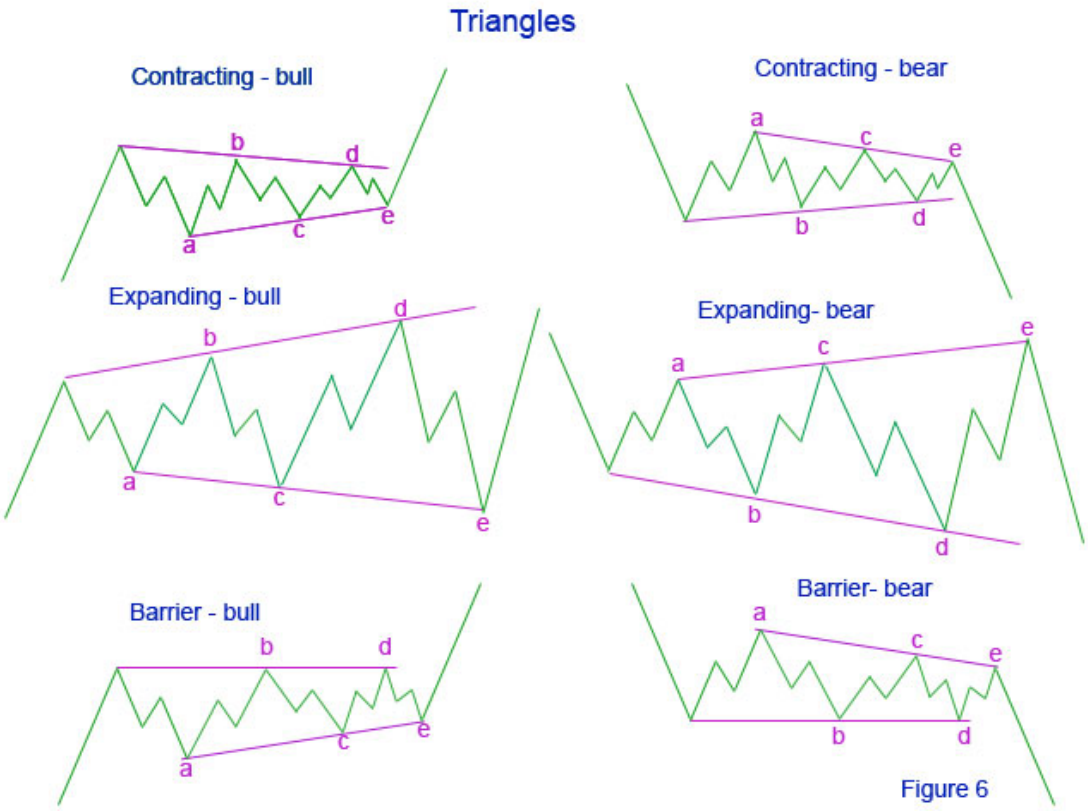


Figure 6

Contracting triangles are reasonably common, barrier triangles less so and expanding triangles are very rare.

Triangles take time and move price sideways. It is very easy for an analyst to label a triangle completed prematurely.

The most important rule for triangles is where the ends of each sub wave can end. This rule is determined by which triangle is forming.

For a contracting triangle wave B may end beyond the start of wave A, but thereafter each wave cannot move beyond the end of the prior same directional sub wave, not even by a fraction of a point.

For an expanding triangle the rule is the reverse. Wave B does not have to move beyond the start of wave A, but thereafter each sub wave must end beyond the end of the prior same directional sub wave.

Barrier triangles are very similar to contracting triangles. Wave D should end about the same level as wave B. In practicality this means that wave D may end very slightly beyond the end of B, but the B-D trend line should essentially be flat. Triangles often occur in B wave positions and in fourth wave positions.

If a triangle is seen then expect price to exit the triangle in the same direction it entered, and that the movement out of the triangle to be the last movement in that direction (it completes the structure of one higher degree).

Doubles and Triples.

Double and triple zigzags should deepen a correction and this is their purpose. Each zigzag is joined by a three in the opposite direction, labeled X, which is usually a zigzag also. Thus a double zigzag has the subdivisions 3-3-3, and a triple zigzag has the subdivisions 3-3-3-3-3.

Double and triple flats seem to exist to move price sideways and take up time. This purpose is the same as that for triangles, and often what an analyst thinks is a triangle turns out to be a double flat. Triples are rare.

X waves within doubles and triples can be thought of as B waves. Because the first structure in a double or triple is a three then the X wave is similar to a B wave within a flat. It may make a new price extreme beyond the start of the first structure, and it is most likely to subdivide into a zigzag. The second and third flats do not need to deepen the correction, so Y and Z do not need to take price beyond the end of W, and the whole movement should be sideways.

Double zigzags, double flats and double combinations are actually relatively common structures. This makes predicting the end of corrections very difficult.

When the first structure is complete the tendency would be to say that is the end of the correction, but only if the subsequent movement is a five and not a three can it be confirmed. This means that following a correction the analyst still needs to see a clear five in the opposite direction. Until this is seen the possibility of a double or triple must be considered with an alternate wave count.

The Money Wave

The Money Wave is the holy grail of Elliott wave. The money wave is the third wave of an Elliott wave structure.

Third waves move fast with strength, and the direction is clear when price is within a third wave.

Day traders may trade short lived third waves seen on hourly charts. More long term traders may trade third waves at larger degrees on daily and weekly carts. Long term investors would trade third waves on weekly and monthly charts.

Which degree you are looking to trade will depend upon your risk appetite and your experience.

As a general rule, trading waves below minor degree involves more buying and

selling. You have to watch the market daily, even hourly. The more times you enter and exit the market the more room for error, and so the greater the risk.

Trading at minor, intermediate and primary degree involves less entries and exits and there is less risk. If your wave count is correct and you identify a third wave you can hold a position for weeks or months for profit.

Figure 7 shows a daily chart of the S&P 500 with a clear third wave at minor degree which offered an excellent trading opportunity.

We can use Fibonacci mathematics to calculate a target for third waves. Within an impulse the actionary waves 1, 3 and 5 often exhibit a Fibonacci ratio between two of the three, and sometimes all three. It is unusual to see no Fibonacci ratio between any actionary waves.

When a third wave begins we know the length of the first wave and have the starting point for the third. The first target calculation is 1.618 the length of the first wave, as this is the most common ratio between first and third waves. If price keeps moving through the first target we look to see if the internal structure of the third wave is complete. If it is not then the next target calculated is at 2.618 the length of the first wave.

Sometimes there is no Fibonacci ratio between the first and third waves, but the ratio may yet to be seen between the upcoming fifth wave and either of the first or third. In these cases we may use the internal structure (a lower fractal) within the third wave to calculate a target.

Third waves have one other property which makes them such good trading opportunities. While corrections have 13 possible structures, third waves have only one. They may only subdivide into the basic five wave structure, an impulse.

Within the basic structure outlined in the first chapter, waves 1, 3 and 5 are called “actionary”. These waves must all subdivide into five wave structures themselves. The first and fifth waves can take one of two forms, diagonals or impulses. The third wave can only take one form, an impulse.

Figure 8 illustrates these two structures.

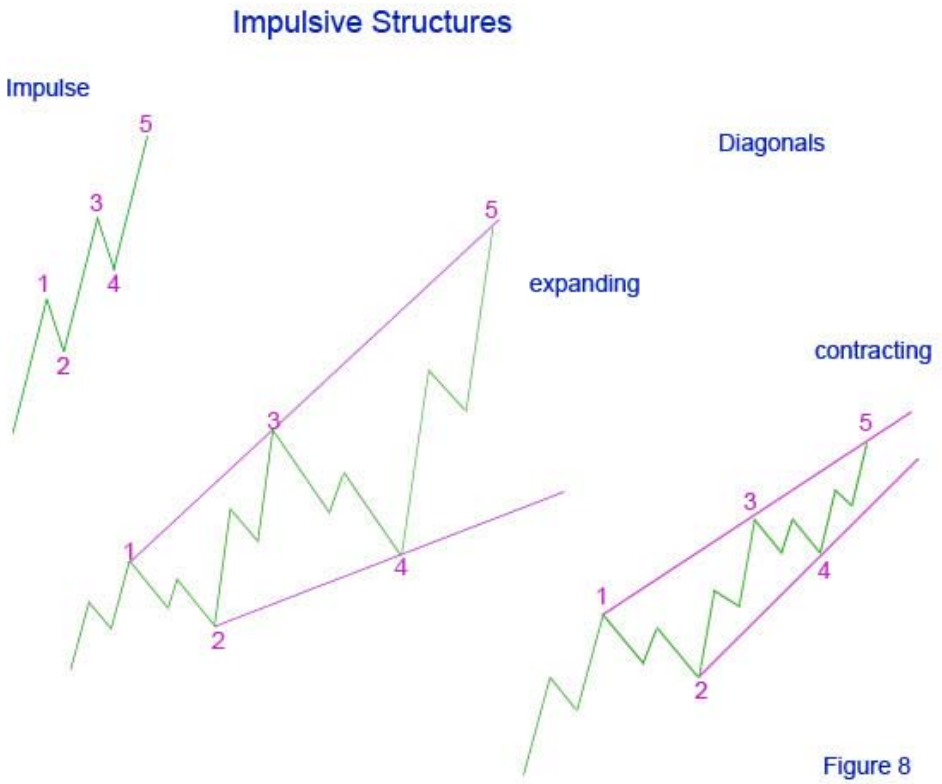


Figure 8

The rules for these two structures are different.

The three core Elliott wave rules for an impulse are: 1) Wave 2 may not move beyond the start of wave 1. 2) Wave 3 may never be the shortest wave. 3) Wave 4 may not overlap into wave 1 price territory.

Diagonal rules are a little different as their purpose is not the same.

First waves begin a new pattern and contain some of the characteristics of the preceding pattern. Fifth waves often “run out of steam” as they are at the end of a pattern. Thus they may subdivide into diagonals.

There are two main differences between diagonals and impulses. Within diagonals each sub wave (mostly) should subdivide into a zigzag, and the fourth wave should overlap the first wave. So diagonals tend to move price somewhat sideways in choppy overlapping movement, similar to a triangle. They are sometimes called wedges or descending or ascending triangles.

Invalidation Points

The biggest difference between professional traders and those who dabble in markets only to lose all their money, is risk management.

Elliott wave analysis has in built risk management. The rules for each structure tell us where price should NOT go. This is an “invalidation point.”

If price moves past this point the structure is not what we thought it was. Therefore, the wave count is invalidated and we need to exit a losing position before losses become too great.

When entering a position the invalidation point is a guideline as to where to place a stop loss. The trader must calculate the potential loss and decide if this is acceptable or not.

If the potential loss is too great the risk is too big and the trader may wait until a better opportunity presents itself. If the potential loss and risk is acceptable the trade may be taken with the risk known.

For example, wave 2 may not move beyond the start of wave 1. The money wave, wave 3, follows after wave 2. A trader looking for an entry point for a third wave would set a stop loss just above the start of the first wave.

If price moves beyond that point the wave count is invalidated and the trade should be exited. If the wave count is correct then price should not go beyond the invalidation point.

Leverage

The single biggest reason why new traders quickly lose all their money is called leverage.

Leverage offered in some online trading platforms is as high as 100:1.

When using high leverage you are not trading, you're gambling.

Professional traders, investment fund managers and stock brokers (if they are consistently successful) do not use high leverage. Sometimes they don't use leverage at all, and 2:1 would be a comfortable maximum.

It is very easy to slip into the trap of using leverage. A trader may have an initial successful trade using leverage which doubles or triples their money overnight. This is a powerful incentive to continue with this behaviour. But the trap is that

just as quickly as the profits roll in, losses can accumulate.

Strict money management rules are not exciting, but they will be the biggest difference between losing all of your investment and learning how to profit from using Elliott wave to increase your capital.

However, it is my experience that most people need to learn from doing. So if you are new to trading invest only a small amount of money first, as you can expect to lose all of your first investment.

It is best to establish a proven track record and method for yourself over at least 6 months, if not longer, before investing some serious capital.

Technical Indicators

We can use a technical indicator, MACD, to help us identify the money wave.

MACD gives us an indication of the strength of a movement. Third waves, the money wave, are the parts of the pattern which show the greatest strength. When the lines on the MACD indicator make a new extreme high or low then a third wave may be underway.

Figure 9 illustrates how this works on a chart of the S&P 500 cash index, of the “credit crunch”. The end of the third wave has the most extreme reading on MACD.

A second use of MACD is to look for divergence between the end of the third and fifth waves within an impulse. A trend line drawn on the price extremes of the third and fifth waves should slope in the opposite direction to a trend line

drawn on the corresponding points on MACD. This idea is also illustrated in figure 9.

Using MACD in this way an analyst can confirm that the wave count is correct. If the wave count is supported by MACD in this way it has a higher probability of being correct.

In the example above the analyst may confirm that teal green (cycle) wave c is a complete impulse, and have a greater insight to the following wave.

Within a correction A-B-C the ends of waves A and C also often show divergence (not always, but often).

Thus, if an analyst is looking for the end of a second wave correction to find an entry point for a trade on a third wave, divergence at the end of the C wave would be a signal that the wave count is likely to be correct.

A word of caution: MACD used in this way will almost always work on daily charts, but not always on hourly charts. At time frames of 90 minutes and above it becomes useful. Looking for divergence in time frames below hourly is too unreliable to be of any use and should not be done.

Figure 10 illustrates a five wave impulse labeled wave a pink. There is no divergence between price and MACD on this hourly chart, yet the movement ended and price changed direction. This example clearly illustrates that MACD used in this way is unreliable on hourly chart time frames.


S&P 500 (Hourly Main I) - 1 hour
there is no divergence at the end of the five wave impulse here. both price and MACD trend lower, the lines slope downwards
MACD

Figure 10

Trend Lines

Parallel channels are useful for finding the ends of waves, and for telling us when a trend change has occurred.

Elliott describes three techniques for drawing parallel channels. The first two techniques are for five wave impulses, the third is for A-B-C corrections.

The first technique is illustrated in figure 11. Here a parallel channel is drawn around an impulse trending downwards. When the third wave is thought to have ended the channel can be drawn. Elliott's first technique is to first draw a trend line from the ends of waves 1 to 3, then place a parallel copy on the end of wave 2. It often shows us where the following fourth wave will end, and in this example wave 4 ended with a slight overshoot of the channel. Fifth waves commonly end either mid way within parallel channels, as in the example, or sometimes about the edge of the channel opposite to the fourth wave.

When the channel is breached by movement in the opposite direction we know that a trend change has occurred. In this example the monthly candle following the end of the downwards five wave impulse breaches the trend channel in the opposite direction. At that stage we had confirmation of a trend change and expected an A-B-C correction to follow the five wave movement.

If this first technique does not accurately show where the fourth wave ends then Elliott describes a second channeling technique for impulses.

Elliott's second channeling technique is illustrated in figure 12. The first trend line is drawn from the ends of waves 2 to 4, and a parallel copy is placed on the end of wave 3. The fifth wave will often end mid way in the channel, and sometimes at the edge of the channel on the side opposite to the fourth wave. When the channel is breached by price movement in the opposite direction we have confirmation of a trend change.

There is only one channeling technique for A-B-C corrections, and it does not work on all corrective structures. This technique is illustrated in figure 11 on the

upwards sloping zigzag for an X wave. The first trend line is drawn from the start of wave A to the end of wave B, then a parallel copy is placed upon the end of wave A. Wave C will often end mid way within the channel, and sometimes at the edge of the channel on the same side as the end of wave A. When this channel is clearly breached by price movement in the opposite direction we have confirmation of a trend change.

Within impulsive movements on daily charts (five wave structures) Elliott's channeling technique works very well. However, within A and C waves, particularly on hourly charts and time frames below, it does not always work well.

The corrective channeling technique works well for zigzag structures and regular flat corrections. It does not work well for many other corrective structures, particularly expanded flat corrections and more complicated double and triples.

In instances where the channeling techniques are ineffective the analyst must use a channel about the movement of one degree lower. For example, a channel about wave C of an expanded flat correction will work where a channel about the whole flat movement would not.

No wave count is ever complete without channels, and they should be drawn as early as possible.

Conclusion

Elliott wave analysis is simple in its concept, but difficult in application. The most difficulty comes because corrections, movements against the trend, exhibit so much variation.

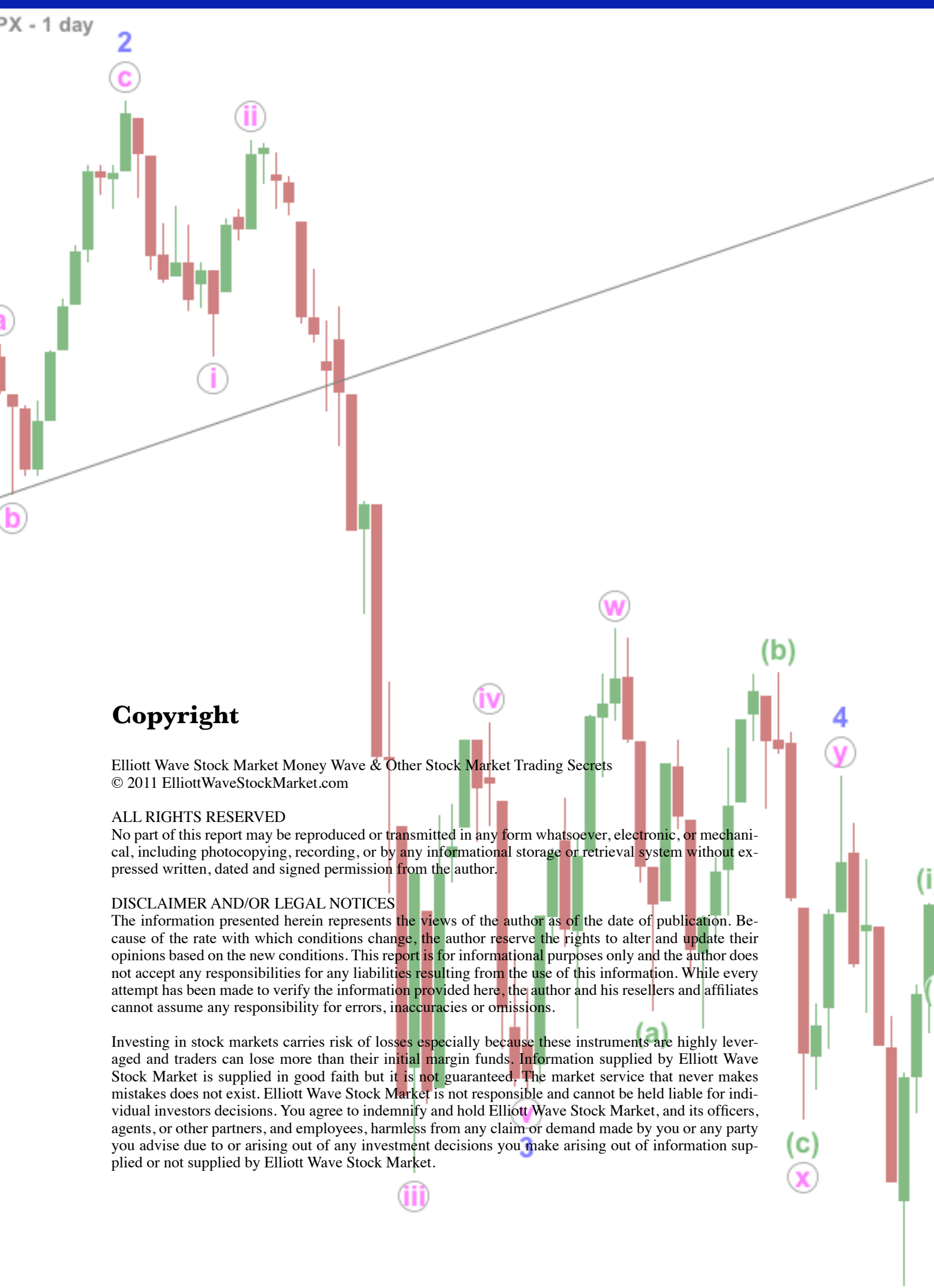
The correct approach to using Elliott wave analysis is to consider as many alternate wave counts as the analyst can see, and then to decide on the probability of each. If the primary, highest probability wave count is invalidated, then the analyst should have an alternate wave count to move to. The probability of each wave count is determined by how common the structures are, and the overall look of the count. An experienced analyst should get a feel for the "right look" of a wave count and be able to assess its probability.

At the heart of Elliott wave analysis is the definition of a movement as either a three wave or five wave movement. Sometimes it is clear and obvious as to

which it is (see the upwards movement labeled X on figure 11, this is clearly a three) but sometimes it is not obvious. The biggest difficulty of the application of Elliott wave to market analysis is when a movement is ambiguous; when it is not clearly a three or a five. In this instance the analyst must consider wave counts for both possibilities.

A skilled experienced analyst can provide great insight into market movements. When the rules and guidelines are followed strictly, and the wave count has the "right look" then a good analyst can provide insight as to the most likely direction for the market to make next. The application of Fibonacci ratios to analysis provides targets, and the application of Elliott wave rules provides invalidation points.

Elliott wave analysis is not foolproof and it is not going to always provide the correct direction for market movement, but it is a tool which is superior to any other technical analysis tool which I have come across.



Copyright