Ramki N. Ramakrishnan

Five Waves to Financial Freedom

Learn Elliott Wave Analysis

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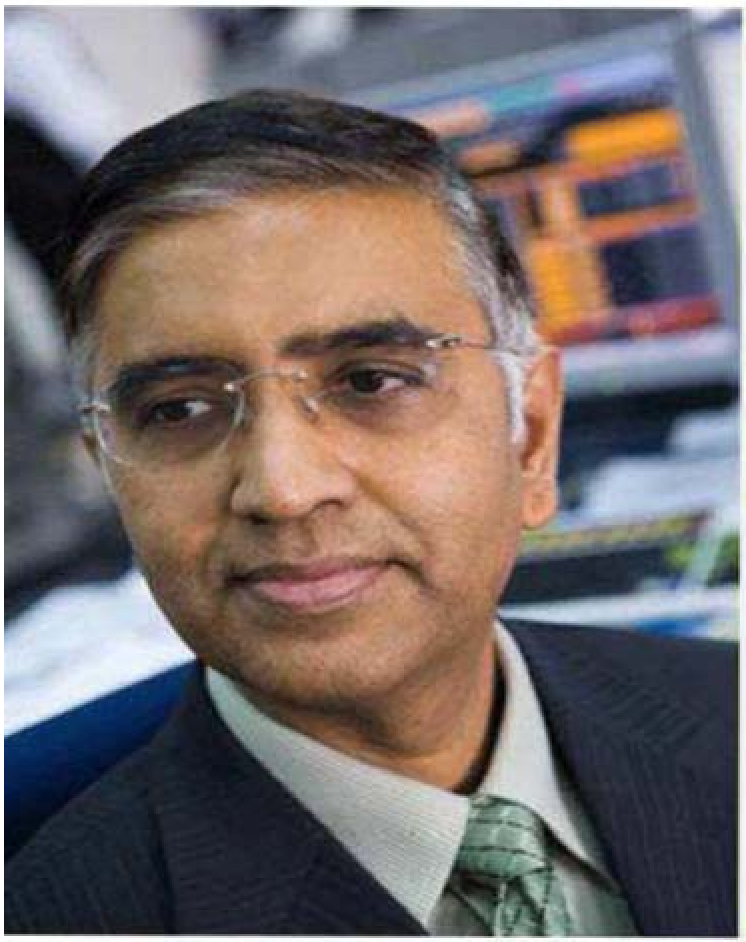

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Foreword by Hans Guenter Redeker,
Global Head of Foreign Exchange Strategy, Morgan Stanley

Five Waves to Financial Freedom

By

Ramki N. Ramakrishnan

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Visit the author website: www.wavetimes.com

ISBN: 978-0-9839680-0-9 (eBook)
Version 2011.08.26

Dedication

To my wife and two children

About the Author

N. Ramakrishnan, or Ramki as he is fondly known in the financial markets, has been sharing his analysis with a worldwide audience since 1989. His followers have mostly been inter-bank dealers and hedge fund managers. Treasurers of several large companies have also been in direct contact with Ramki over the years. He also counts several Central Banks among his followers. Ramki's analysis on the Foreign Exchange markets became a daily staple for dealers from every corner of the world. His posts on Reuters page SCXE (which many thought was sexy!) were often the very first thing that forex traders read in the morning. When Ramki moved from Standard Chartered Bank to Chemical Bank, he continued to write on CHMB. Later on, when he moved again to National Bank of Kuwait, his comments appeared on NBKG. More recently, he has been writing his views on a professional blog *www.wavetimes.com.* He now covers a wide range of instruments, including Commodities, Indices, Stocks, Interest Rates and of course Foreign Exchange. Ramki has been quoted widely in the press.

A graduate in Economics, Ramki also holds a string of other qualifications, including a Masters in English Literature, a Masters in Marketing Management, and an Associate level professional Banking qualification from both the Chartered Institute of Bankers, London and the Indian Institute of Bankers. He is also a qualified Treasury Manager, having acquired the prestigious ACT qualifications from the Association of Corporate Treasurers, UK. He topped the worldwide rankings at the ACIB examinations, with specialization in International Banking.

Ramki has been living in the Middle East for over 20 years, but his influence is truly global.

What Readers Are Saying About Ramki

Forbes columnist John Navin puts Ramki as one of three excellent Elliott Wave Analysts out there.

Buzz on "Five Waves to Financial Fortune": "*Nos teneo quis nos operor ignoro*", The very old latin phrase says it all. "We know, what we do not know" Therefore, one seeks answers to puzzling questions when one attempts to accumulate wealth by investing or trading in markets. But what one doesn't know about investing or trading, often ends up hurting you. Knowledge is the key and Ramki has coalesced important strategies (tried and true)within this ebook. Some pay thousands to learn the "secrets" of investing. Ramki brings 20 years of experience, compiles key aspects of Elliott Wave analysis, and passes that knowledge on to would be investors for $10. A marvelous read with current examples and strategies that can be immediately applied. "Five Waves to Financial Freedom" is worth 100 times the $10 price. This truly is "rites of passage" Thank you Ramki your ebook is priceless.

Ziad on **Gold** : " What a nice call on Gold Ramki, first up to your target then down to your target as well. This is BRILLIANT."

Antony on **Crude Oil** : " I was so pessimistic about Elliott Wave and believed market prices moves in random, but after reading two main post about crude oil (2008-2010) and silver Feb-2011 – june 2011…. i am really impressed and believe what i see ….about your wonderfull analytical explanation of wave count…I am here to learn more from you sir…THANK YOU FOR ALL YOUR WORK to educate newbies like me."

Manish on **Silver :** " I am a avid follower of your blog. I have to congratulate you on your precise calculations and observations of Elliott Wave. I know these tools you have acquired from experience and that too over time, one cannot have them overnight...btw, why I posted in Silver (is) because once again you are correct! "

Manoj on **NSEI** : " Tons of wishes for (NSEI reaching) your target …Can't express my feelings —At my home I always tell about your Views –I say you are GOD of Technical(s) —Personally A BIG Family Fan is Here With me !! Thanks For your Views."

Simon Eedle (Managing Director, CA-CIB) on **WaveTimes**: "I have been following Ram for my more than 20 years, first as a foreign exchange dealer in

London where I relied on his analysis to help in my short term trading, to more recently where I follow up with a much longer term view for my own investments. I have always appreciated the easy style of his analysis, you do not have to be a geek to understand all the possibilities, and overall he has added to my professional and personal profitability."

Frank on **EUR/USD**: "Thanks very much for these charts. Very informative. I was following the Euro during this period, but couldn’t make sense of the moves. Now with hindsight it looks logical. More practice for me!"

Foreword

Written by Hans Redeker, Global Head of FX Strategy, Morgan Stanley

Markets talk to us, but it will be up to the market participant to understand the 'market language'. Elliott Wave is an attempt to understand Market psychology. Different phases of bear and bull markets witness different investor behaviors. A deep understanding of the Elliott Wave theory can help one to anticipate these market swings. The structure of the past move provides information on the direction and magnitude of the upcoming moves.

Ramki N. Ramakrishnan is a long time practitioner of Elliott Wave. We met the first time when we both worked at Chemical bank, which merged into Chase Manhattan Bank and later into JP Morgan. Ramki worked as a trader while I was Chemical Bank's economist responsible for Germany, Benelux and France. I soon realized that economic forecasting can provide information on long-term trends, but economists generally fail in identifying strategic positioning.

However, the right time to enter the market is essential for long-term success. I myself started to experiment with various tools of technical analysis only to conclude that Elliott Wave can produce the best results when properly used. I started my professional career in November 1987 just one month after the October equity market crash. Time and magnitude of the crash took many investors by surprise. Robert Prechter, who made famous the 'Elliott Wave theory', had correctly forecast that crash. Post 1987, and lasting until nowadays, there has been a lot of research published under the Elliott Wave banner, and the theory has deepened and has become more comprehensive.

My friend Ramki traded markets according to the findings of his Elliott Wave research for most of his professional life. His book illustrates how Elliott Wave is successfully used from a practitioner's point of view. It is a refreshing read, giving deep insight into the theory. I enjoyed each minute reading this book and I was putting it aside only after having turned the last page of this fascinating read.

Preface

One of the greatest desires of man is to make money by anticipating the future. This is the reason why so many people go to the Races, where they try to anticipate which horse will win. Others go to Las Vegas and take their chances with a game of cards. Some others bet on which team will win a cricket or football match. But the most fascinating of all is the financial market where, as folklores go, one can turn a few thousand dollars into several hundred thousand dollars or more.

A casual search on Amazon.com will throw up literally dozens of books that purport to teach readers “How to make Money in Stocks” or share the “Secrets & Successes of Wall Street’s Best & Brightest”. One of the best known books is by Jesse Livermore, who offers, in his own words: The Jesse Livermore secret trading formula for understanding timing, money management, and emotional control”. Despite this plentiful supply of resources, most traders seem to be losing money in the stock market. What they seem to lack is a trading system that can work in good times or bad, a system that does not require the use of deep financial knowledge.

In their search for a reliable system, most people will give technical analysis a try. Typically they will start by reading about various chart formations. But when it comes to executing their trade ideas, they always seem to be lagging the market. A formation is confirmed only when it is complete, and by then it is too late to do anything meaningful.

Enter the Elliott Wave Principle, a framework mooted by Ralph Nelson Elliott who discovered that crowds tend to behave in a predictable manner. Of all the approaches to technical analysis, nothing works better than the Wave Principle in anticipating a move. However, most of the Elliott Wave resources available to the reader tend to give very old examples, and are illustrated with examples from unfamiliar markets. Moreover, in an effort to cover the subject in its entirety, some authors have taken the readers on such an exotic journey that most people want out half way through! That is a great pity because, once understood, the Elliott Wave Principle will be a most rewarding experience.

I have been writing my technical comments based on Elliott Wave analysis for over 20 years, and have come across numerous requests from traders around the world for an easy to read book. The recent market turmoil has left most people groping for a method that will work well in both bull markets as well as bear markets. After a great deal of thought, I decided to write this book with the sole purpose of teaching you in simple language how to use the Elliott Wave Principle to identify market direction and turning points. The idea is not to make you an expert in Elliott Wave analysis, rather to give you enough of grounding that you can start applying the methods being taught here fairly quickly, and to any instrument, including indices, stocks, foreign exchange, commodities and interest rates. It doesn't matter which part of the world you live and trade in. The only requirement is that you apply these techniques to instruments that are freely traded and where there is a lot of participation (basically, if you wish to apply Elliott Wave analysis to a stock that is thinly traded, your results may not be as good as when applied to a very liquid stock).

As a first step, I approached Thomson Reuters for permission to use the charts available on their robust platform. They willingly gave me the go ahead. Every chart that you see in this book has been sourced from Thomson Reuters. They own the intellectual property rights to the charts.
Next, I wrote to the Bombay Stock Exchange, and asked if they would allow me to use some of the data that they provide. They too were very supportive. The examples of Indian stocks and indices are all from the Bombay Stock Exchange, and I gratefully acknowledge their support.

I wish to thank my numerous followers for sharing with their friends the information about my blog www.wavetimes.com, (what better joy is there than sharing what we know!) This book is especially for you, with the hope that after reading it, you will become even better at navigating the financial markets. When I ran a post on my blog asking what would be an appropriate price for this book, I received hundreds of responses. The price ranged from $20 to $200. I wish to thank all of you who responded, and hope the final price you paid for this makes you happy.

Special thanks go to Bob D and Guru for proofreading this book, to Satyamurthy, Stefan De Beer, Hussain Al Aryan and Nagaraj for a string of ideas on bringing out this Book. I wish to particularly thank Hans Redeker, who, despite his very busy schedule, took time off to write the foreword for this book.

Table of Contents

Part 1

In Part 1 you are going to start from the very basics and progress quite quickly to tackle some of the most interesting and useful aspects of Elliott Wave Principle. Within a short period of time, you will be able to apply what you have learned, and transform your trading results in a very positive way.

1. The Basics First!

Most likely you are a beginner with Elliott Wave Principle (EWP). That is a useful assumption to start with! So we will start from the basics and gradually build up the level of complexity. Even if you are an experienced user of the EWP, this book will give you my own unique perspective on how to use the theory in the real world. That should make this book worth your time and money.

Let me be upfront with you about one thing. I am not planning on giving you a research type of a book that will be high on jargon and low on usefulness. This book is packed with charts, and brief comments. I prefer fewer words where possible.

Also, I am not going to spend any time extolling the virtues of Elliott Wave analysis when compared to other technical methods. There are a lot of books out there that have done a splendid job on such matters.

So let us jump into the pool directly, shall we? The shallow end first, please!

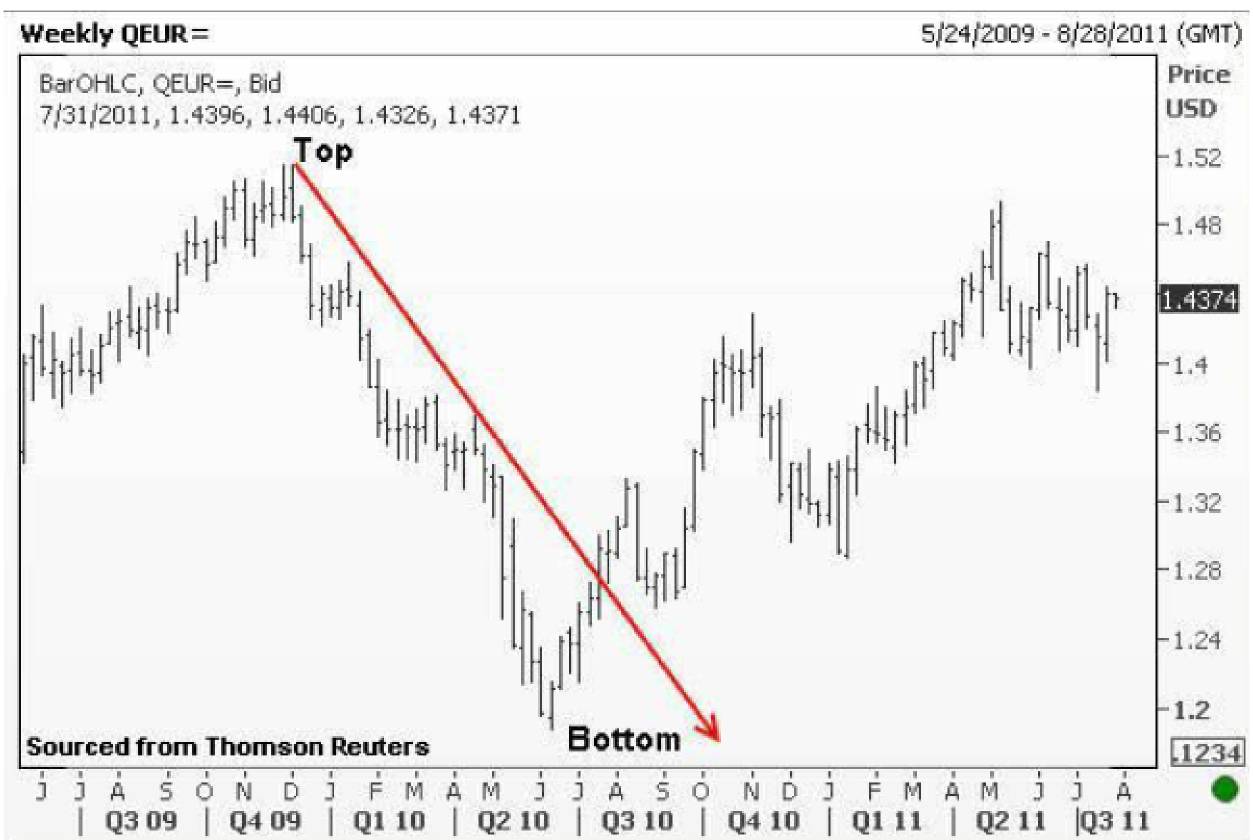

Fig 1a - A simple bar chart showing EUR/USD in a down trend

So what do we have here?

This is a *Weekly* chart of the Euro or EUR/USD. You can see the “Period” at the top left hand corner where it says “Weekly”. If I were to show you a “5 minute” chart of Gold, for example, the top left of the chart will display “5 Minutes QXAU=”. So you see both the period as well as the Thomson Reuters Symbol for the instrument being shown. XAU is the Reuters Code for Gold.

Move your eyes to the top right, and you will see what time frame is covered by the chart. In this instance, you are seeing how the Euro moved between the week of May 24, 2009 and the week of August 28, 2011. Clearly, there is a small blank space towards the right end of the chart, signifying that we haven’t gone to the month of August at the time of the screen capture. As a matter of fact, the current time is the start of the week of July 31, 2011. This date stamp can be seen again near the top left. Just above the date stamp you can see the word 'bar' followed by the letters OHLC. This tells us that we are looking at the bar chart for Euro, and the chart also shows us the Open, High, Low and Close for each week of the period covered. The actual price levels for the latest week (the current week) appears in the same order. Thus, the week opened at 1.4396, the high seen till now was 1.4406, the low was 1.4326 and the last price is the latest price at the time of the screen capture. If I placed the cursor on any of the bars to the left of the last bar, the chart machine would have displayed the OHLC for that particular week. The red colored arrow going down from Top to Bottom is what I have drawn myself to illustrate that the Euro was in a downtrend during that period. (If you are reading this using a black and white electronic reader, the arrow’s color will probably not be red!)

I am now going to show you another chart, and without looking at the notes at the end of this chapter, try and see if you can figure out all the details yourself.

Fig 1b - A 5-minute chart of Gold

Notes: This is a five minute chart of Gold. The chart covers the period from 05.45AM to 12.00PM, but currently the time (as of the last bar in the chart) is 11.45AM on July 25, 2011. This can be seen at the top left, as well as the fact that the Open, High, Low and Close for Gold (Reuters symbol XAU) for the current period were respectively $1617.80, $1617.80, etc. (I didn't explain what the Q in front of XAU stands for. But you can guess that it means a Quote!) Finally, Gold seems to have been in an uptrend during the period under review. I can also see that there is a green line connecting the bottoms and travelling upwards. This is clearly an uptrend line! Wait a minute.

Do I see that the uptrend line acted as a resistance once it was broken? Yes.

Old supports do tend to become resistances later on (and vice versa).

That was quite easy, wasn't it? Onwards, now!

2. The Concept

Sometime in the late 1930s, Ralph Nelson Elliott revealed to the world his fantastic discovery. Sure, all human beings tended to behave in a predictable manner when they acted as a crowd. But Elliott found patterns of behavior in the stock market that kept repeating itself over and over again. He likened the ups and downs in the markets to cyclical patterns.

True, the idea of market cycles existed even before Elliott came forward with his ideas. But our protagonist took it a step further. He spoke about different degrees, starting with the Primary Wave, and continuing down the scale with an intermediate, minor, minute, minuette and finally a sub-minuette cycle.

Now here is the good news. In this book, I am not going to describe whether a move fit in a major cycle or a minute cycle. Who cares so long as we can figure out where the market will go next! We will leave the academic discussions to the more learned people.

But hey! It is important for us to appreciate where we are in the bigger picture. For example, just a week before I wrote this chapter, I was focused on the 5-minute charts, and was trying to figure out whether I can make a 50-pip/tick profit on the EUR/USD. In the bargain, I missed out on a more important move that was just beginning because I neglected the bigger picture. These things will happen to all of us, but I have warned you early enough, lest I forget! Never lose sight of the bigger picture, at least of one higher degree!

So where were we? Yes, the Concept.

What has Elliott given us? In an uptrend, or a bull phase of the market, he found that prices went up in five waves. Three of these were in the upward direction, and he called these waves ‘impulse waves’. Each of the three waves was followed by a downward movement, which he called a ‘corrective wave’.

Now here is a tip. Whereas the first and second impulse waves were followed by a smallish correction, the downward move that came after the fifth wave up was a larger move. This was so because this last mentioned downward move corrected not just the preceding impulse wave (the 5th wave), but also the entire five wave sequence.

So, to recap, in a bull market, we will see three upward moves and two downward moves. Once the five waves are completed, we will get a correction that will be bigger than the two previous corrections because this downward move corrects not just the fifth wave, but the entire set of five waves up.

Let us look at a chart now.

Fig 2a - Elliott's cycle consists of eight waves: 5 waves up and 3 down

In Fig 2a, we see a 10-minute chart of Silver.

(Don't worry about the N/A, N/A you see after the prices; that's there because I had removed some other studies that were on this chart before the screen capture).

You can see clearly that the up move has been made up of five waves.

Waves 1, 3 and 5 are called impulse waves.
Waves 2 and 4 are the corrective waves.

Once wave 5 was finished, we got a down move that I have labeled a/b/c. Together, this set of abc is bigger than both Wave 2 and 4 individually.

If there is one key lesson you have learned in this chapter, it is this: Once a 5-wave sequence ends, look for a correction that is BIGGER than either of the prior 2 corrections.

Now grab a fluorescent marker and highlight the last sentence. If you are one of those cool guys and gals who are reading this as an eBook, you are smart enough to know how to highlight this, and maybe also scribble a note to yourself!

If a sequence of five waves plus three waves is completed as above from a significant low, then that completed cycle will represent the first and second waves of a cycle in the time frame of the next higher degree. Every impulse wave is actually made up of a five-wave sequence within itself. Corrective waves are usually made up of three waves, or combinations of three-wave sequences.

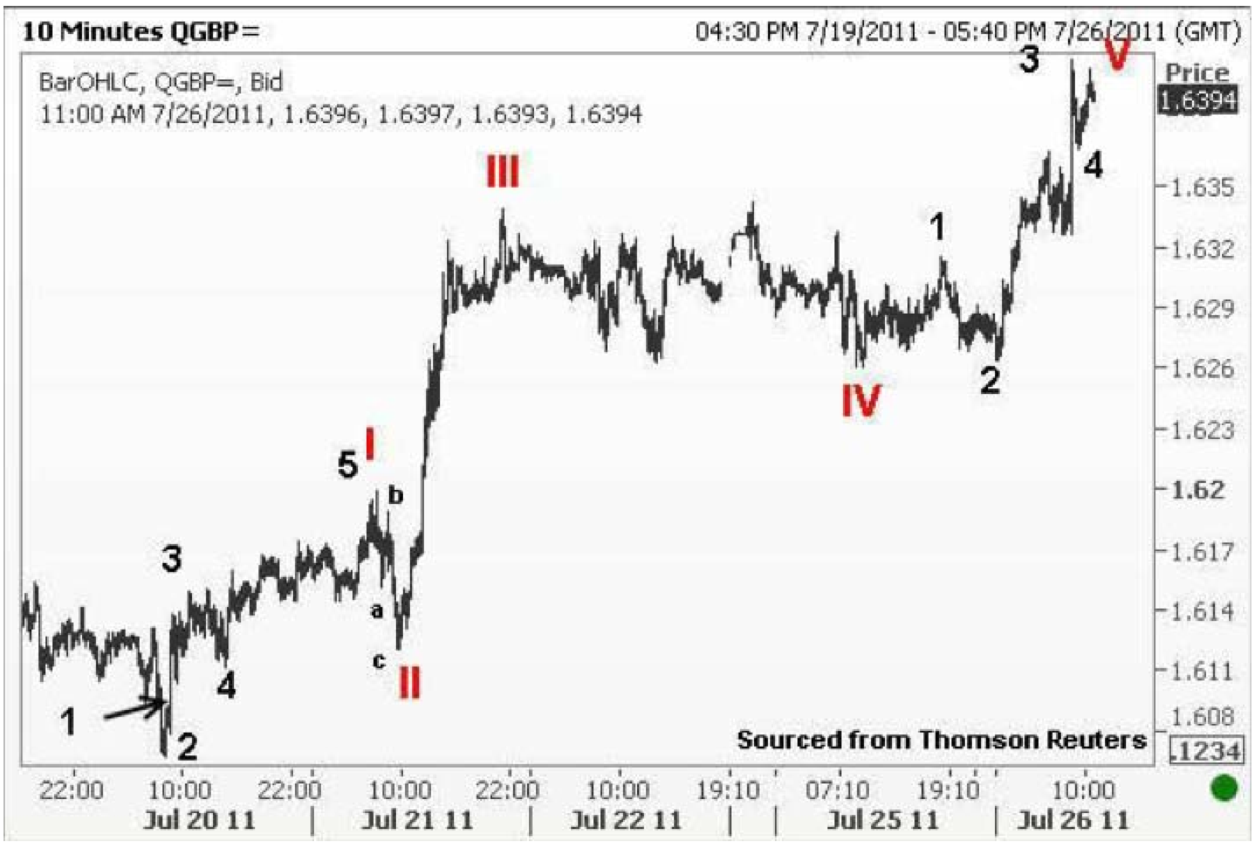

Fig 2b - Every impulse wave has 5 sub waves

Observe how Wave I and Wave V are both made up of 5 waves of a smaller degree. Wave III too had 5 internal waves, but I left it out for sake of clarity. Also note how wave II is made up of abc, a 3-wave down move. Wave IV is a complex correction, involving a combination of sets of three waves!

Before we move on to the next chapter, you need to study the above chart carefully, and see if you can remember some of the points we talked about in the prior pages. Let me remind you of the more important ones!

We are in the final stages of a short term up trend (we say short term because this is a 10-minute chart of the British Pound, and we need the bigger picture to determine where we are in the medium term). When wave 5 within wave V finishes, we would have completed all five waves of the current uptrend, and so we should look for a correction that is BIGGER than either wave II or wave IV.

That's it for now! Time for a coffee break, or a quick jog, or (sigh) the idiot box.

3. Rules of the game

There are just three straight forward rules that you need to remember.

In a five-wave progressions:

- Wave 2 can never exceed the start of Wave 1
- Wave 3 can never be the shortest impulse wave
- Wave 4 can never overlap Wave 1 (i.e. cross into the same price area) except within a diagonal triangle.

Easy enough, right? I am sure many of you who are somewhat familiar with EWP would have heard these rules before. **But this book is going to show you HOW to use the rules to your advantage.** The first rule is easy enough to understand.

Fig 3a - Wave 2 can never come below the starting point of Wave 1

In Fig 3a, if you label wave 2 where I have shown it, you will be violating one of the three key rules of Elliott Wave Principle. Wave 2 can NEVER, ever, go below the bottom of wave 1.

Now for the second rule which states wave 3 can never be the shortest of the three impulse waves. Suppose you see a situation where wave 3 was shorter than wave 1, what should you do?

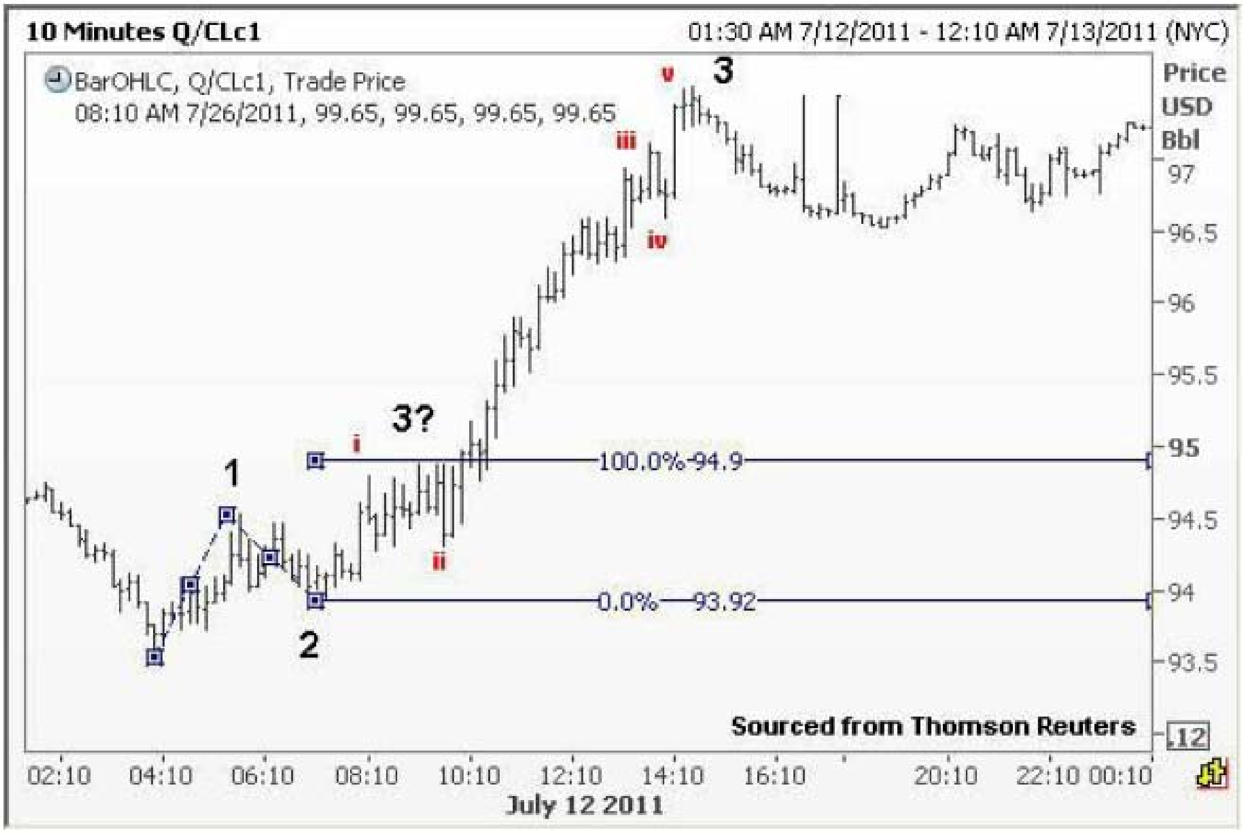

Fig 3b - In this chart of Crude Oil, we see an extended third wave

In the above 10-minute chart of Crude Oil, can you observe that wave 3 (with the question mark placed for obvious reasons!) is falling just short of the 100% measure of wave 1? Especially when you are expecting a substantial rally, you should be on the alert for a move above the top of the shortest Wave 3 to buy a large amount at once because what just finished there was potentially the first wave within a much bigger wave three, a prime candidate for extension.

Being able to spot these situations can make you very rich indeed.

Lastly, let us take a look at the third rule, which states that wave 4 cannot overlap the top of wave 1.

Fig 3c - The New Zealand Dollar is clearly only in a correction as of now

Imagine you were under the impression that a significant bottom was posted on Aug 9, 2011 in the New Zealand Dollar, and you went long at an appropriate pullback (Wave 2 bottom). Wave 3 also went up quite quickly, and you are rubbing your hands in glee. Wave 4 started off quietly, but pretty soon it was overlapping on top of wave 1 as shown in Fig 3c above. What should you do? Of course, run for cover!

Fig 3d - The New Zealand Dollar is in a complex correction

As you can see from Fig 3d, the Kiwi is in a complex correction and although it looks like a triangle at present, that shape could easily change. What we can be fairly certain is the major trend is not over and sooner or later the Kiwi is going to come off again. Hence, we should look to sell at the right levels. Never forget, it is always safer to trade in the direction of the trend. *So if you determine that your market is currently in the middle of a corrective move, spend your time to figure out where the correction is likely to end, and place your orders there to join the next move in the direction of the trend.*

4. Fibonacci Ratios

Let me be forthright about this. Knowledge of how to use the main Fibonacci ratios would be an invaluable aid in your road to prosperity. But now is perhaps the best time to caution you that many traders think they know the Elliott Wave Principle if they have mastered the Fibonacci technique. Wrong.

Without understanding the underlying wave structure, and the personality of the waves at each position, one could be blindly applying the Fibonacci ratio on the charts and the outcome would be more dependent on chance, rather than reward for work.

I am not going to tie you down with history and about the various spheres in our world where you could spot the Fibonacci summation series at work. You can easily Google it and get more information than you might care to read. Instead, I will focus on how to use the ratios in our chart analysis.

There are perhaps seven or eight main ratios that seem to appear again and again in most charts. These are 23.6%, 38.2%, 50%, 61.8%, 100%, 123.6%, 138.2% and 161.8%.

In addition to these ratios, you should also consider 70.7% as a key number.

All the ratios up to and including the 100% are used in measuring corrective waves.

For example, wave 2 in a five wave sequence could travel all the way up to the start of Wave 1.(But it cannot go below, else it will violate one of the rules we discussed earlier [See "3. Rules of the game"] When wave 2 comes down all the way to the start of wave 1, it is said to have retraced 100% of wave 1.

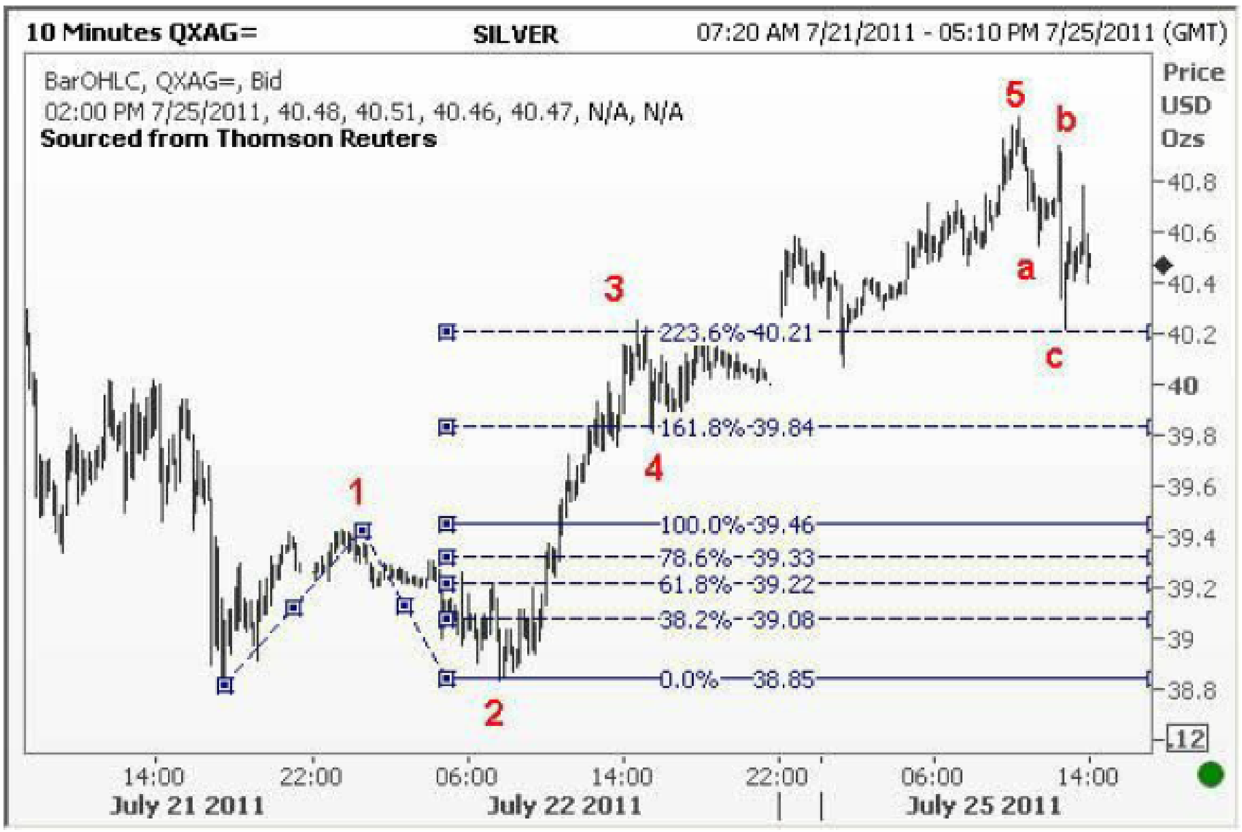

Fig 4a - Wave 2 can retrace up to but not more than 100% of wave 1

Fig 4a above shows that Wave 2 of Silver has retraced 100% of wave 1 before commencing on wave 3.

The most common retracement for wave 2 is up to the 50% level, but very often we also see a 61.8% retracement of wave 1.

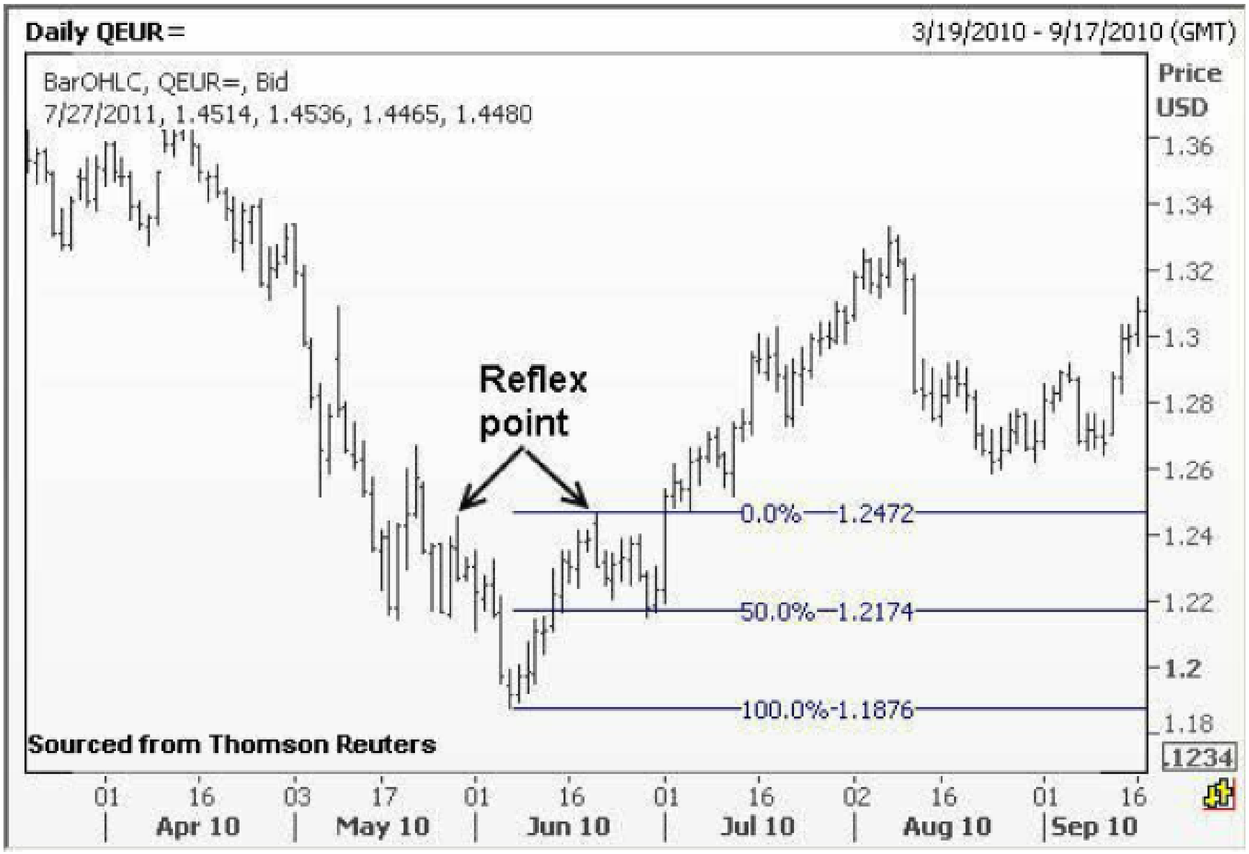

Fig 4b - Once, you see a move past a reflex point, be prepared to buy on dip

From the 100% level upwards to 161.8%, the ratios are usually used in projecting the target for either Wave 3 or Wave C in an ABC correction.

So, when you are comfortable with the view that a correction has ended, and a new wave 1 has also been completed, you will look to buy a 50% to 61.8% retracement of wave 1 with the expectation that the upcoming wave 3 will travel a minimum distance equal to 100% of Wave 1. If the third wave started from 61.8% or 100% retracement level, you will look for the third wave to tend to move a distance of 161.8% of wave 1.

Any third wave that does not travel more than 161.8% of Wave 1 is considered to be a ‘normal’ Wave 3. If it exceeds this measure by more than a few points, the trader should start planning for an extension. Elliott has said that one of the three impulse waves within a five wave move will likely be extended.

There are no guaranteed points of termination for an extended wave (not to say that there are guarantees for anything in the market!)

But ***an extending third wave, for example, could travel 200%, 261.8%, 300%, or even 461.8% of Wave 1***. These are all Fibonacci ratios that you should keep in mind, but they are seen less frequently than the ones described above.

Fig 4c - The third wave extended to 300% of wave 1

When a normal third wave is completed, wave 4 typically corrects the third wave by 38.2%. The next most likely correction level is to the 50% level. However, when the third wave has extended, it is more likely the correction will be shorter, and there is a tendency for Wave 4 to finish at the 23.6% retracement level. But once again, this is only a tendency.

If you look again at the below chart redrawn with Fibonacci extension, you will notice that although the third wave was 300% of Wave 1, the ensuing wave 4 went down to the 38.2% level.

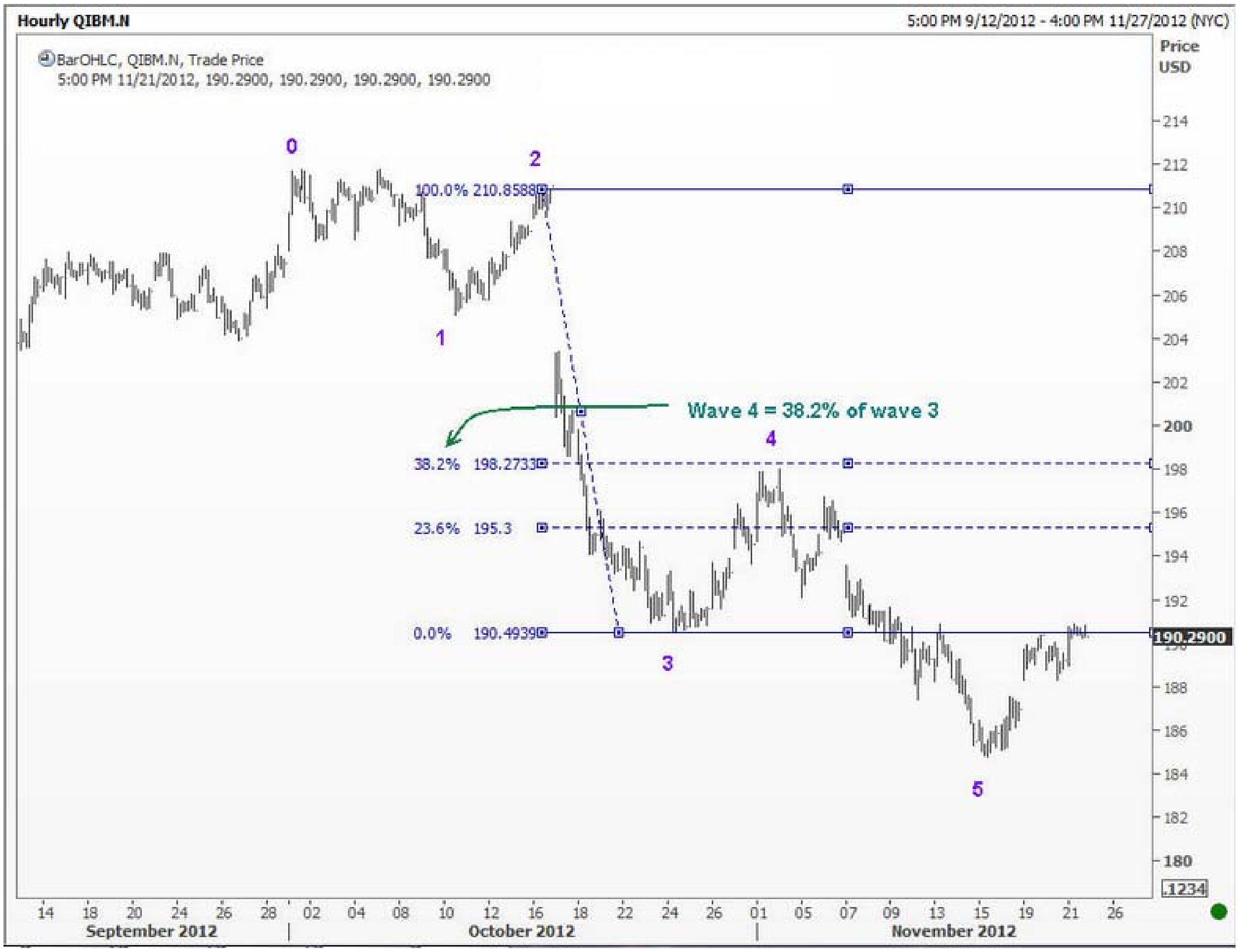

Fig 4d - The fourth wave is retraced 38.2% of wave 3

The Fibonacci ratio series is also used to anticipate the terminal points of wave 5. The technique involves calculating the distance traveled from the start of wave 1 (i.e. point 0) to end of wave 3, and computing both a 38.2% and 61.8% measure. Add the results to the bottom of wave 4, and you will get two potential targets for Wave 5. If both waves 1 and 3 were normal waves, then we should expect wave 5 to be an extended wave, and the possible target will range upwards of 100% of the distance from point 0 to point 3.

Be aware that there is a tendency for two of the three impulses to be equal, i.e. 100% of each other. So if Wave 3 is an extension, there is a bright chance for Wave 5 to equal wave 1 in distance.

There are numerous examples in this book to illustrate the working of these ratios and you will gradually become quite adept in computing targets for corrections and impulse waves. I want to mention one point here. Many traders think that they need expensive software to practice wave analysis. This is not true. To understand and practice Elliot Wave analysis, all you need is a standard bar chart, and this is often available for free at many websites. Then you need an understanding of how to compute the ratios mentioned above. So don't be intimidated by the lack of the software that I use to draw the Fibonacci grids! You really don't need it.

You might want to read this blog post before you proceed:
http://tinyurl.com/fibonos

5. Impulse Waves: Wave 1

In the last chapter, you were introduced to the impulse waves. All impulse waves are made up of five internal waves. Fortunate is the person who manages to buy at the start of the first wave and sells it out at the end of the fifth wave! Can it be achieved?

Let's be honest here. I have had several trades where I went long at the very bottom. But I have never been able to hold on to such positions till it reached the end of wave five. This is due to my psychological make up! And I believe most people are like me. However, it is possible for one to buy very close to the bottom, and hold on to it till almost the very end of the move. It requires tremendous discipline, but it is possible.

The key to success consists of several important steps:

- Identifying a low risk entry point before the markets reach there
- Having the courage to act on one's belief, i.e. to buy at the identified level and not wait for more confirmation.
- Having the discipline to hold on to the position till your view is proved wrong, or till your profit objective is reached
- Immediately getting out of a position the moment it is confirmed your analysis is wrong
- Staying out of the market when you are unable to come up with a valid wave count

I will try and show you how to achieve many of the above steps. Let us begin by looking at impulse waves a bit more closely.

In this chapter, we will look at wave 1.

The First Wave

The first wave in a bull market starts from a significant low. What do I mean by a significant low? I won't quarrel with others about what they think is the right explanation for this. As far as Ramki is concerned, it depends on our trading time frame.

If you are trading the hourly charts, where your trading horizon is only a few days at most, look at the daily chart and spot the lowest level seen in the recent past. That is your significant low. A more scientific explanation will be to look for a cycle low, i.e. look for the end of a 5+3 waves move, because at the end of that cycle, we should commence a new cycle.

But what is more relevant for us, as traders, is to figure out how to spot a first wave as it begins! It is a no-brainer to realize that the end point of a correction is the starting point of a new impulse wave.

For example, the ending point of wave 2 is also the starting point of wave 3. Likewise, the ending point of wave 4 is the starting point of wave 5. What about wave 1, you ask. Wave 1 starts at the ending point of the prior correction! Hmm, come again!

You see, it is like this. We cannot go back in time and catch a stock at the very bottom of its first rally. So let's get practical. We are going to get on board the next rally when a correction ends. The first wave we seek could possibly be the first wave within a third wave, or within a fifth wave, or even within a correction!

How can we spot the end of a correction?

A correction is usually made up of three waves, but the key thing to note is the last wave within a correction should be made up of five waves (for example, if the correction is made up of waves a, b and c, then wave c will be made up of 5 waves).

So if you can see a fifth wave finishing on the way down, you are getting close to the end of that move, right?

Suppose you have done your homework well, and identified a possible end point for the correction that is in its final stages. (I will teach you how to do this later on). You will now watch the market like a hawk, waiting for a tiny five wave rally. When you get a 3 wave correction of that rally, you will immediately jump on board.

Where will you place your stop-loss order?
It will be just below the starting point of the tiny five wave move you spotted. Why? Remember the rule that wave 2 can never go below the start of wave 1? That is why.

Let us look at it another way. As you spot the tentative end of a correction, you will notice a reflex point in the final stages of the move that is ending. This will probably be the 4th wave end within the fifth wave of the correction that is almost over. Wait for a rally to get past this reflex point, and then start counting the waves from the low. If you can count a minor 1-2-3-4-5, you have probably seen the completion of a tiny wave 1 in a new cycle. So now you will get ready to buy on the dip. If after passing the reflex point you can only count 3 waves, and especially if wave 3 was only equal to wave 1, you have to be doubtful.

In my experience, wave 1 is rarely a clean formation. The markets tend to build a base after a steep decline, and very often we will get repeated tests of the low. Occasionally, the move will resemble a wedge, which is known by a special name: diagonal triangle (More about that later!) So we will have to take our chances if we wish to get into a trade at the very bottom! Some traders will use oscillators and divergence studies to gain in confidence. Most standard technical analysis books explain how to use divergences to trade. You can also find lots of websites that discuss this technique. What I urge you to do is to keep Elliott Wave Principle as your main tool, and use these other tools to support your main view.

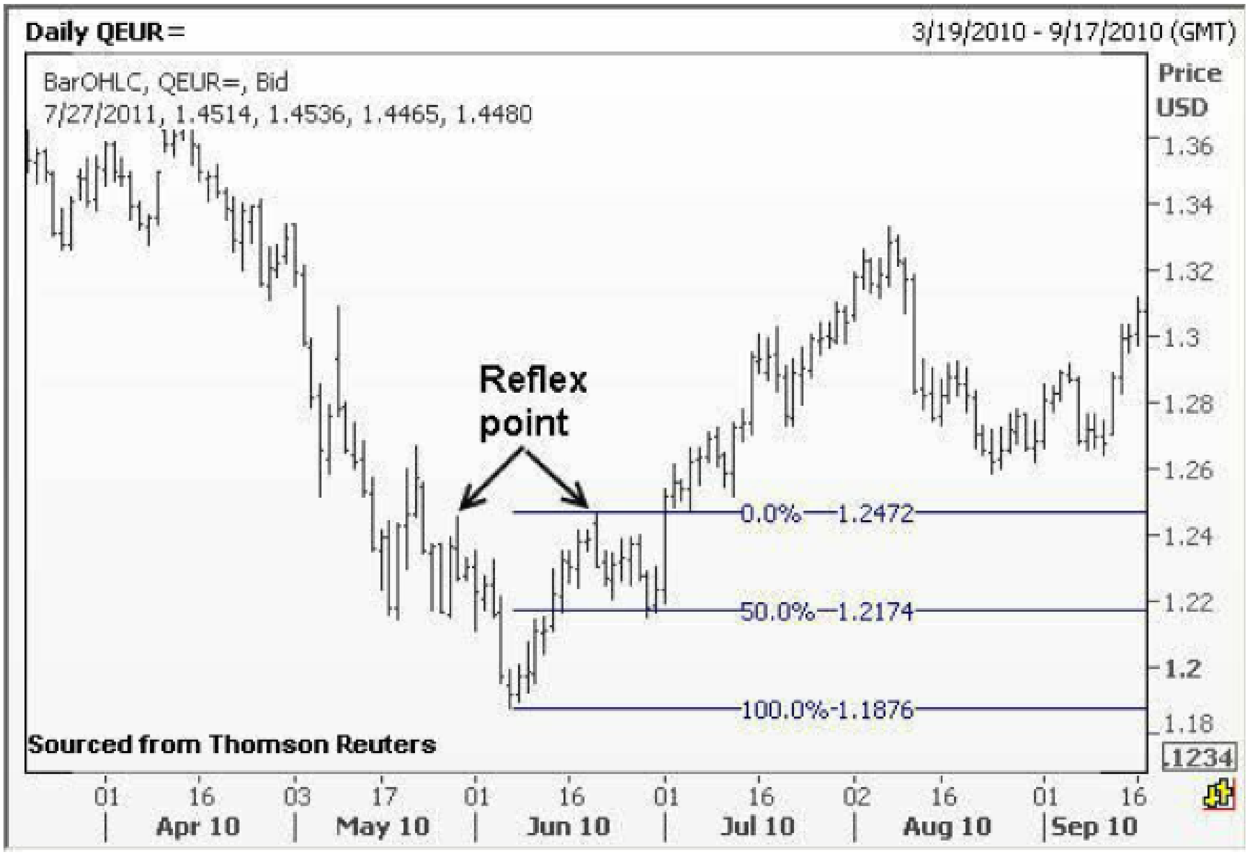

Fig 5a - Once you see a move past a reflex point, prepare to buy on dip

Observe in Fig 5a that the Euro went slightly past the reflex point in the prior decline. If you had confirmed from the hourly charts that this move up was made up of five waves, then you will get ready to buy at the 50% to 61.8% pull back (more about these ratios later) Your stop would have been below 1.1876 now. Well, OK, that was a large stop! But that was a daily chart.

How about a shorter time frame, you ask? Let me see….

How do you like a 1-minute chart of Crude oil? Take a look.

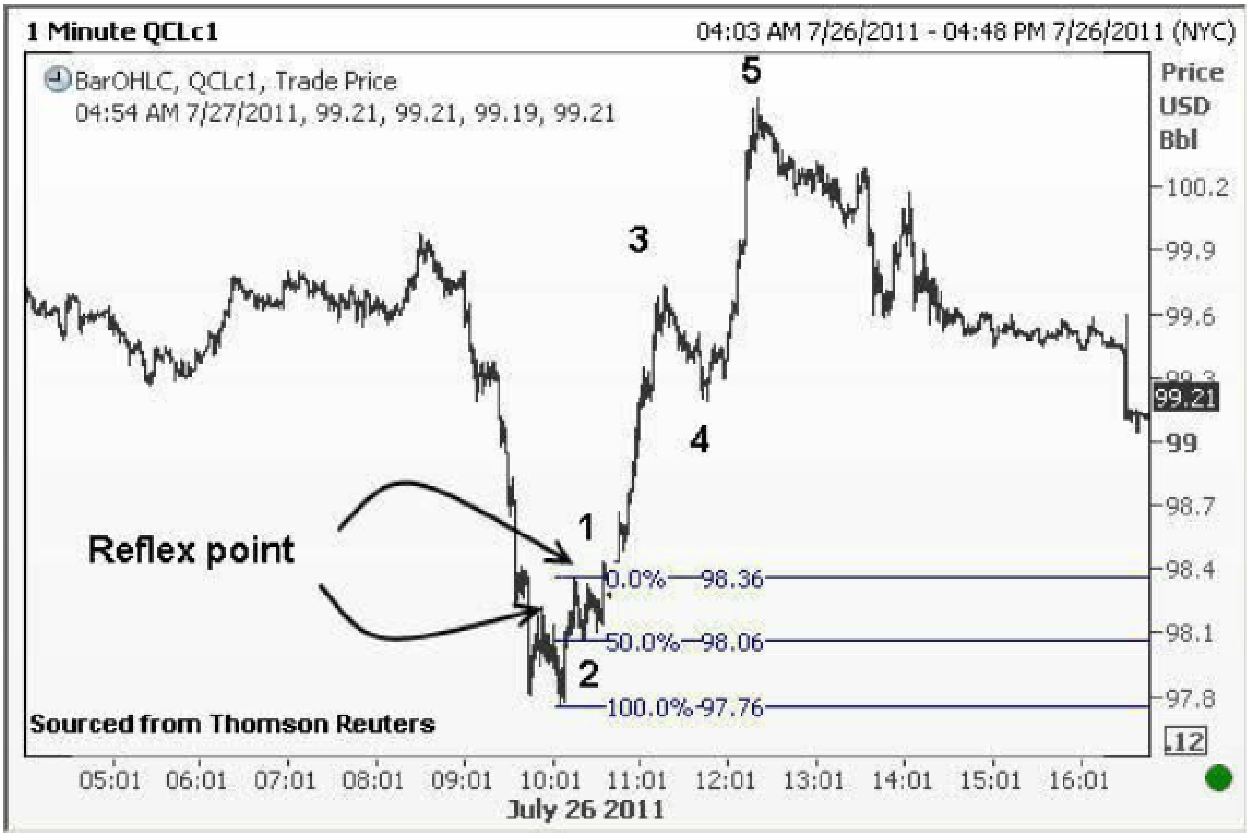

Fig 5b - Wave 1 went past the prior reflex point in this 1-minute chart

Clearly, the same technique can be applied over all time frames and across any well-traded instrument.

How about looking at a first wave down after reaching the top of a move? Remember, even in a correction there are two impulses, for example, in a 3-wave (ABC) down move, wave A and wave C are considered impulses.

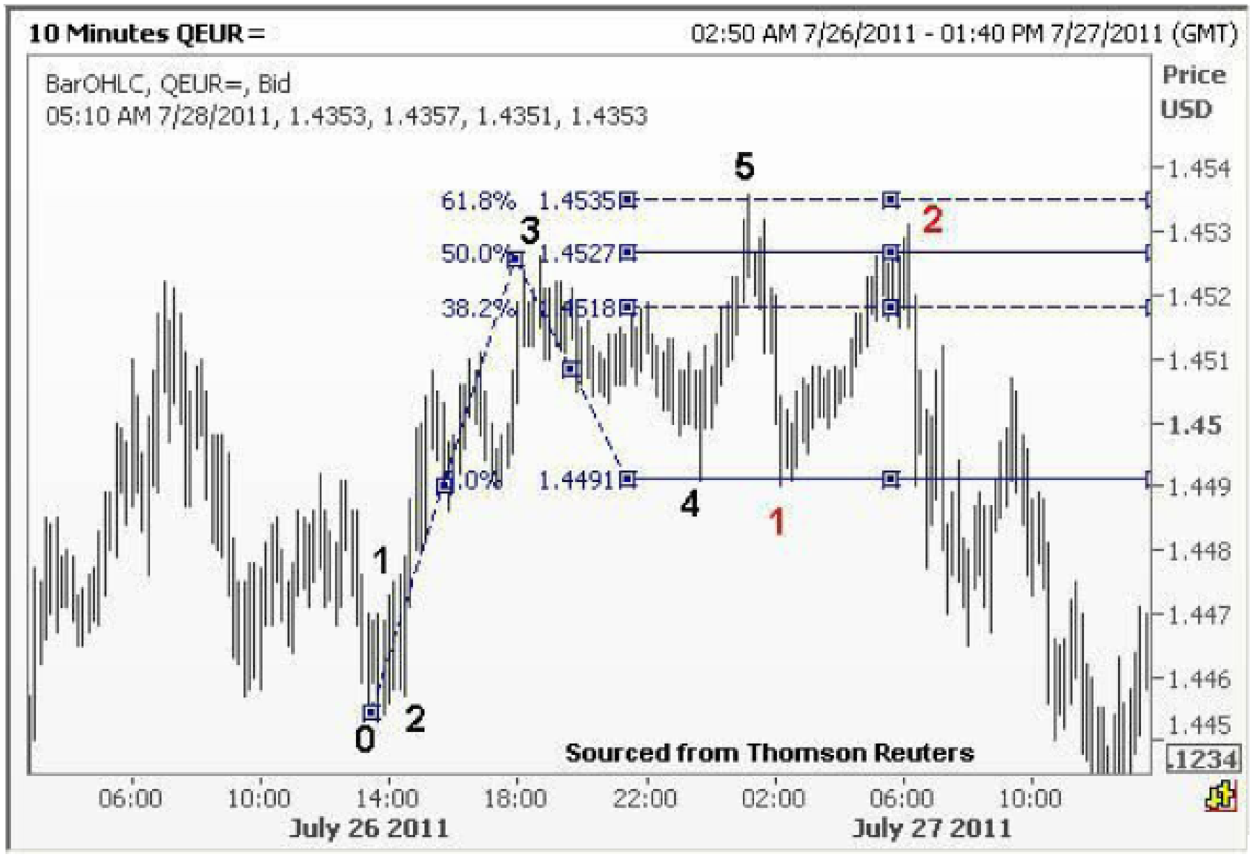

Fig 5c - The technique works in down trends as well

When you see a topping out 5 wave move as shown by waves 1 to 5 in Fig 5c, you will be on the alert for a down move that will take it to the prior reflex point (wave 4 level here). You will then see if you can make out 5 tiny waves within the new move down and potentially label it wave 1 (red color). Thereafter, you will look to sell on a 50% to 61.8% retracement and keep a stop loss above the top of wave 5, which tentatively coincides with the start of the new wave 1. In case you are wondering what happened to that move, here it is!

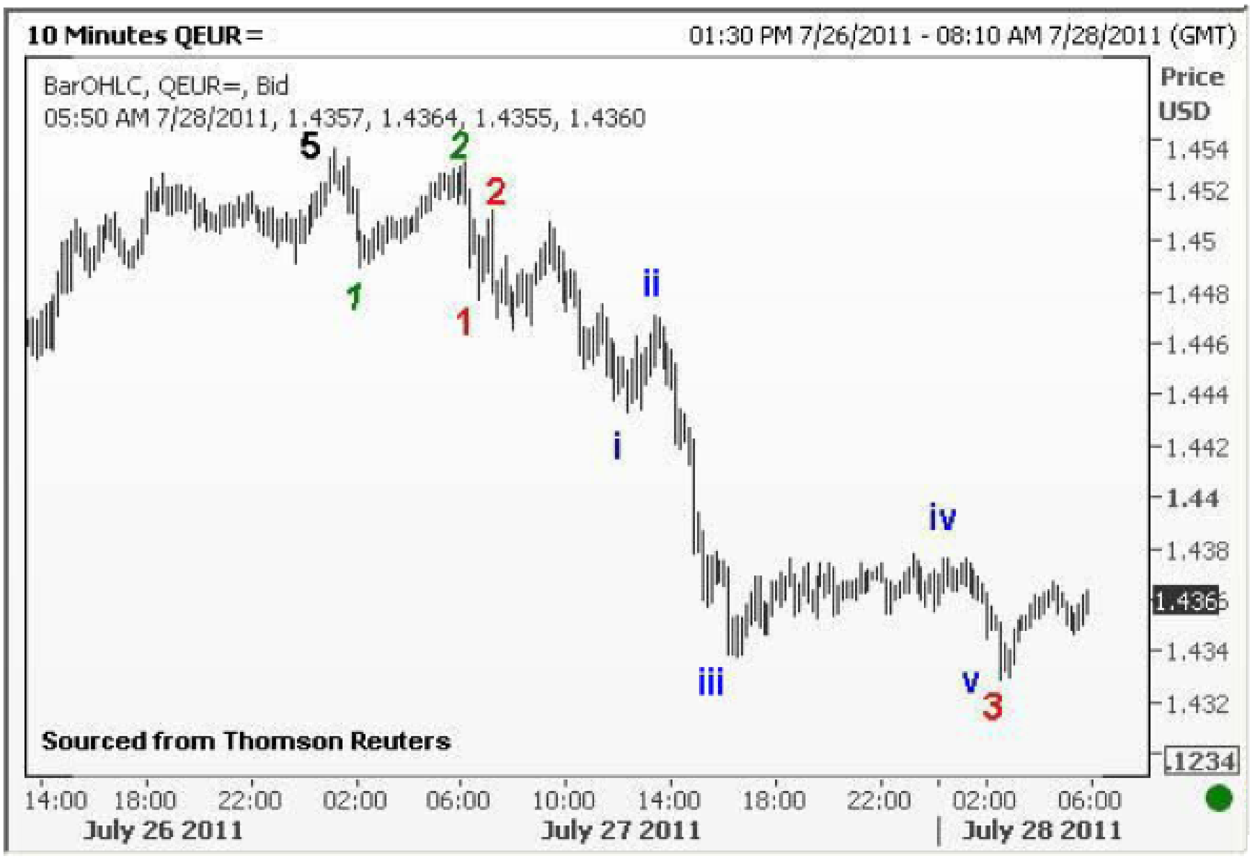

Fig 5d - Selling on the pull back was hugely profitable

6. Impulse Waves: Wave 3

Third waves are wonders to behold!

Prices will typically take off in a powerful fashion, and the more you delay joining in the direction of the move, the farther it will go away. Stop loss orders will all get executed and push the prices more and more. Even fundamental news will get interpreted to suit the move (i.e. even if the news was bad, the market will somehow interpret it to mean the worst is over!) During an uptrend, any trader who tries to pick a top and sell for a brief correction will soon find himself stopped out. At the end of the day, there will be blood on the street! The cat will get kicked at home, and the wife will listen (probably for the umpteenth time) how our trader had the right ideas, and was waiting for a pull back to buy; only the pull back never came. He could have made his month's profit target in just one move, and he missed it.

Out of the five waves that make up an impulse wave, three are in the direction of the trend. These are typically labeled waves 1, 3 and 5. We have already discussed wave 1 in the last chapter. Wave 3 is usually the longest and strongest. In fact, just by looking at any chart, you can figure out a third wave. The slope of the 3rd wave is almost vertical. Try it now. Flip back and forth to any image in this book, and check it out yourself.

Let us turn to how to deal with a 3rd wave.

Naturally, you want to be part of the move from the best possible level, right? Unfortunately, there is no guarantee about exactly where the second wave will end. However, you will be able to make an educated guess about where wave 2 is likely to end, using techniques that I will explain in the chapter dealing with corrections. [See "11. Simple Corrections- Zigzags"] But at this stage, you need to know that Wave 2 typically finishes at either the 50% or 61.8% retracement of Wave 1. Occasionally, we also get a 70.7% retracement, and a bit more frequently a full 100% retracement of Wave 1.

The key point to remember here is Wave 2 can never go below the bottom of wave 1. Thus, your stop loss order will have to be placed a few tics below the low for wave 1. This allows you to determine in advance what your maximum loss is going to be for this trade. Once you have reasonably satisfied yourself that wave 2 is very near its completion point, you will have to take a bold stance, (which includes the ability and willingness to suffer a small loss), and enter the market.

Once you are in the position, there are three things you MUST do. First, you should place your stop loss order below the bottom of wave 1. Second, you should cease looking at the price every few minutes to see whether the 3rd wave has started! Frequently, this anticipation and waiting makes one nervous, and many traders exit the position solely because they are anxious. The third thing you should do is to refuse to take profits until your profit objective is met.

Of the three impulses within a five wave up move, Elliott says it is usual for at least one to be an extended. An extended wave is a move that travels a distance farther than what is normal.

We will deal with extensions later on. But be aware that the most common place for an extension to happen is during the third wave. This is one of the reasons why I urge you to refrain from taking profits during a third wave.

How can you know that the third wave has started? You will see prices moving up suddenly and swiftly. When you look at the chart, you can immediately see that the third wave is steeper than the first wave. Volume will typically increase during the third wave.

Sometimes, a trader goes long very close to the bottom of wave 2, and prices start going up. However, he sees that the price is moving up rather slowly. So he starts getting all nervous. Suppose there is an economic news release that affects his market. He might even see the prices coming down instead of going up. Occasionally, it will go below the level he went long, and the panicked trader will cut his position immediately, because he can’t bear to see what will happen next. But so long as the bottom of the prior wave 1 was not violated, it often turns out that the economic news merely served to shake off weak traders such as our friend. Two or three minutes after he cuts his position, the market will abruptly turn around, and race higher, and in a matter of a few hours, will be close to the profit target that the trader had originally planned for.

It is precisely because of the regular occurrence of the above described scenario that I am urging readers to place their stops below wave 1, and not look at the position for a while, especially if there is economic news in the way.

Now there are a few additional points that you should take note here. As already mentioned, the third wave cannot be the shortest of the three impulse waves. This means it can be shorter than wave 1, provided wave 5 is shorter still. So you cannot conclude that what is finishing is not a third wave merely on the fact that it is shorter than the prior wave 1. It could be that wave 1 had extended, and hence wave 3 was a normal wave. That brings us to the question, ‘what is a normal wave 3’?

A normal third wave should typically respect the relationship that internal waves bear to each other. What are these relationships?

It is normal for any two impulse waves to tend to equality. For example, waves 1 and 3 could be equal, or waves 3 and 5 could be equal, or waves 1 and 5 could be equal. When I say equal, bear in mind that this is, an approximation. So, inside a normal 3rd wave you will observe such a relationship between the sub-waves.

If wave three (now we are talking of the bigger wave 3) travels beyond the equality measure of wave 1, then the next likely target will be 123.6% of wave 1, or 161.8% of wave 1. So long as wave 3 does not go farther than 161.8% of wave 1, then we will assume that this was a ‘normal’ third wave.

What happens when a third wave goes beyond 161.8% of wave 1? In this case, we will conclude that wave 3 was undergoing an extension! How far can an extension travel? Honestly, there is no way one can tell in advance (which is another reason why you should not rush to take profits if you are on board a third wave, because who knows, it could extend tremendously, and make you stinking rich!)

However, beyond the 161.8%, typically one will see the market pausing for breath at the 200%, 261.8% and 300% measures of wave 1. We will deal with these ratios in a separate chapter. [See “8. Impulse Waves: Special Cases-Extensions”]

Now let us look at some charts to illustrate what has been discussed above

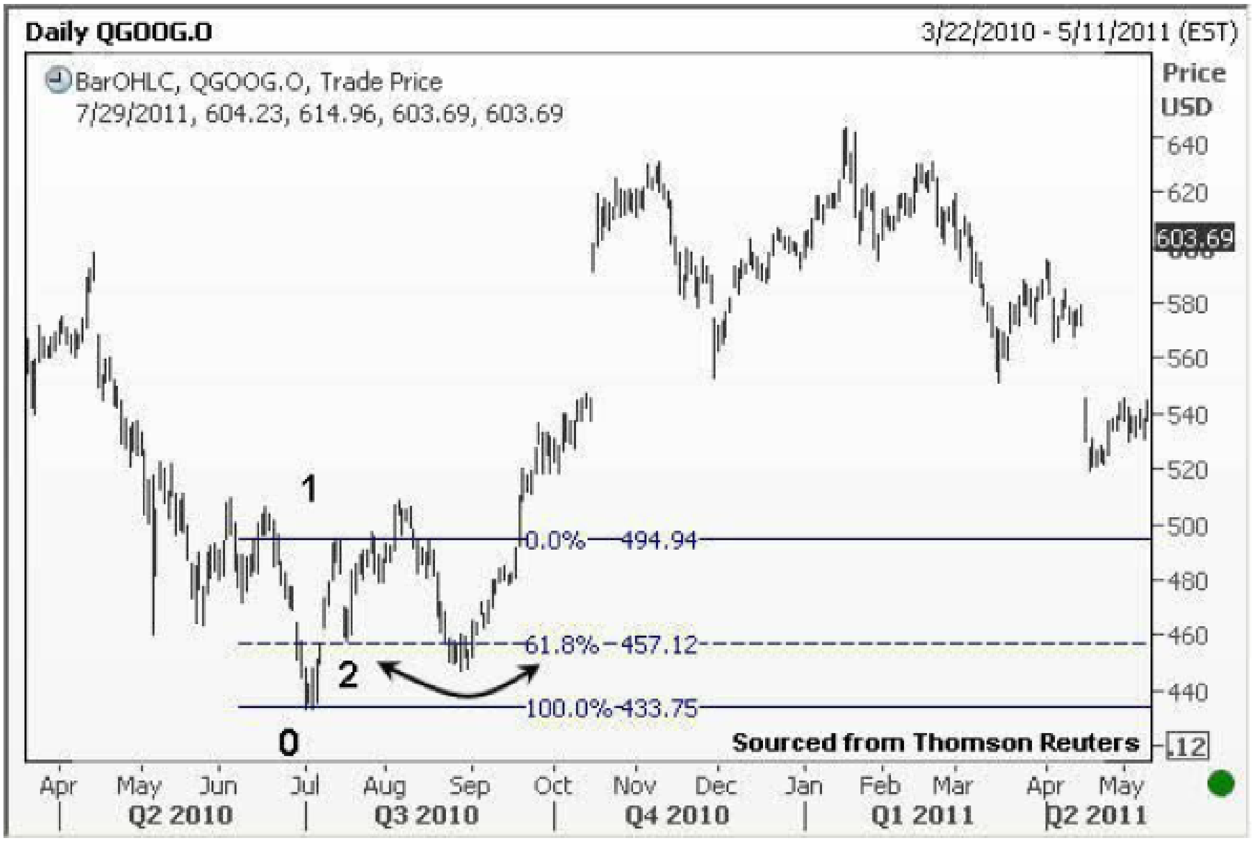

Fig 6a - While a 61.8% pull back offers a good support, it is not a guarantee to halt correction

In Fig 6a, you are seeing a daily chart of Google Inc. Upon seeing a sharp rally [See "5. Impulse Waves: Wave 1"], our trader places a buy order at the 61.8% retracement of wave 1. He is overjoyed that his order is filled, and price is edging higher. Then, quite unexpectedly, things take a turn for the worse. Not only does he see his entire profits vanish, but the price of Google drops even below his purchase price. (This is exactly the scenario I have described earlier in this chapter). What should he do? The best advice is to stay put and see if his original stop loss below the point 0 gets done. He was willing to take that loss a few days ago. Why should he suddenly become more risk averse? Sure enough, once the weak longs were shaken off, Google commenced its third wave up, and it happened to be an extended third wave, reaching 300% of wave 1. See Fig 6b below.

Fig 6b - The third wave extended to 300% of wave 1

There are other points that are noteworthy. During a third wave, one will often observe there are gaps in prices. This frequently happens because stop-loss orders get done, and more and more people wake up to the fact that the price is running away from them. You will also notice that volume spikes higher during the third wave. These are illustrated in the Google chart below.

Fig 6c - Third waves often experience gaps and volume spikes

7. Impulse Waves: Wave 5

One of the strange tendencies for traders is to become fixated to playing the market either from the long side, or from the short side. Some traders are perpetual bulls, while some others are perpetual bears. If a trader is a perpetual bull, he would prefer to sidestep the entire down move and wait for a proper signal to buy. Likewise, the steadfast bear will be more comfortable in taking sell signals! For these kinds of people, identification of the terminal point of a move becomes all the more important. But even for the traders who are comfortable playing from both sides of the market, knowledge of the likely end points is very important.

You already know that there is a tendency for at least one of the impulse waves to extend. If the first wave and third waves were normal, (i.e. if wave 1 did not have any extensions inside it, and wave 3 was not more than 161.8% times wave 1) then wave 5 is a prime candidate for extending. On the other hand, if wave 1 had extended, then wave 5 would tend to be equal to wave 3.

As a first step, you need to figure out where wave 4 is likely to end (this is explained in the chapters dealing with corrections). Once you know that wave 4 is finished, and wave 5 has begun, you will start doing some calculations using the Fibonacci ratios.

Take the distance from the start of wave 1 (point 0) to the end of wave 3 and compute the following ratios: 38.2% and 61.8%. You will then add the results to the end of wave 4 to arrive at two potential targets for wave 5. Of course, if you are expecting equality to wave 3, the number you will add to the end of wave 4 will be the distance traveled by wave 3.

If you are expecting wave 5 to extend, then you will measure the distance from 0 to 3, and add that full number i.e. 100% of the measure to the end of wave 4. This will be the most likely target for an extending wave 5. But sometimes wave 5 goes to 161.8% of the distance travelled from 0 to 3. As I have said before, you can never tell in advance where an extending wave 5 will finish. However, you can still look at the internal waves of the wave 5 and do the same steps as outlined in the last few chapters. You can find out where the fifth wave of wave 5 will finish by doing the exact same steps as outlined above.

Let us now look at some examples. When I came into the office this morning, I looked at the chart of the Euro. The time was 06.50 GMT which you can see at the top left corner of the chart. I could immediately make out that we are in the fifth wave of a move. It was also evident that wave 3 had extended. (You don't even need to do any measuring to see that)

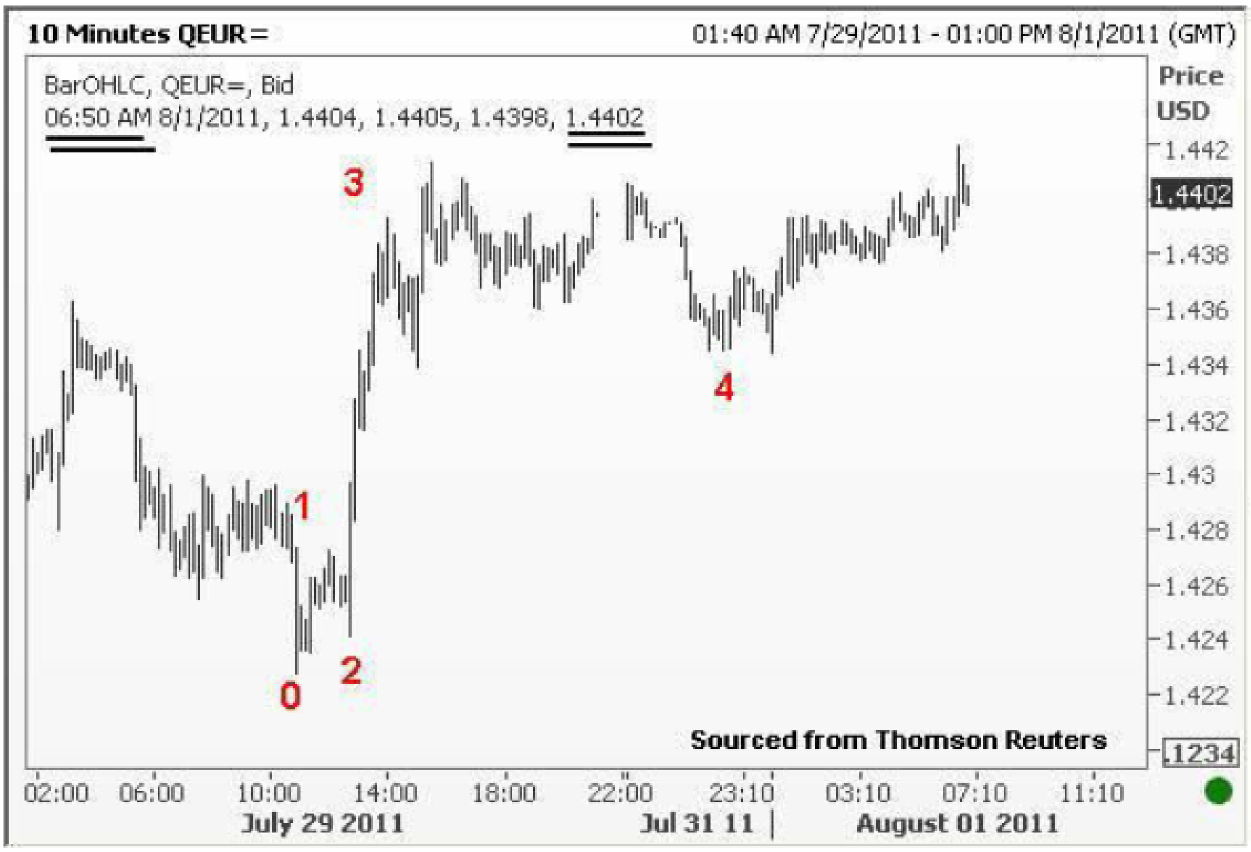

Fig 7a - Planning the trade as we approach the fifth wave end

I also knew that a complex correction was completed where I have marked as wave 4. So all I need to do now was to figure out where to sell!

So I used the technique outlined earlier in this chapter. I used my easy tools to figure out where the 38.2% and 61.8% of the move from point 0 to point 3 will land, and saw at once that the Euro had already crossed the 38.2% level. So the place to sell was around 1.4445.

Just to make my point that you don't need these fancy technical tools to come to the same conclusion, let us work out the numbers using a simple calculator. The point 0 was 1.4228. The point 3 was 1.4393. So the difference between these two was (1.4393 minus 1.4228 =) 0.0165. I then computed 61.8% of this number. 0.0165 x 61.8% = 0.0101. Add this to point 4 which was at 1.4345, you get (1.4345+0.0101=) 1.4446.

Fig 7b - Computing probable end points of wave 5

Next I decided to look at the internal waves of wave 5 itself, to see if I can fine tune this a bit more.

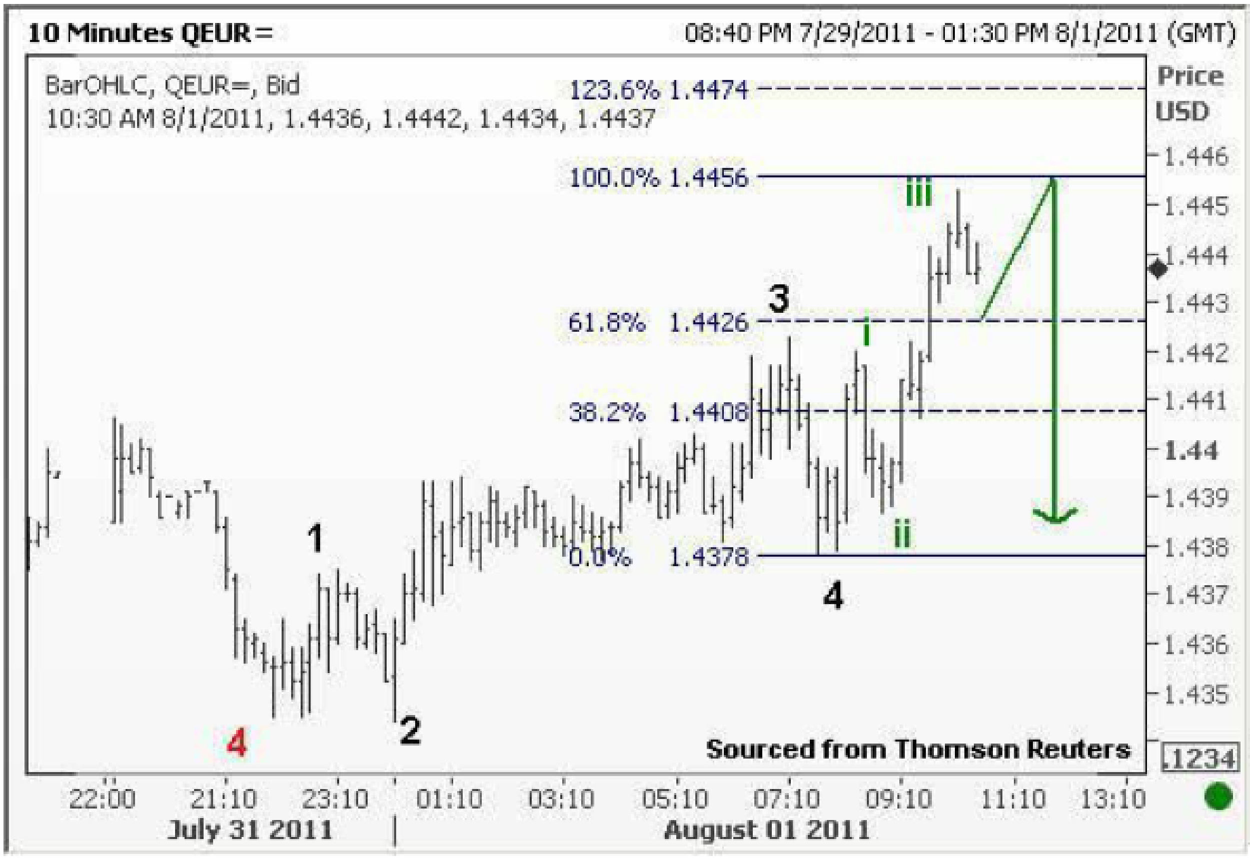

Fig 7c - Looking at the internal waves of the fifth wave

I figured that there existed a small chance to reach 1.4456 as can be seen from Fig 7c. But more importantly, because wave 3 and wave 1 were ‘normal’, I thought that wave 5 (within the fifth wave) was going to extend). This is how I figured out the 100% equality measure for this final wave 5 as seen in the chart above. I will later on be sharing with you some key information about how extending fifth waves can make you very profitable. But let us see what really happened.

Fig 7d - The euphoria when a trade works out well!

The actual top was 1.4453 and by 15.10 pm the Euro was trading below 1.4200. This is the power of Elliott Wave analysis. If you carefully study the techniques taught so far you will already start seeing improvements in your trading performance.

You might be wondering how the sell off managed to break below the start of wave 1 in the above example. The reason is it was the third step down in the larger picture, as illustrated in Fig 7e below.

Fig 7e - Always keep the big picture at the back of your mind

Notice how the sell off is pausing around the 100% measure of the first move down. If you look carefully, you will also see that the correction to 1.4453 was a complex correction, where the B wave was below the end of the first five wave move. We will talk about corrections in a subsequent chapter, but just remember here that C waves are made up of 5 waves, and that was the rally to 1.4453 which we witnessed earlier on.

8. Impulse Waves: Special Cases-Extensions

Now let us turn to the special cases when dealing with impulses. You already know that one of the three impulse waves will extend. So let us deal first with extensions.

What is an extension? It is a wave having disproportionately larger amplitude. How can we discover that wave 1 was extending? You have already read that wave 1 is, in itself, made up of five smaller waves of one lower degree. Suppose the minor wave 3 travels more than 161.8% of minor wave 1 then we are seeing an extending wave 1. Suppose wave 3 is of normal proportion. Once the minor wave 4 is finished, you should draw a channel where the lower line connects the bottom of minor wave 2 and minor wave 4. The upper parallel line should be made to touch the top of minor wave 3. If the minor wave 5 goes above the top of this channel, then we are seeing the minor wave 5 within wave 1 extending, which means the whole wave 1 is an extending wave!

Extending third waves are relatively easy to anticipate. If wave 2 was 38.2% or less than wave 1, i.e. if the correction of the prior impulse wave was abnormally short, then there is a very high probability for the next impulse wave to extend. (The same goes for wave 5. If wave 1 was normal and if wave 4 was abnormally brief)

It is just as common to see a fifth wave extension as you can see a third wave extension. The only difference is third wave extensions are quick to reach their targets. When waves 1 and 3 are of normal proportion, and especially if they are equal, then the chances are high for a fifth wave extension. Occasionally we get two extensions in a five wave sequence. When these are the third and fifth waves respectively, there is an even greater chance for a sharp correction once the extended fifth wave is completed. As you have seen several examples already of extending third waves (and there are more to come!), let us look at this last case of two extensions in a five wave sequence.

The following charts are of Tata Consultancy Services Ltd, a blue chip Indian stock.

Fig 8a- Extensions within an extension

As you can see from Fig 8a, wave 3 had travelled to the 300% projection of wave 1. It is interesting also to note that wave i within wave 3 was an extended wave by itself (one of the special cases mentioned above.) We then saw an irregular correction as wave 4.

Fig 8b - When wave 3 extends, look for a brief wave 4

The irregular wave 4 came down to the 23.6% retracement level. You already know that when a third wave extends, the ensuing fourth wave has a tendency to come down only by 23.6% of wave 3.

Fig 8c - Occasionally we get two extensions in a 5-wave sequence

In Fig 8c, you can see how I have tried to project the possible end point for wave 5. But it has gone above the 61.8% measure of the distance from 0 to 3, and has approached the 100% level. Clearly, wave 5 is also extending, the rare case of two extensions within a five wave sequence.

Fig 8d - Internal wave counts help to fine tune turning points

Finally, in Fig 8d above you can see the internal waves of the extended fifth wave. Wave 3 has travelled 461.8% of wave 1. We then came down to the level marked wave 4, but I have put a question mark there. This is because there is a small chance that we are in the middle of a complex correction and so wave 4 might have finished at the point where I have tentatively placed the number (1) to the right. As far as the investor is concerned, he should have gotten out of this stock at the point marked wave 5 top because that was as high as one could ride his luck in an extended fifth wave. In the not too distant future, we should expect Tata Consultancy stock to be dumped and for it to reach the low 800 level.

9. Impulse Waves: Special Cases-Diagonal Triangles

Remember the rule which says that wave 4 in an impulse wave cannot overlap the top of wave 1? Well, there is one exception to this rule. Every now and then, either wave 1 or wave 5 will take the shape of a wedge. Elliott has called this formation a Diagonal Triangle. A diagonal triangle differs from a regular (horizontal) triangle in that it slopes in the direction of the trend. So when the eventual break out happens, the next move will be in the opposite direction.

There are two main types of diagonal triangles. One is where the two boundaries of the triangle converge and the other where they diverge. The second type is known as Expanding Diagonal Triangles. *Irrespective of whether they are converging or expanding diagonal triangles, if they occur in the first wave position, where they are known as 'leading diagonal triangle', the internal waves are made up of 5-3-5-3-5 sub waves. If they occur in the fifth wave position, they are known as 'ending diagonal triangles' and the internal waves are made up of 3-3-3-3-3 sub waves.*

These two types of diagonal triangles also occur in corrections, but in this chapter, we are dealing only with their impulse wave avatars!

First of all, in a converging diagonal triangle, you will notice that the third wave will be shorter than the first wave, and the fifth wave will be shorter than the third wave. You will also allow the overlap of wave 1 by the fourth wave.

Let us take a recent example using the daily chart of Gold to illustrate this.

Fig 9a - Leading Diagonal Triangle in Gold

In Fig 9a you can see that waves 1 and 3 were normal waves, which increased the odds for a fifth wave extension. The first sub wave within the extended fifth wave developed into a leading diagonal triangle. To be honest, in its early stages, I was very suspicious of the recovery from wave 4 bottom because of the overlaps. But when the move started and went back into the wedge there was no mistaking that we finished a leading diagonal triangle as wave 1 within a fifth, and so we should see Gold much higher.

Here is the Hourly chart of Gold, to zoom in on the details!

Fig 9b - Hourly chart of Gold- Leading Diagonal Triangle

You should also observe that wave 2 following the completion of the leading diagonal triangle did not go below the start of the triangle, and hence continued to respect Elliott's other rule that wave 2 cannot go below the start of wave 1.

Here is some additional reading for you on leading diagonal triangles: *http://tinyurl.com/leadDT*

Now let us see some examples of an ending diagonal triangle. I will show you the rarer of the formations, i.e. an expanding ending diagonal triangle, using a recent chart of the New Zealand Dollar. The NZD, or Kiwi as it is known affectionately in Forex circles, has been on a stupendous rally for just over two years. During this time, it went up by over 80% in value. That rally is apparently drawing to a close at the time of writing, and we are able to see a nice ending diagonal triangle at the fifth wave position.

Fig 9c – The Kiwi is coming down rapidly after having posted its wave '5' inside an expanding diagonal triangle.

The above 'Daily' chart shows you a big picture view of the movement.

Now let us zoom in a bit closer to capture the details.

Fig 9d – Here is an Hourly chart of the NZD where the internal waves are clear.

Next we shall see if the internal waves have any relationship to each other.

Fig 9e – NZD in an ending diagonal triangle

In the above chart, you will notice the following:

- Wave 2 did not go below the bottom of wave 1
- Wave 3 was a normal wave, and travelled only 138.2% of wave 1
- Wave 4 overlapped the top of wave 1
  (this is allowed only in diagonal triangles)

Fig 9f - Ending diagonal triangle respects Fibonacci relationships

Also lastly, you will notice that wave 5 inside the expanding diagonal triangle was an extended wave, and traveled a distance equal to 200% of the move from 0 to 3.

Thus, every point we discussed earlier in this chapter has been covered in this chart. There is one important matter that you should remember. When an extended fifth wave finishes its run, the ensuing correction will be dramatic. This too has happened with the New Zealand Dollar.

10. Impulse Waves: Special Cases-Failures

Failure or Truncation

A failure occurs when an impulse wave weakens and falls short of its minimum objective.

Typically, a failure occurs when a fifth wave fails to exceed the end point of the third wave. The most important clue that comes from a failed fifth wave is the probability that the ensuing move in the opposite direction will be quite strong.

Frequently, traders either don't spot the failure in good time, or they hope that the failure was only a brief wave 1 within what could possibly be an extended fifth. I must confess being guilty of this just yesterday (August 4, 2011) and here is the story.

Given the turmoil affecting the global markets the Swiss Franc has been appreciating rapidly and the USD/CHF reached a low of 0.7608 on August 2. The Swiss National Bank, (the Central Bank of Switzerland) announced that the Franc was extremely overvalued and it was cutting interest rates to near zero percent. It also warned that it stood ready to take additional measures to set right this condition.

The USD/CHF zoomed to 0.7786 in a three wave move, during which time I did nothing. Then I watched it come down all the way to 0.7632. During this down move, I went long USD and waited because I knew that we will probably get another three wave move higher. I anticipated that the SNB might give me a helping hand, and also did some Fibonacci Ratio projections and determined that we could potentially reach 0.7920, but certainly the 0.7850 area was within reach.

Sure enough, the USD/CHF started climbing, and I was rubbing my hands in glee. It reached 0.7800 in three waves, and came down to 0.7755. OK, that was no problem. It went back to 0.7800 a second time and now it drifted down to 0.7739. So I knew that we just finished the fourth wave of the first move from 0.7632. As the first and third waves of the current moves looked normal, the fifth wave would likely extend. Suddenly, the USD was moving again, and it jumped higher to 0.7780. Here goes, I said to myself.

My close friend and an ace trader, Gurumurthy, who was in the Southern Hemisphere, was also heavily long USD/CHF at the same time. I quickly messaged him to get ready for a spectacular finish for the day. What happened was the USD went to 0.7800 a third time, and started gradually coming down. Perhaps this is a complex correction? Sure enough, after a dip down, the USD was edging higher again, but around 0.7790 it stopped and turned around. There was extreme volatility as the ECB President was speaking, but before long, the USD/CHF was trading below 0.7700! I just experienced a failed fifth wave! Here are the charts.

Fig 10 a – USD/CHF goes up after correcting the first “a-b-c” move

Observe how the correction was also in three waves.

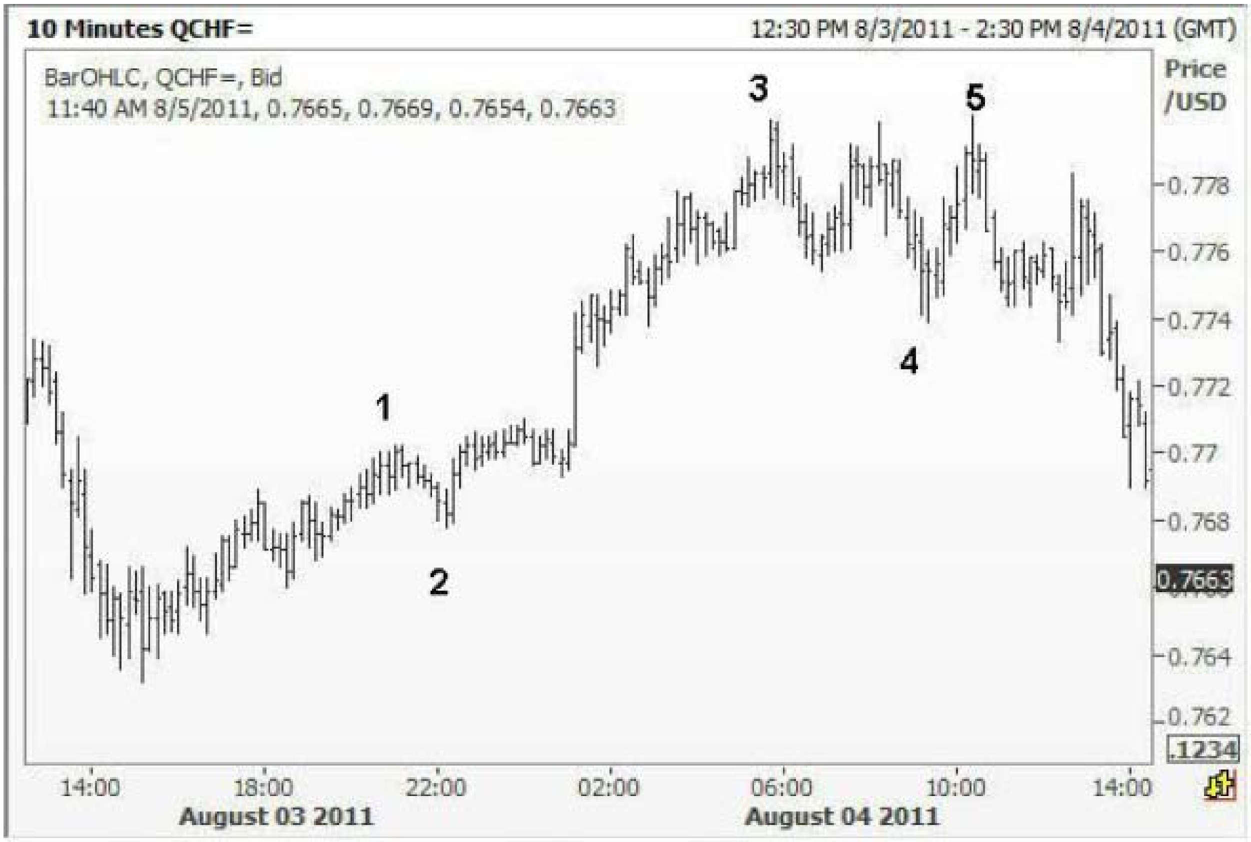

Fig 10b - USD/CHF went up after the correction in 5 waves.

I didn't know beforehand that wave 5 could end up in a failure.

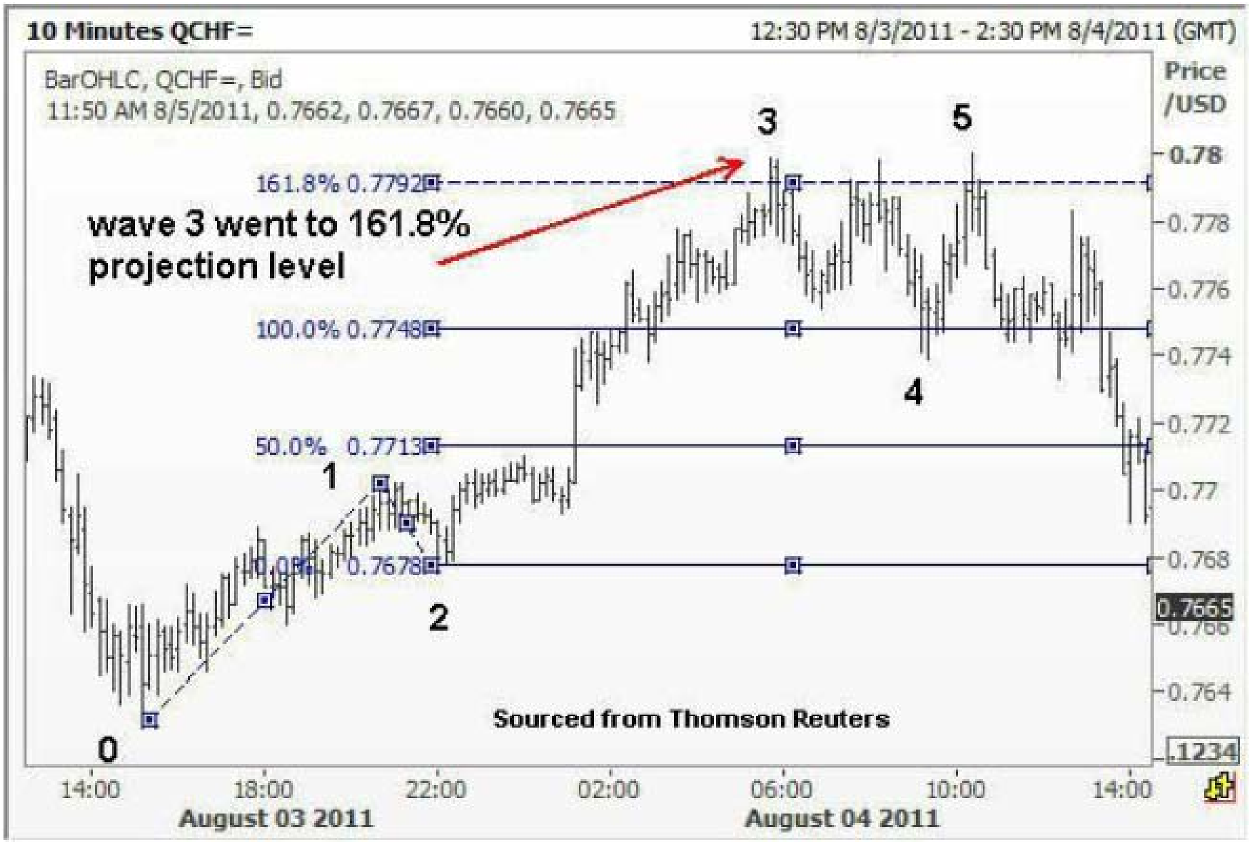

Fig 10c - Shows how wave 3 went to 161.8% of wave 1.

Notice that Wave 2 was brief, and I felt confident that we will get an extended wave soon. Observe also the characteristics of the third wave, its steepness etc. A tiny fifth wave inside the third wave also looks like a diagonal triangle, although I haven't drawn the boundaries here for sake of clarity.

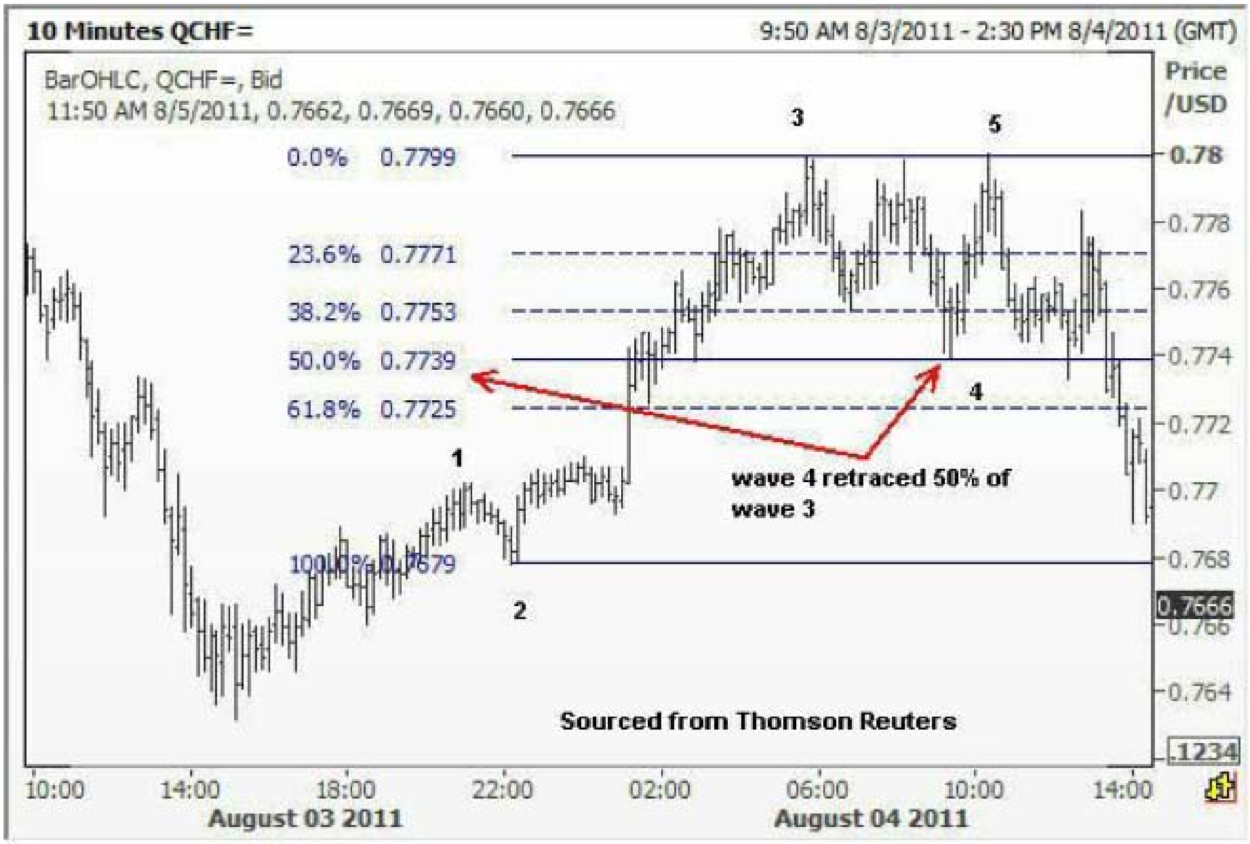

Fig 10d – Notice that wave 4 came down in 3 waves and retraced exactly 50% of wave 3

So far everything was going as per plan. All we needed now is an extended fifth wave to complete the first step of another a-b-c. But the market had other ideas.

Fig 10e - USD/CHF fifth wave projection

USD/CHF wave 5 had its earliest target at the 38.2% level, but that will make a very short wave 5 and I was expecting an extended fifth wave.

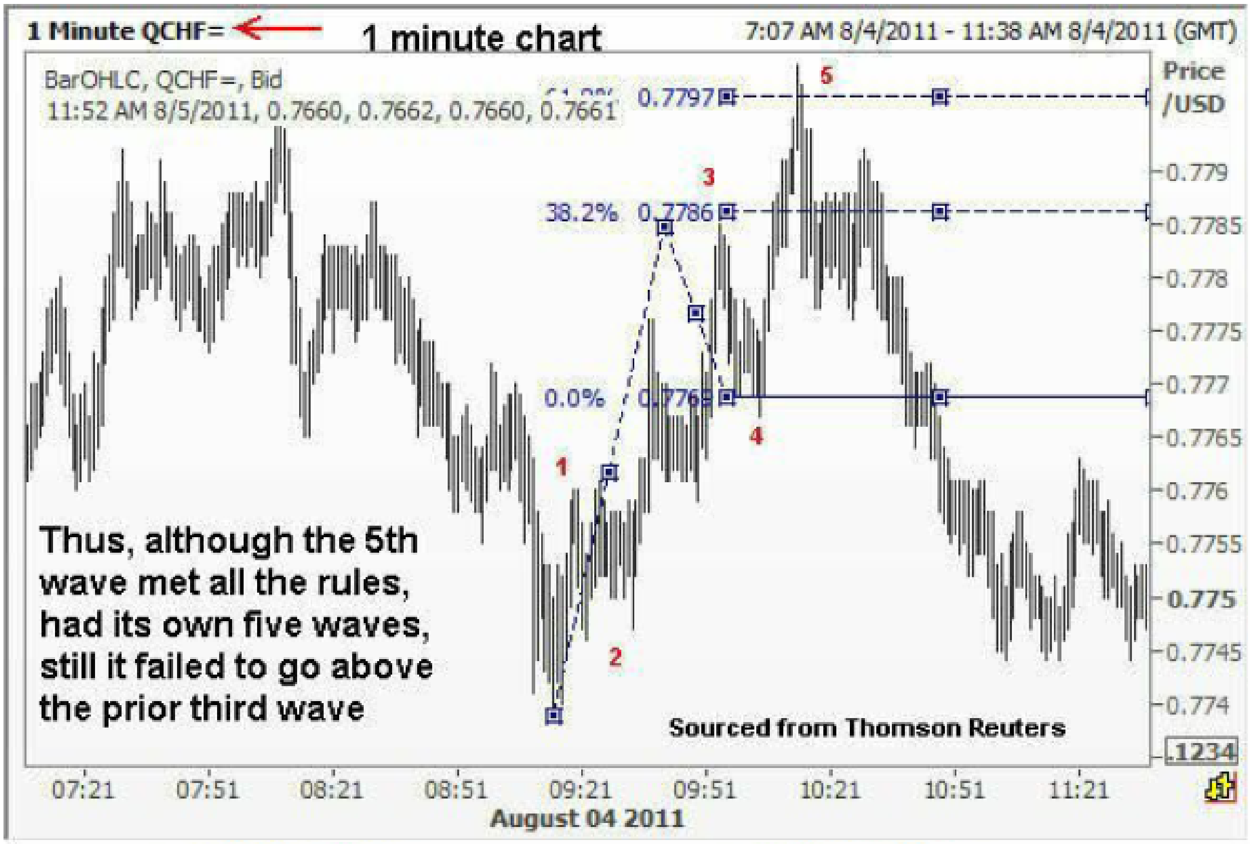

Fig 10f - Internal sub waves of the failed fifth wave shown in this 1-minute chart

As you can see, even the failed fifth wave respected all the rules and guidelines of the Elliott Wave Principle. The third wave was 161.8% the first wave and the fifth wave finished at the 61.8% measure of the move from 0 to 3.

So what is the take away for you from all this. When it comes to trading the fifth wave, you should be very alert. Once a five wave move ends the ensuing correction will be larger than the second wave or the fourth wave that preceded it. There is no way of telling beforehand that a move will fail. But you should be alert to notice a failure as it is happening and take steps to exit your position in time. I should have gotten out when it came back to 0.7790, but I didn’t. But that’s another story!

11. Simple Corrections- Zigzags

Some of you might think the material you have read up to here is difficult. But do not despair. To tell you the truth, the subject of corrections is going to be a bit more challenging. But be patient.

Once you have read the entire book, especially the later portions where I discuss practical application of the Elliott Wave Principle, you will find everything makes sense. Afterwards you would come to love this approach to the market so much that you cannot trade without counting the waves first! That's my promise.

Before we plunge into the deep end of corrections, let us quickly review what you have learnt so far. Elliott's cycle consists of eight waves in all, five up and three down. If we take just the five waves that go up (the growth phase) we will see that this set is made up of 3 impulses and 2 corrections. Thus, although the complete set of five waves is ONE impulse wave, there are 3 impulses and 2 corrections that are of a smaller degree (together making up the 5 waves). Once the growth phase is over, we get the corrective phase which is made up of three waves. Of these three waves in the corrective phase, two waves are in the short term direction, separated by one correction. We normally label the internal waves of the five wave impulse wave as 1, 2, 3, 4 and 5 whereas the three wave corrective phase is labeled as a, b and c.

Waves 2 and 4 of the larger impulse wave as well as wave 'b' within the corrective phase are all 'corrections'. For instance, wave b corrects wave a before we get wave c. Wave 2 corrects wave 1 and wave 4 corrects wave 3. Once the five-wave impulse is over, the set of a, b, and c together corrects the entire five-wave rally. Thus this set of abc is together larger than either wave 2 or wave 4. Because waves 2, 4 and b are all corrections, each of them is made up of 3 waves.

There are four main categories of corrective waves: Zigzags, Flats, Triangles and Combinations. We will deal with each of these one by one. In this chapter, we will look at Zigzag corrections in detail.

This is the simplest form of correction, (A, B and C) where Wave A is made up of five waves and Wave B has 3 internal waves. Wave C is always made up of 5 waves in any correction, irrespective of the category.

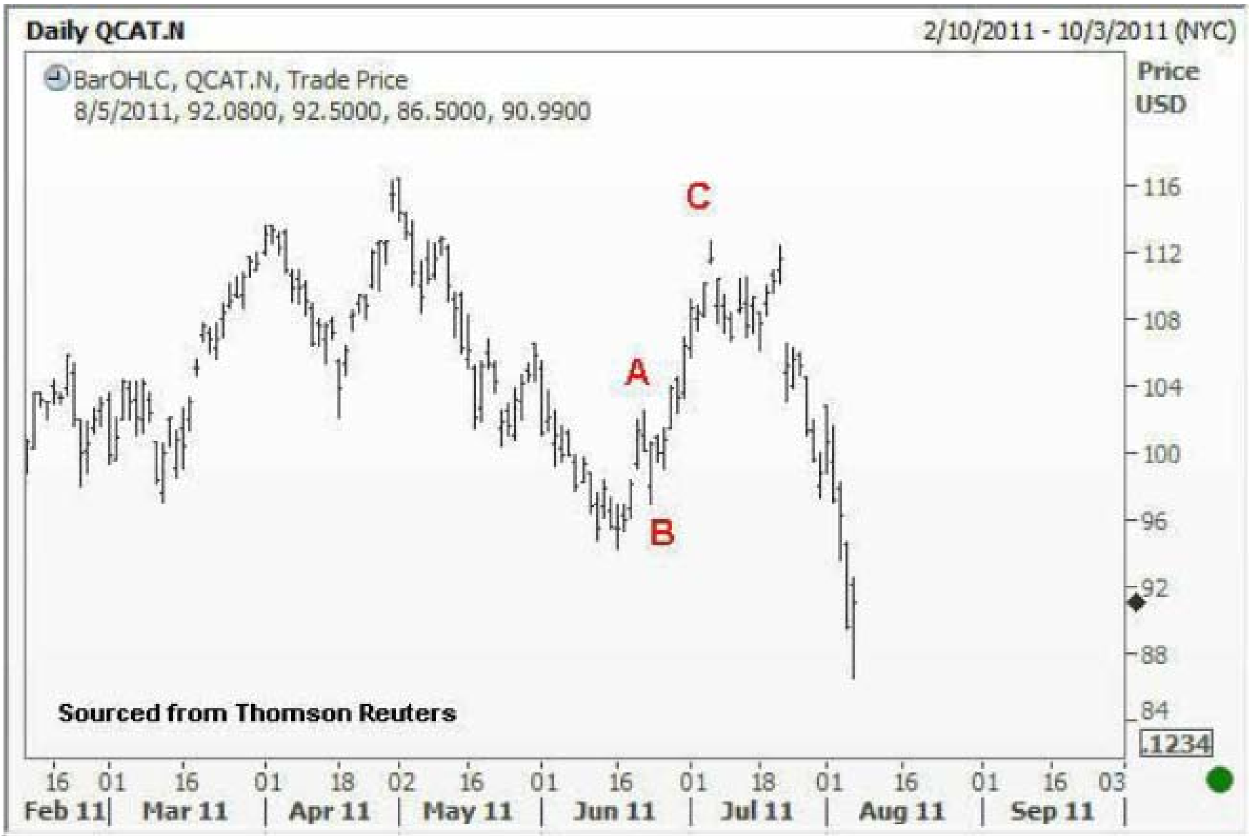

Fig 11a A zigzag correction in Caterpillar Inc

The key points to note about a zigzag correction is wave B usually ends well above the start of wave A, and wave C travels well above the top of wave A.

The following chart shows the internal waves of the ABC.

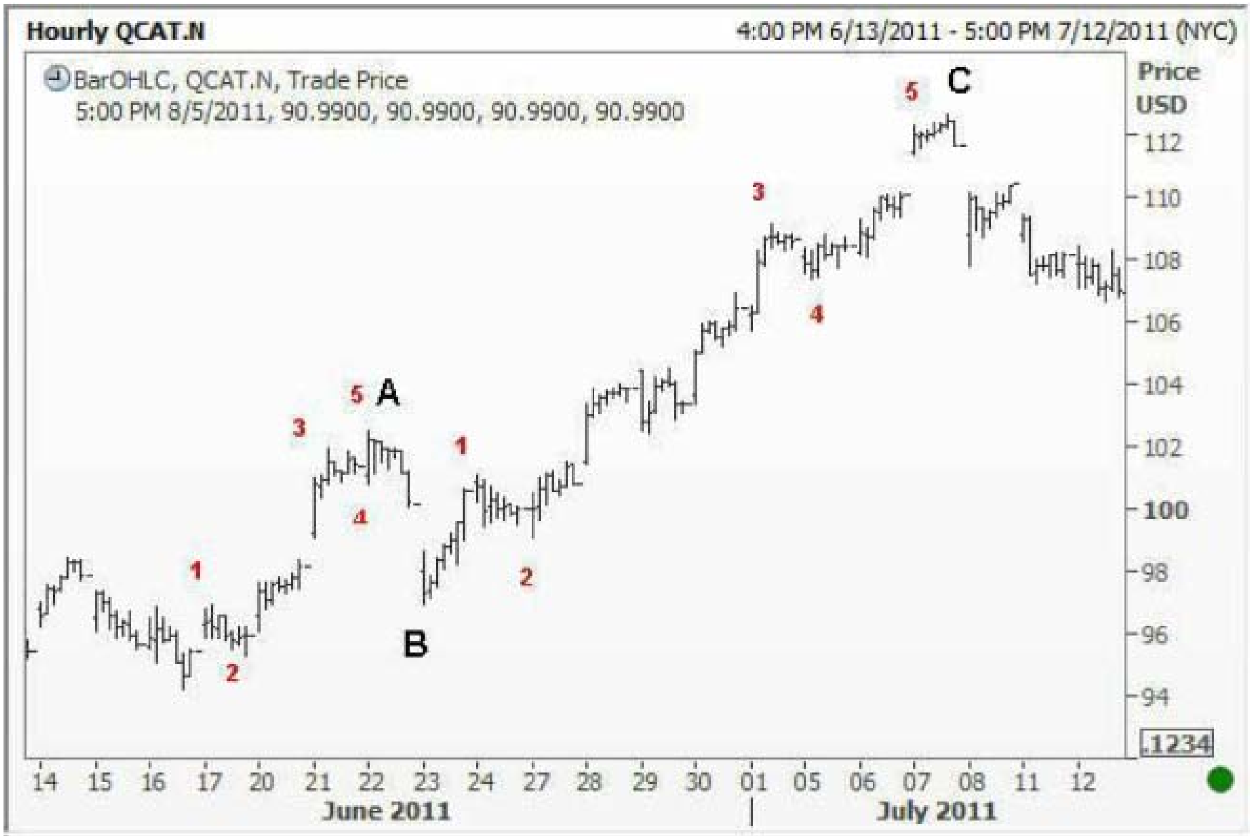

Fig 11b- Internal waves of a Zigzag correction

As you can see from Fig 11-b, Wave A assumes the form of an impulse wave with five minor waves. It is moving in the direction of the immediate trend, which is up, although the bigger direction is down. Wave B is made up of 3 waves, but not so clear in this hourly chart. Wave B serves to correct Wave A. Be aware that counting waves in the very short term is often a challenge, and you must attempt it after you gain some experience. Wave C that commenced at the end of Wave B is also made up of 5 waves.

How can we use this knowledge in practice?

Once you spot the completion of waves A and B, you will compute the 100%, 138.2% and 161.8% projections. Once Wave C starts off in the desired direction, you will apply the rules of determining the end point for wave 5 within wave C as described in the chapter dealing with wave 5.[7. Impulse Waves: Wave 5] When the projected end point thus obtained matches with the 100%, 138.2% or 161.8% projections you have already computed, there is a fairly good chance of it working. Actually, this approach should work for all your projections for end points of corrections (whether it is a zigzag, flat or irregular corrections.)

If a zigzag occurs in Wave 2 position, the maximum distance it usually travels is to the top of wave 1 of the preceding lower degree. As this is quite a useful guideline, let me explain it a bit more. Suppose for a moment you assume that the Fig11b was showing you Waves I, II and III instead of waves A, B and C respectively. Notice that wave II (or B in the chart) has come down only to the top of wave 1 inside wave I (or A in the chart). Wave 1 is of lower degree than Wave II because wave 1 is a sub wave within wave I.

If a Zigzag occurs in a wave 4 position then the maximum distance it travels is usually limited to the top of wave1 in the same degree. There is, however, no compulsion for it to come down to the maximum extent, because it could end well above that. But should you spot a Wave C of a zigzag coming close to the top (ie ending point of) of Wave 1, you should view it as a low risk trade to position in the direction of the bigger trend.

Another important clue that you can keep in mind is this. Compute the time and distance travelled by both the waves 2 and 4 of the lower degree. Then, your zigzag correction will be bigger in size and take longer time than the bigger of waves 2 and 4. For example, suppose wave 2 travelled 50 pips and took 3 hours, whereas wave 4 travelled 25 pips and took 5 hours. In this case, your zigzag correction will take more than 5 hours and will travel more than 50 pips.

Clearly, with zigzag corrections you have lots of clues to figure out how long and how far the move is likely to travel.

12. Simple Corrections- Flats

A flat correction is a horizontal formation that occurs in between two impulses. Like all corrections, this corrective wave is also made up of three waves. Unlike in a zigzag where Wave A is made up of 5 sub waves, the Wave A in a flat is made up of just three waves. This by itself signals a lack of strength to correct deeply the prior impulse wave. Wave B inherits some of this characteristic and ends near the start of wave A, and unfolds in 3 sub waves (remember in a zigzag, Wave B ends some distance away from the start of Wave A). Once Wave B is completed, the ensuing Wave C unfolds in 5 sub waves, but once again, unlike wave C of a zigzag, this wave C will finish at or just beyond the terminal point of Wave A. A flat is usually found in the fourth wave position.

The most important clue from the preceding paragraph is when you see a move back to the start of an initial 3 wave correction you should get in the habit of labeling it as a flat correction. This would mean the end of Wave C is unlikely to go much beyond the bottom of wave A. Of course, a flat could be the first in a series of combinations (discussed in the next chapter), but you will at least know that any trade to capture the movement of Wave C should be covered once it reaches the vicinity of Wave A's end.

How can you anticipate a flat? The best hint that a flat correction is likely to develop is for the preceding correction to have been a zigzag.

Thus, if wave 2 of a move has been a zigzag, you will get ready for the upcoming wave 4 to be a 'Flat' and for its Wave A to be made up of 3 waves. This is very valuable information if you are an active trader. You will approach the treatment of wave A just like a separate zigzag as explained in the preceding chapter.

Suppose the first wave of Wave C of a flat proves to be strong, in that it falls below the second leg of the preceding wave B, we should prepare for a much deeper move before Wave C is finished. A useful guide will be to multiply this first wave down of wave C by 3, and subtract from the result the anticipated maximum expectancy for the whole correction. (Remember that if this flat was following an extended third wave, we are looking for the whole correction to be just 23.6% of wave 3, for example. But occasionally we do see a 38.2% correction)

From my experience, Wave C in a flat tends to finish at the 138.2% projection of Wave A. You can safely use this as a simple and easy to remember guideline. But always try and use the method outlined in the chapter for impulse wave 5 in order to confirm where the C wave will end. If you find that the targets obtained by using the 138.2% of wave A corresponds to the target obtained by using the other method, then there is a high chance for success.

Fig 12a - A flat correction in wave 4 position

Observe the 10 minute chart of Gold in Fig 12a above. The correction is clearly in a fourth wave position. The first thing you should notice is whether the first move from the top of wave 3 is a three wave move or a five wave move.

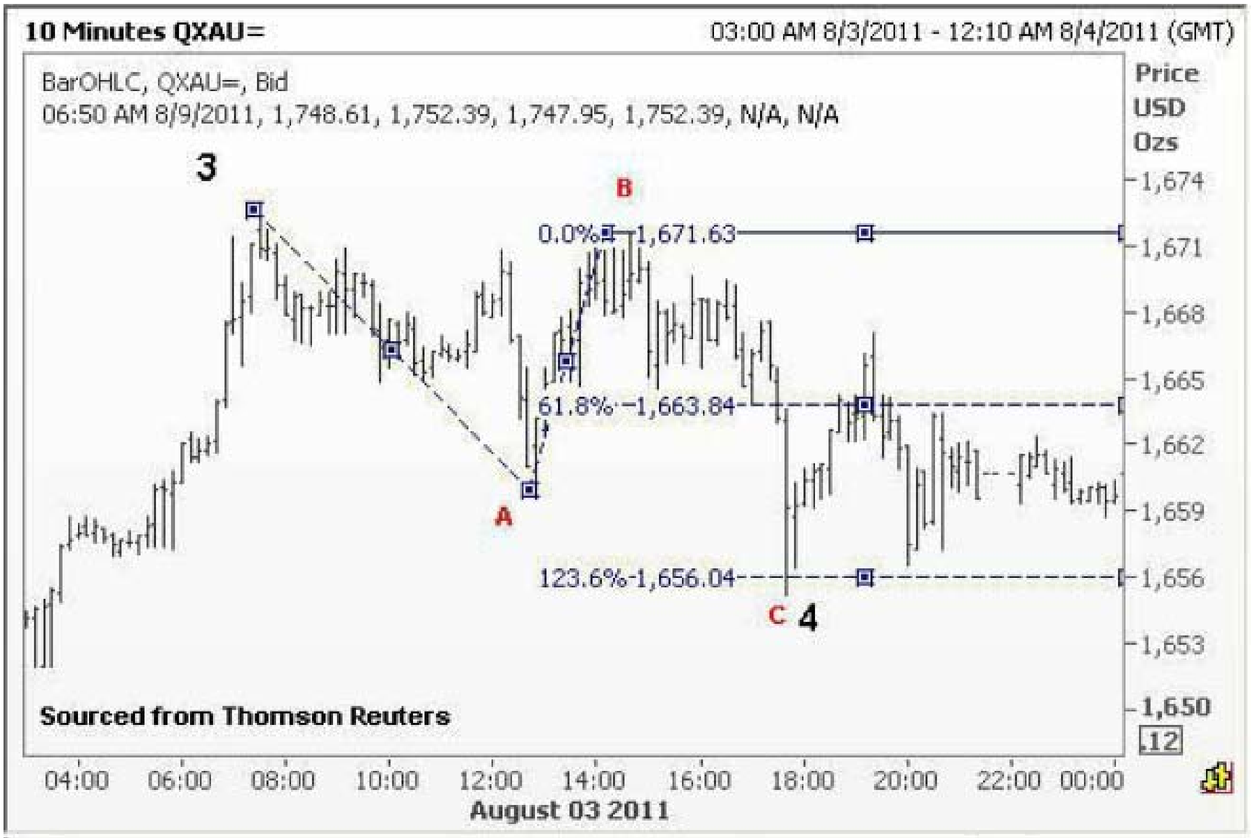

Fig 12 b - Wave A came down in 3 waves.

Because Wave A came down in 3 waves, and the price started moving up again, we would anticipate two things. First, this correction is going to be a flat, which means wave B will come close to the top of wave A. Then we would expect Wave C to unfold in 5 sub waves. We would also calculate some Fibonacci projections of Wave A to determine the likely end points for Wave C. As you can see from Fig 12b above, Wave C finished very close to the 123.6% of Wave A projection level, which is normal for a Flat correction, in that the C wave finished only slightly below the bottom of Wave A.

Fig 12c - The whole Wave 4 finished exactly at the 38.2% retracement of the Wave 3 it was correcting

As a summary, you have figured out that Wave 4 would normally retrace between 50% and 38.2% of Wave 3. You also knew that this Wave 4 was going to be a Flat correction the moment Wave B started going up with only 3 waves of Wave A being completed. You also knew that Wave B will likely go all the way back to the start of Wave A because of this correction being a Flat. And finally, you computed a 123.6% projection for Wave C and found that it was close to the 38.2% retracement level of the prior Wave 3. It would also have been possible for you to compute the end of wave 5 within the C wave by using the methods discussed in the chapter dealing with Impulse Wave 5 [See “7. Impulse Waves: Wave 5”]

13. Irregular Corrections

A typical B wave in a zigzag seldom goes beyond the 61.8% retracement of the A wave, and in the case of a Flat, the B wave will finish near about the start of Wave A. In the case of an irregular correction, however, the B wave goes beyond the starting point of Wave A and just when everyone is convinced that the original trend was probably back in place, the price turns around and comes down rapidly as the C wave to complete the correction.

Irregular corrections usually appear after wave 5 of a cycle, and would correct the entire five waves according to Elliott's approach to this phenomenon. The first move after the end of wave 5 would be a three wave affair and is labeled as Wave A. The Wave B that follows will also be in three sub waves but the price will exceed the top of Wave 5. Thereafter, we will get a normal Wave C made up of five sub waves.

An irregular correction is frequently spotted at the end of an extended fifth wave, because (as we shall discuss in greater detail later), an extended fifth wave is subject to what is known as double retracement. The first retracement usually covers only that portion of the fifth wave that went beyond a normal fifth wave. We can also compute where the irregular top will likely occur by doing the same calculations we would use for a zigzag.

Remember that the irregular B wave will be made up of 3 waves just like a zigzag, which means the smaller 'b' wave within the irregular B wave will go no lower than 61.8% of the smaller 'a' wave. Additionally, we can relate the smaller 'c' wave to the preceding 'a' wave.

Irregular corrections can also occur after a normal fifth wave. The only difference is we need not get the full second retracement of the fifth wave as is common with an extended fifth wave.

An important clue for traders is when an irregular correction appears either after wave 1 or wave 3, (i.e. if either wave 2 or wave 4 is an irregular correction) then the next impulse wave will be very strong. For example, if wave 1 and 3 were normal waves, and wave 4 was an irregular correction, you can almost be certain that wave 5 will be an extended fifth.

The distance of the “C” wave of an irregular correction can also be anticipated by multiplying the length of Wave A by 138.2% and 161.8% and measuring it off from the end of the irregular Wave B. Occasionally, we get a devastating C wave that travels 200% or even 261.8% of Wave A, and typically you see such damage if the C wave was doing the second retracement of a hugely extended fifth wave.

Another method to determine the end point of the Wave C is as follows. Compute the distance between the starting point of Wave A and ending point of Wave B. Let us assume this was 40 cents. Now compute 100%, 61.8% and 38.2% of this number, (in our example, it will be 40, 25 and 15 cents respectively). Then add (or subtract if wave C was coming down) these numbers to the end of wave A to get the levels where the C wave is likely to finish.

Fig 13a - Daily chart of USDJPY shows an irregular correction.

In the above chart of USD/JPY, notice that the irregular B wave went well below the end of the third wave, and then snapped back as a devastating C wave to finish exactly at the typical 38.2% retracement of third wave!

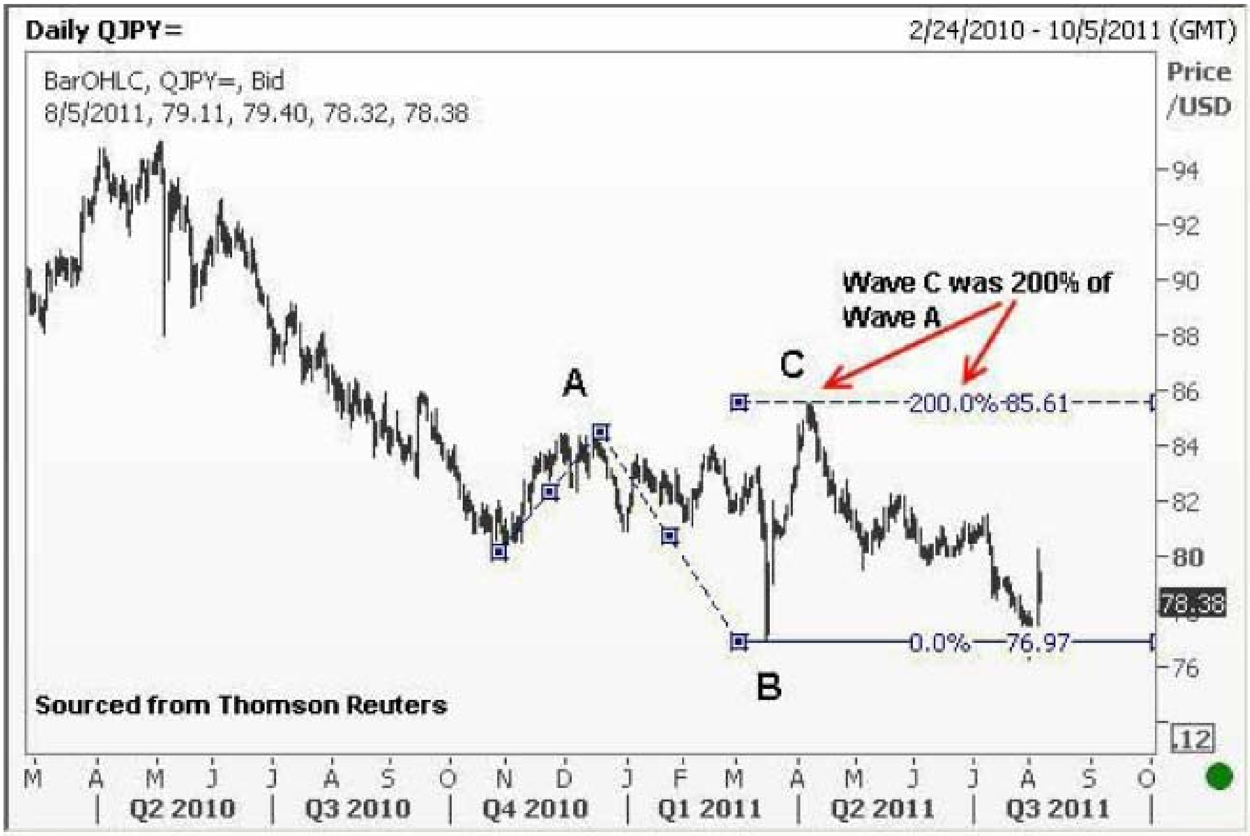

Fig 13b - Here you see how wave C was also 200% of wave A

Typically, in a fast moving market, you wouldn't know that we are doing an irregular correction until the C wave has gone some way back. You could use some of Elliott's rules and guidelines to assist you. For example, when we pass a reflex point on the way up, you might start thinking that maybe this is going back all the way up. (In this instance, the Bank of Japan was intervening in the markets, and anyway one would have run for cover if he/she was shorts the USD).

The next thing to do is to determine where to resell! As I pointed out in Fig 13a earlier, we could compute 38.2% and 50% retracements and be ready with the levels. When the 200% projection of wave A coincided with the 38.2% retracement level, then one had to be extra alert. Also, using the hourly charts, one could determine where wave 5 of the C wave would end. Using all these tools, it would be possible to take low risk positions very close to the actual turning point for the instrument being traded, in this case the USD/JPY currency pair.

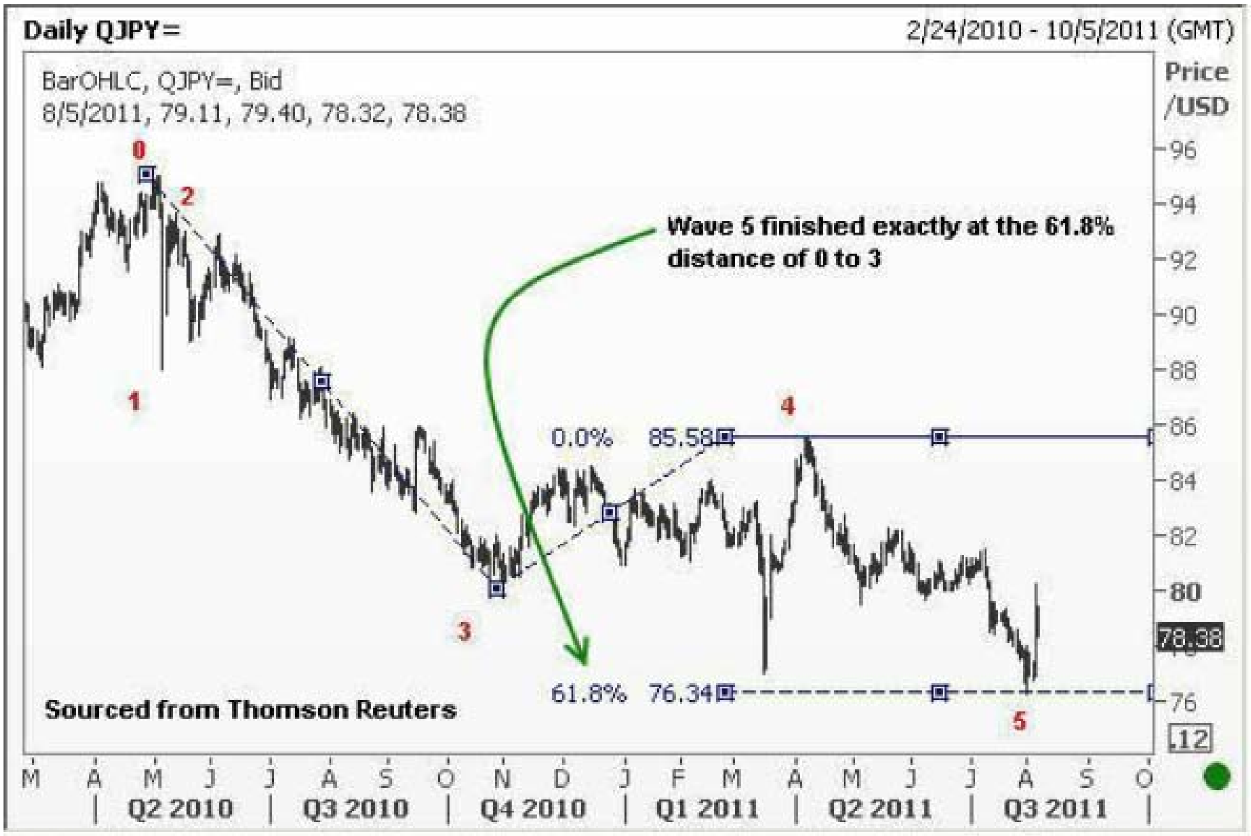

Fig 13c – Determining where the fifth wave will end?

Just to complete the example of using Elliott Wave analysis after encountering an irregular correction, you can see from Fig13c that one could have anticipated a significant bounce by computing the distance from point 0 to point 3 and calculating a 61.8% measure. Subtract that from the end of wave 4 to get the potential wave 5 ending point, and Hey Presto! An easy 200 pip profit is in the bag.

If you seek more examples on irregular corrections, please check out the following links:

http://tinyurl.com/irregularB
http://tinyurl.com/irregularBbhp
http://tinyurl.com/irregularBeurusd
http://tinyurl.com/irregularBbp
http://tinyurl.com/irregularBgbp

14. Complex Corrections

We have already discussed simple corrections in the form of a zigzag or flat. Every now and then, just when you think the markets have completed one of these corrections, you will see a pause, and another round of corrective moves taking place. What you then get is a complex correction, which is basically a combination of two or more of these patterns.

When two zigzag patterns are combined, with an intervening separator move which we usually label the X wave, then we end up with a double zigzag. (Elliott used the term inverted zigzag to refer to the correction happening during a down trend, but for the sake of clarity we will only deal with the normal patterns. Just remember that any of these corrections can occur in an uptrend or a down trend)

Coming back to the double zigzag, you will remember that a zigzag has 5-3-5 as its internal waves. So a double zigzag will have 5-3-5 in its first set and another 5-3-5 in its second set. The intervening X wave is usually made up of 3 waves.

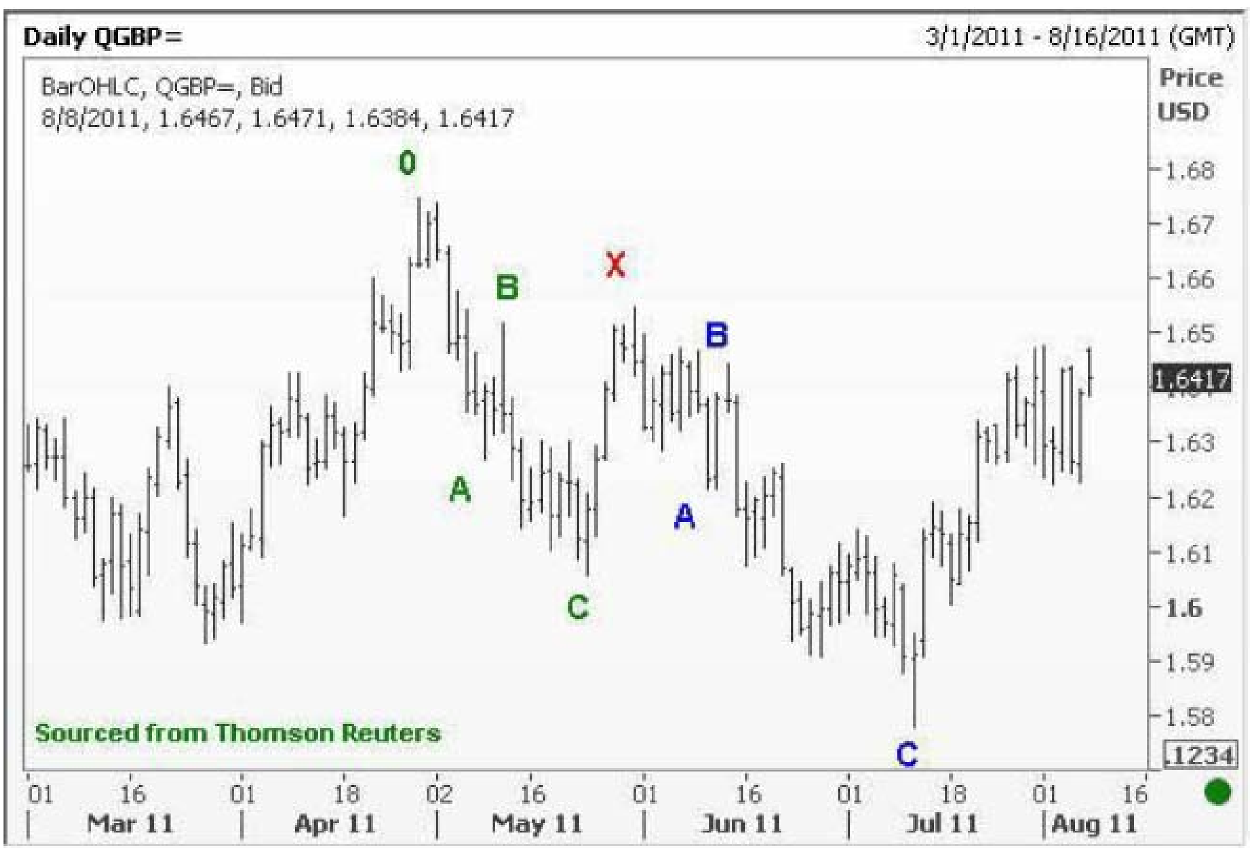

Fig 14a - A double zigzag in the GBP/USD daily chart

You will also be able to make forecasts for price levels even as a move is unfolding. For example, Wave C was related to Wave A in each of the two sets of zigzags.

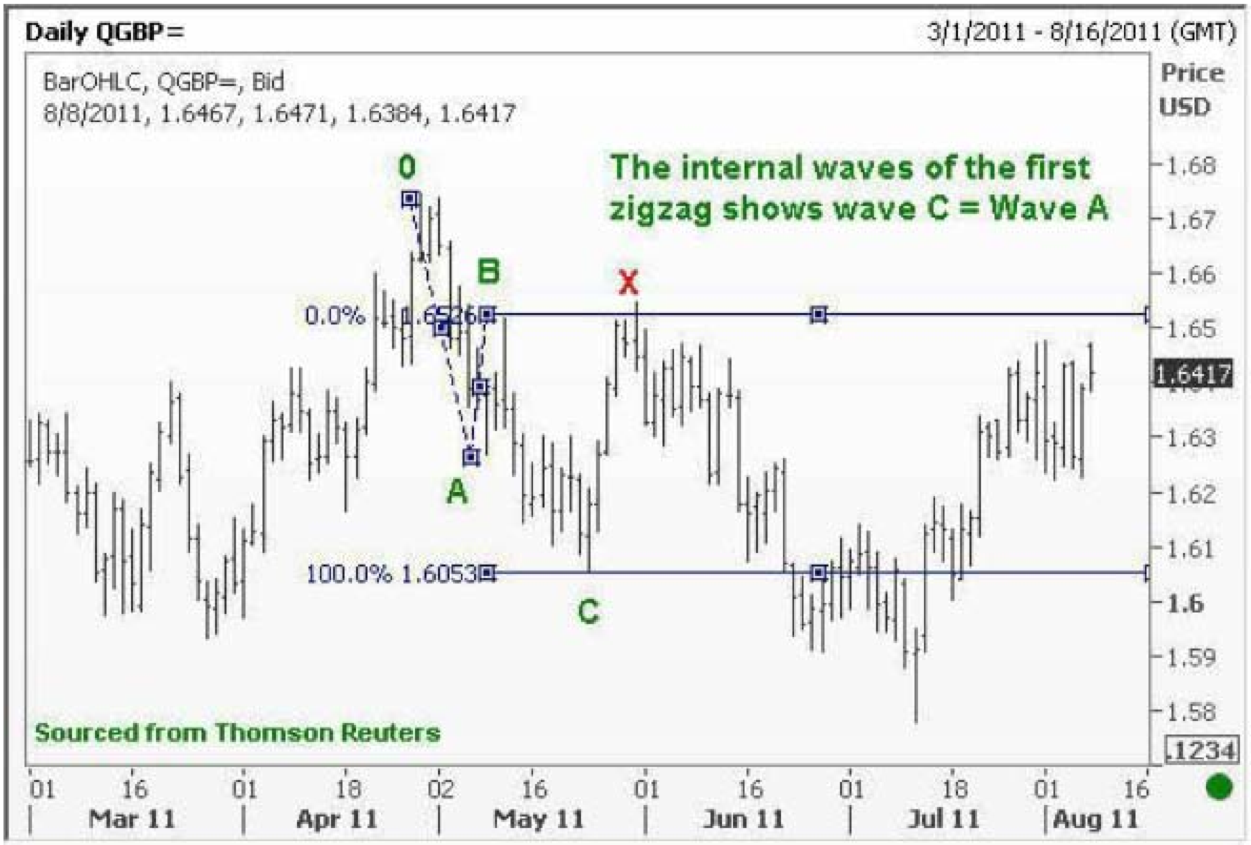

Fig 14b - Wave C was 100% of Wave A in the first zigzag.

If you were trading these waves, you would have been able to apply the guidelines for forecasting a fifth wave of an impulse when dealing with Wave C.

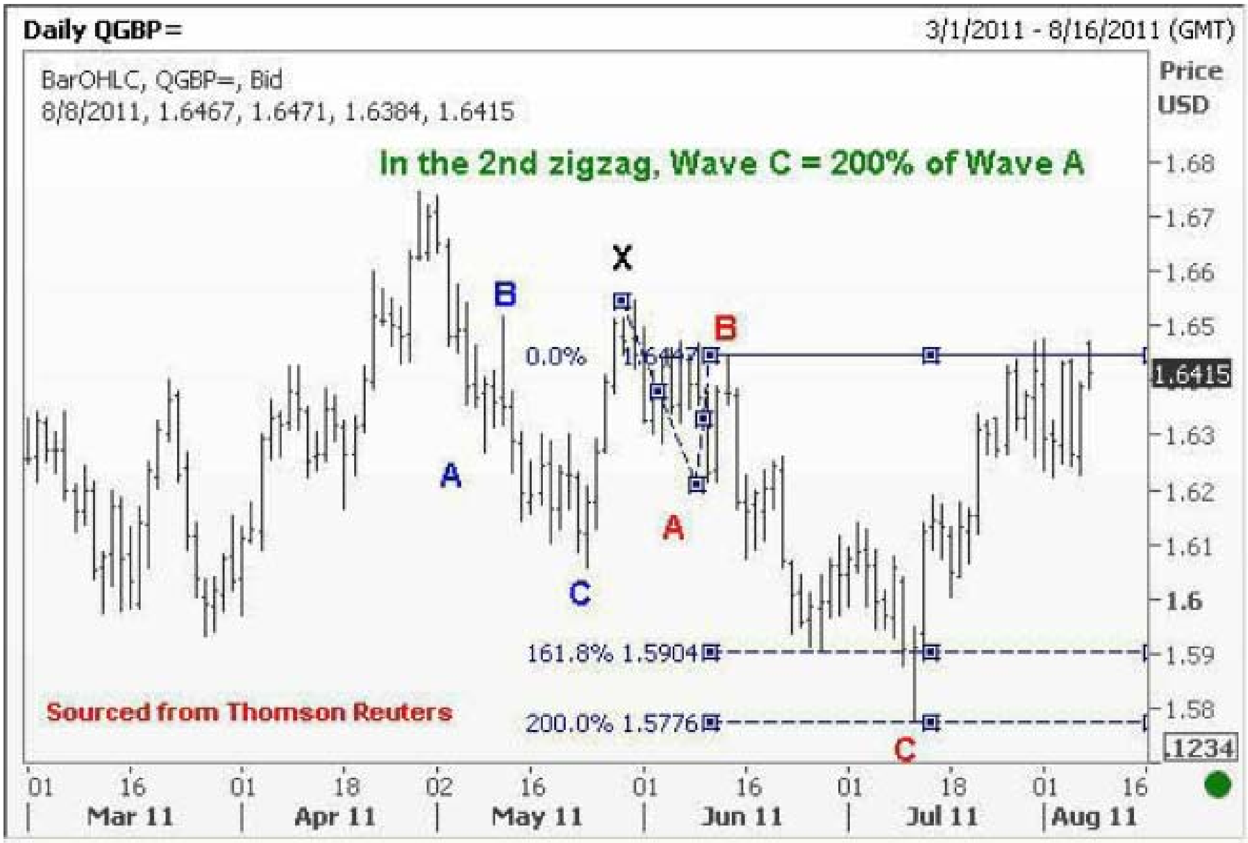

Fig 14c - Here you can see that Wave C on the second zigzag was 200% of wave A

Although the move finished at the 200% projection, there was money to be made at the 161.8% projection level as well. Notice that there was 200 pips to be made in the reaction upwards before the final move down happened.

At first sight you might think that Wave A in the second set of ABC looks like a 3 wave move. But the picture is clear when you zoom in to the hourly charts as shown below in Fig 14d below.

Fig 14d - Here you get a close up view of the internal waves of the second zigzag

Just as one could get a complex correction in the form of a double zigzag, one could also get a complex combination of two flats! Not surprisingly Elliott called it a double flat! (If you get a combination of three flats, it will be called a triple flat) Just like a normal flat will have as its internal waves a 3-3-5 pattern, so also each of the two flats that combine using an X wave in between will also have a 3-3-5 pattern.

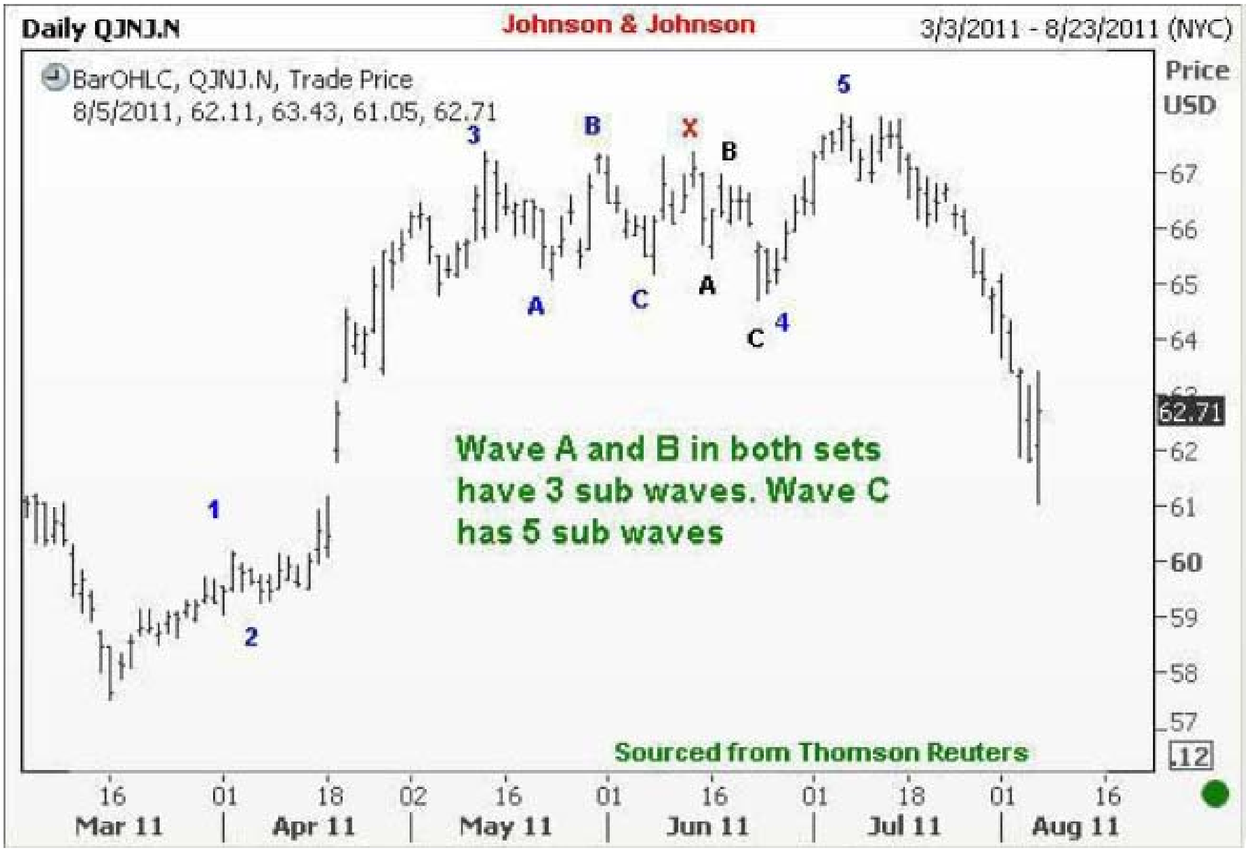

Fig 14e - A double flat appears in the chart of Johnson & Johnson Inc

Notice how the B waves tended to finish near the start of the correction, and the C waves too did not go too far below the bottom of A waves.

15. Triangles

One of the easiest formations to spot in a chart is a triangle. According to Elliott, a horizontal triangle occurs only in a Wave 4 position except in some very rare occasions when it appears in the second wave. It will never be seen in impulse waves 1, 3 or 5. However, some well known practitioners of the Elliott Wave Principle have introduced the concept that it is possible for a horizontal triangle to occur In any correction, and particularly in the B wave position. My own experience also tends to lean in that direction.

Triangles could be both converging and expanding type. I have seen the expanding type of a triangle a few times, but was not able to immediately get an example for you from recent market action. Elliott himself did not place too much value on the expanding triangle.

A triangle in Elliott Wave analysis is typically made up of five internal waves, each of which is a made up of three sub waves.

Fig 15a - Triangle in Crude Oil chart

In Fig 15a, I have captured a part of a large triangle still in progress. This formation actually happened a few months ago, as you will presently see. Notice that inside the large triangle (bounded by the pink lines) you can see a smaller triangle in the Wave b position. This smaller triangle also has 5 sub waves. The small triangle resolved to the up side, i.e. the breakout happened over the upper boundary. But in the bigger picture, the larger triangle was a bearish formation, which is why I was adamantly bearish for Crude Oil to approach the low $70s even though several large investments banks were calling it back towards $150 at that time.

The example in Fig 15a is one of the more complex corrections as you can see from the way I have labeled the internal waves.

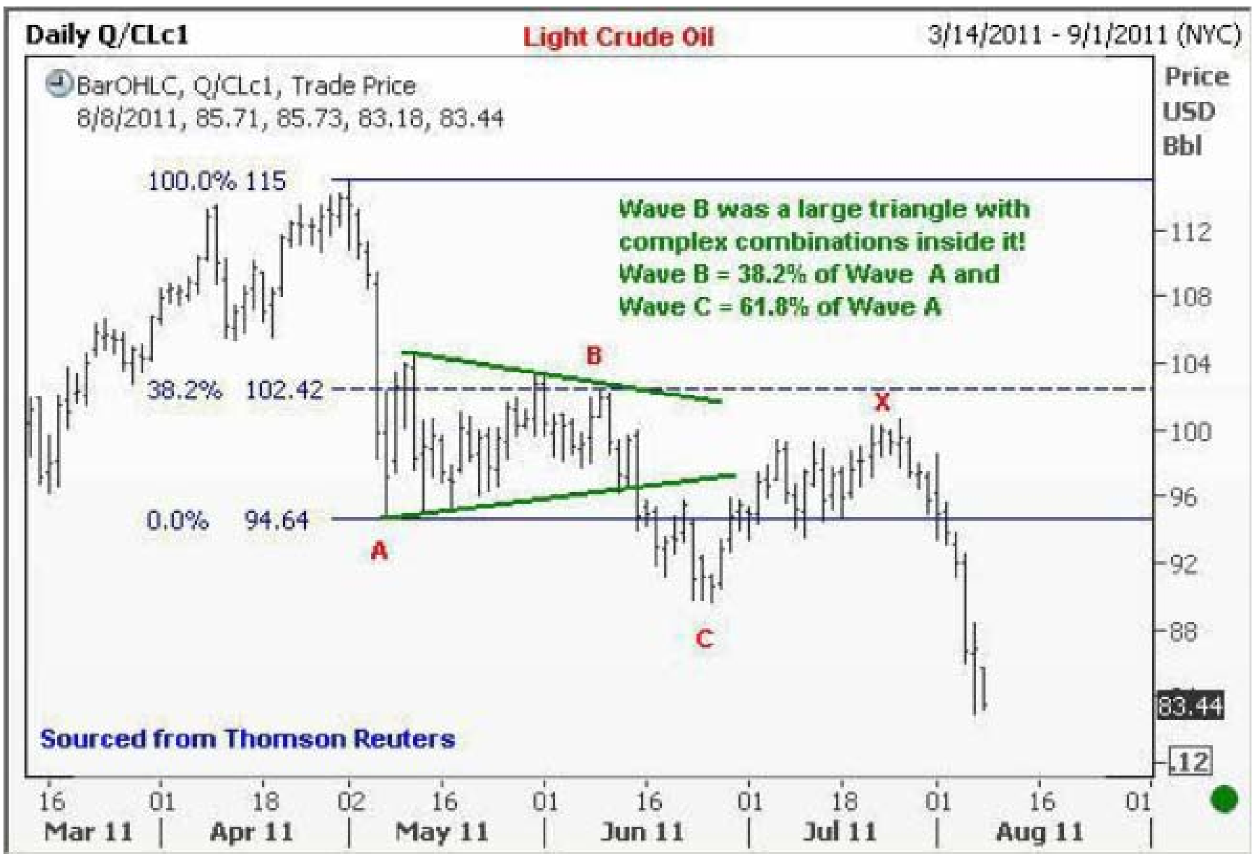

Fig 15b - The bigger picture for Crude Oil

In Fig 15b above, you are able to see the bigger picture at the time of writing (the date is at the top left hand corner). The price has broken to the downside as anticipated, and I have tentatively labeled the whole down move from $115 as a double zigzag. With the intervening B wave a triangle.

Next let us see if we can establish any relationships between the waves. (You already have a clue in Fig 15b, but it might be useful to see it more clearly)

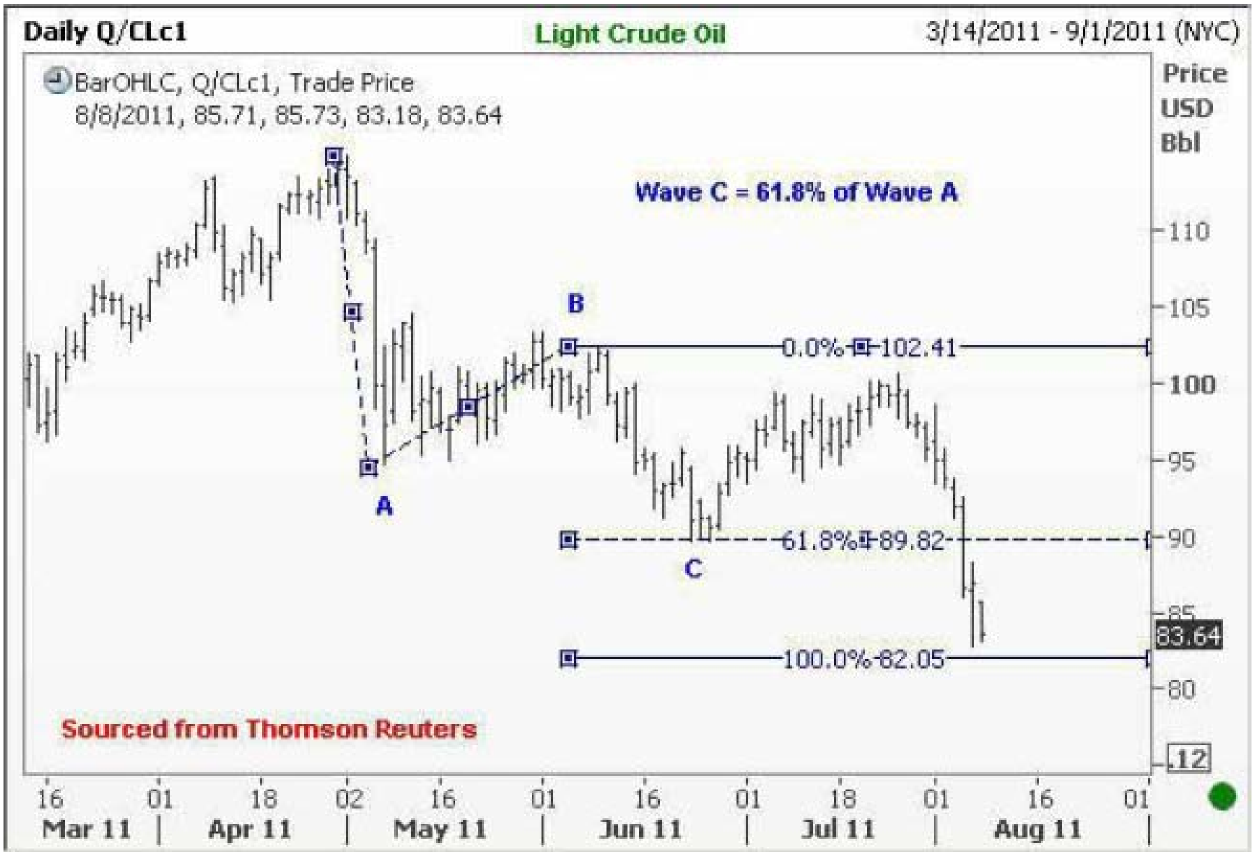

Fig 15c - See how the internal waves of the zigzag are related to each other

As you can make out from the above chart, Wave C finished at the 61.8% measure of Wave A. Incidentally, the final wave of the triangle finished exactly at the 38.2% retracement level of Wave A.

Elliott spent quite a bit of time on Diagonal Triangles. We have already seen in an earlier chapter the treatment of Diagonal Triangles when it occurs as an impulse wave. <u>In this chapter, we look at diagonal triangles when they appear as a correction</u>.

According to Elliott, diagonal triangles are often found as Wave 4 in situations when the upcoming fifth wave was likely to extend. The third wave would have traveled a considerable distance in a short space of time, and the diagonal triangle itself would appear sloping in the direction of the major trend. For example, in an uptrend, the ending point of the fourth wave diagonal triangle will be near or even above the top of the third wave. Then all of a sudden, when the ‘e’ wave of the triangle is finished, price will break even higher and the fifth wave will race upwards. This type of a price action is often seen in the 1-minute chart, especially in the foreign exchange markets.

But a more reliable pattern occurs when the diagonal triangle occurs either in Wave A position or Wave C position. When it occurs in Wave A position, it becomes a leading diagonal triangle, and when it occurs at the Wave C position, it is an ending diagonal triangle. **When it is a leading diagonal triangle, the internal waves are made up of 5-3-5-3-5 sub waves. However, when it is in wave C position, the internal waves are 3-3-3-3-3**.

As the formations are quite similar to the diagonal triangles discussed in the case of impulses, you may wish to quickly check out chapter 9 for some charts [See “9. Impulse Waves: Special Cases-Diagonal Triangles”]

Part 2

In Part 2 you will take your understanding of the Elliott Wave Principle to one level higher. By learning some very useful guidelines, your Wave counting efforts will get further refined, and you will start enjoying the thrill of anticipating market turns. Putting your new-found knowledge to practice in the real world is then just a few short steps away. Start with small amounts first, until you gain in confidence, and gradually move to your normal trading size.

Good luck!!

16. Alternation

Now that you have spent time reading about the concepts and rules that govern the Elliott Wave Principle, it is time to move on to understanding some of the guidelines that will help you apply what you have learned to the real world.

At the very outset, you can observe that every other wave goes in the pposite direction to the preceding wave. In an uptrend, Waves 2 and 4 go down, while waves 1, 3 and 5 go up. During the ensuing correction, Wave A and C go down, but Wave B goes up. The opposite is true during down trends.

Particular attention should be given to corrective waves. The pattern that Wave 4 takes will alternate from the pattern of Wave 2. So if Wave 2 was a simple correction, we should anticipate Wave 4 to be complex, and vice versa. This is an enormously useful guide, allowing us to side step the difficulty of trading a complex Wave 4.

If Wave 2 travelled deep, then it is likely that Wave 4 will be sub normal. If Wave 2 took more time to finish, Wave 4 will probably be a quick one.

Fig 16a - Observe how wave 2 was a quick zigzag whereas Wave 4 was a leisurely flat

Within a correction itself we can find evidence of alternation. For example, if Wave A was a normal zigzag, we can anticipate an inverted Flat for Wave B. If Wave A was flat, then Wave B could turn out to be a zigzag. As already noted, Wave C is always made up of five sub waves.

Fig 16b - Wave A was a Flat, but Wave B was a zigzag

Elliott has also observed that major peaks and troughs over a long term also alternate. For example, if a major bottom was seen several years ago and that bottom was an irregular B wave, then it is likely the next visit to the same area will be a normal bottom.

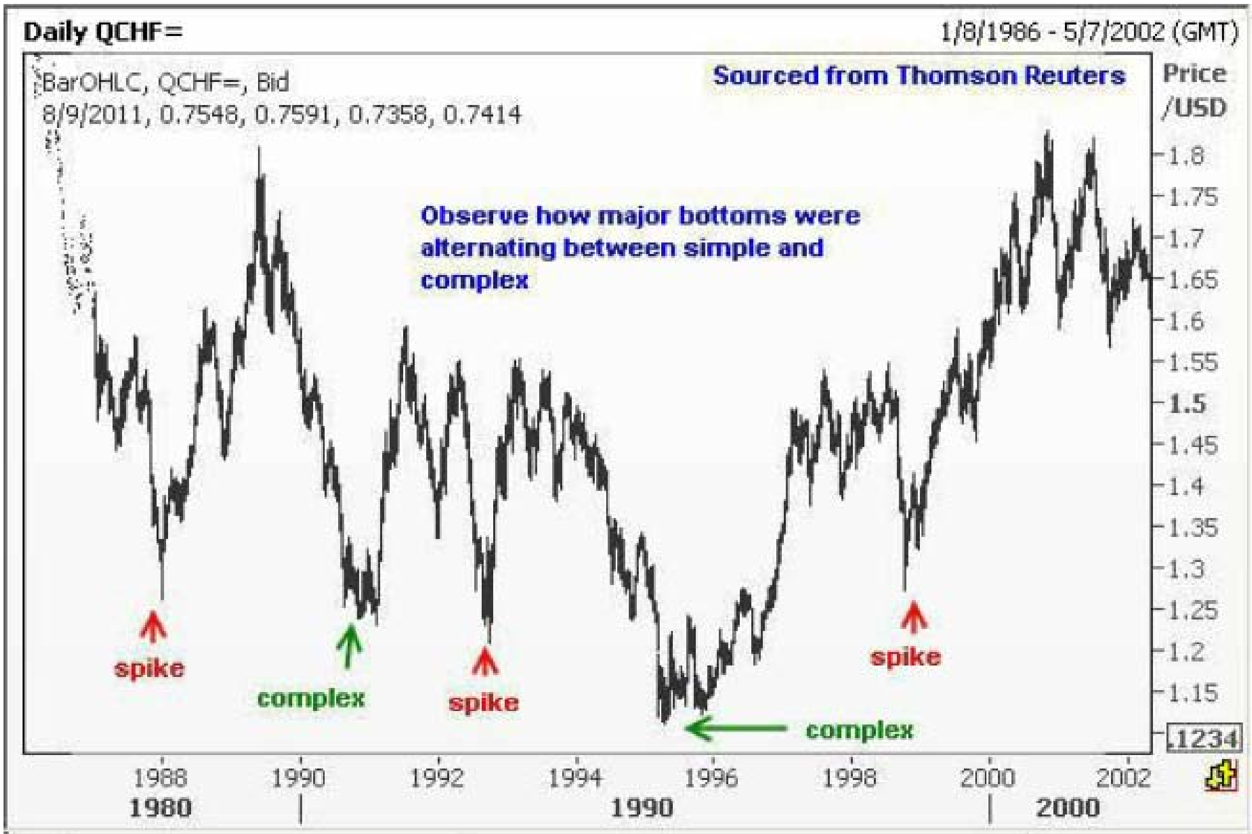

Fig 16c - In this USDCHF chart going back over 20 years, see how bottoms alternate

Finally, *bear in mind that these are only guidelines. So there is no guarantee that you will get such alternation, but you will be better off for expecting it.*

17. Channeling

I have mentioned earlier that there is a tendency for two of the three impulse waves to tend to equality. This information could be used in an approach called channeling to forecast the likely ending points for waves 3 and 5. Before I outline the method, I wish to emphasize that you should use this only as a guide, and pay more attention to the underlying rhythm of the waves.

Let us assume you are in an uptrend for this explanation. In order to draw Elliott's channel (which is different from the channel that you might have learnt from the classical approach) you need to wait for waves 1 and 2 to be finished, and for wave 3 to have begun. You will then draw a line connecting the bottom of waves 1 and the ending point of wave 2. This line will become the base line for the channel. Extend the line further to the right.

Next, draw a parallel to the base line, but let it be touching the top of wave 1. This upper line will be the tentative line which could potentially stop a wave 3. However, if wave 3 were to be very strong, (and certainly if it extends), it is going to break above this upper line. Typically, you will also draw a parallel to wave 1, slanting to the right and starting from the end point of wave 2, to determine where that slanting line will meet the upper boundary. That meeting point is where you would think a normal wave 3 will finish.

Once wave 3 has finished, you will make adjustments to your channel. You should now connect the tops of wave 1 and wave 3 with a new line, and draw a parallel via the ending point of wave 2. This new lower line is expected to offer support when the unfolding wave 4 reaches it. Once again, remember it is just expectancy as of now. When Wave 4 is completed, you should take the most important step, that of determining where wave 5 could end. For this, you will connect the bottoms of wave 2 and wave 4 with a new line. Thereafter, you will draw a new parallel line via the top of wave 3 and extend it to the right. Unless wave 5 was going to be exceptionally strong, in which case you will see a throw over beyond the top of this parallel line, you will expect it to finish near about this parallel line. You can also draw a parallel sideways to wave 3, starting from the bottom of wave 4 to see where that will intersect the upper boundary.

If wave 3 was exceptionally strong, then the parallel to the new base line (connecting waves 2 and 4) can be drawn via the top of wave 1 instead of from the top of wave 3 as described above.

Fig 17a - Weekly chart of S&P500 Projecting end point of wave 5

In the above chart of the S&P500 index, you can see that wave 2 was brief and wave 4 was deep and took more time. In order to project the end point of wave 5, we would first draw a line connecting the bottoms of Wave 2 and Wave 4. Then we draw a parallel touching the top of wave 3 and extend that line. Notice the important point that Wave 5 appears parallel to Wave 3! So you could have had an approximate idea of when and where Wave 5 could possibly end.

One you got an approximate idea of the terminal point, you will apply the other techniques you already learnt, to see if they also produce levels which are similar.

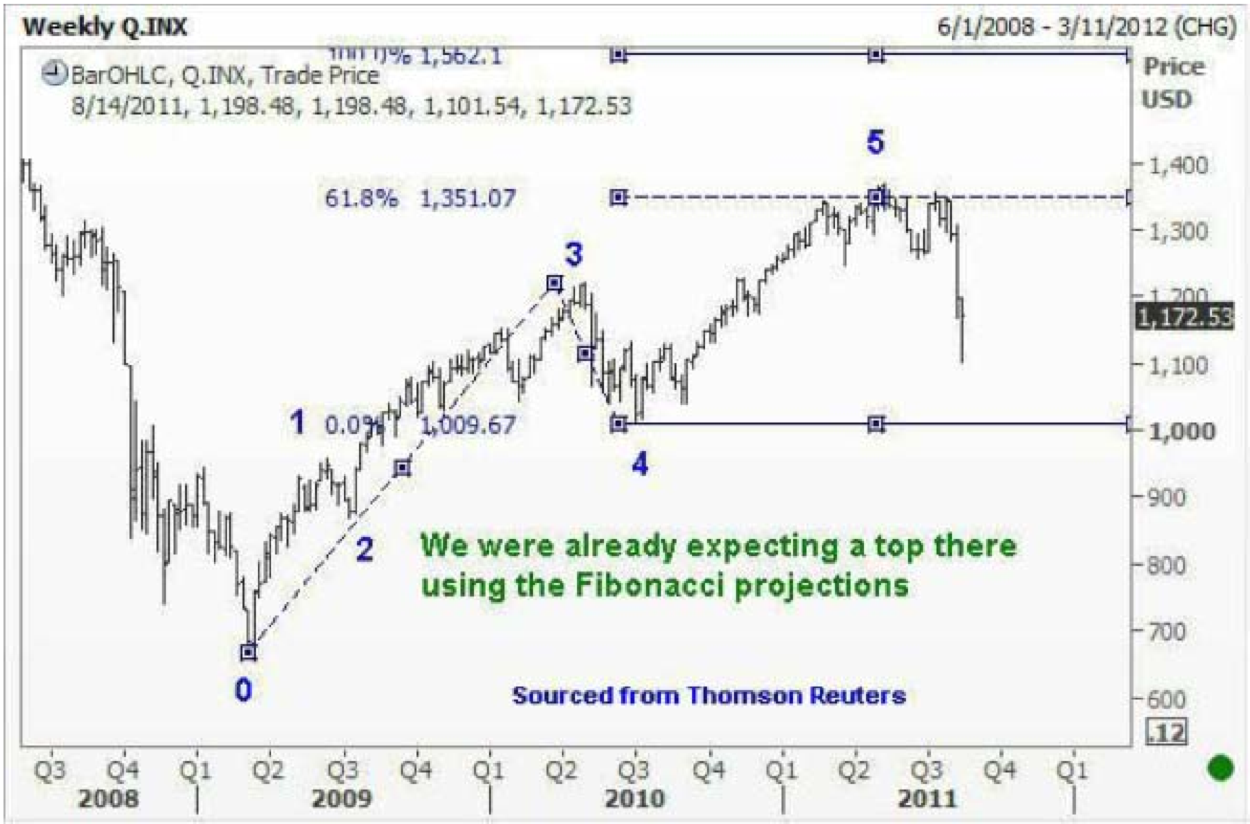

Fig 17b - Forecasting Wave 5 by using Fibonacci projections

In Fig 17b, you can see how one could have taken the distance between the start of the five waves, point 0, and the end of Wave 3, and then computing 61.8% of this measure. You will add the result to the bottom of Wave 4 to get the target for Wave 5, and you can see that the levels are approximately the same as what you got using the Elliott Wave channels.

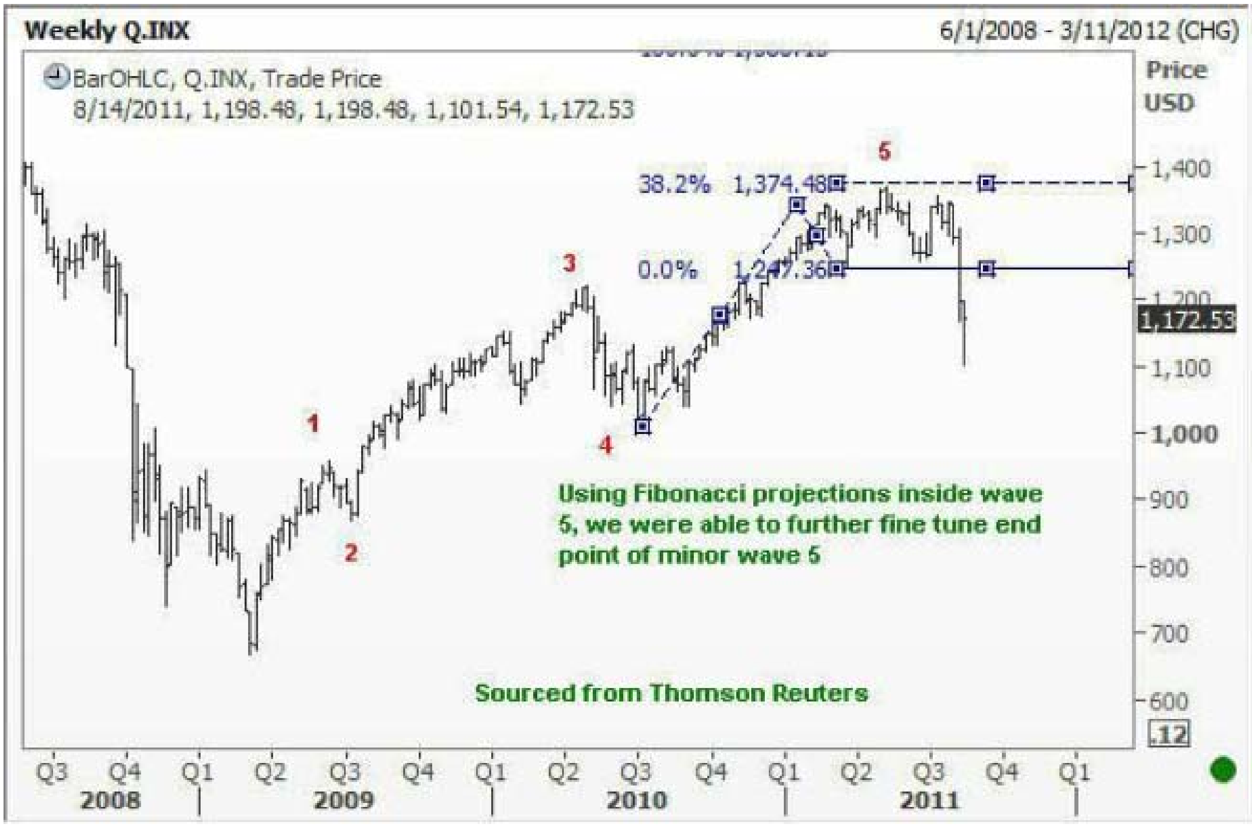

Fig 17c - Fibonacci projections to determine end point of wave 5 inside the larger wave 5.

As you know, fifth wave targets are obtained by computing either the 38.2% or 61.8% measure of the distance between point 0 and point 3.Whereas in the larger picture (Fig 17b above) we used 61.8%, when looking at the fifth wave within the larger fifth wave, we use 38.2%. The choice is just a matter of trial and error, to see if you can achieve a confluence of numbers. The end of the minor fifth wave is not far off from the projected end of the bigger fifth wave, and so we become more comfortable in calling a top there.

Fig 17d - Anticipating end of Wave 4 using channels

Once again, looking at the same SP 500 index chart, you could have anticipated where the fourth wave will end by doing the following. You will connect the top of Wave 1 and Wave 3 and draw a parallel via the end of Wave 2. As expected, Wave 4 finished around this parallel line.

As a final example for this chapter, I am showing you the chart for the Dow Jones Industrial Average. You can see that the same techniques we discussed above also worked in this case.

Fig 17e - The Elliott Channel worked very well in picking the top for the Dow as well.

18. Wave Personality

This is an area that I would urge you to study carefully and not only understand what is being discussed, but also assimilate the material. Doing so will make your trading experience so much more enjoyable. As you practice the art of EWP, there will be times when you are unsure about what wave count to give to a certain stage in the movements. At these times, you will find the knowledge of Wave personality extremely helpful.

Every wave in Elliott's cycle has a certain personality, and reflects the influence of mass psychology. Let us discuss this in terms of an imminent bull market, but the concepts will apply equally well in a bear market. Wave 1, for example, starts off at the end of a significant move. Of all the waves, I have most difficulty with the first wave. Sometimes, this wave springs as if released from a stretched rubber band! Corrections are not deep and even Wave 2 falls short of the 50% retracement level. The S&P 500 index is a perfect example of this.

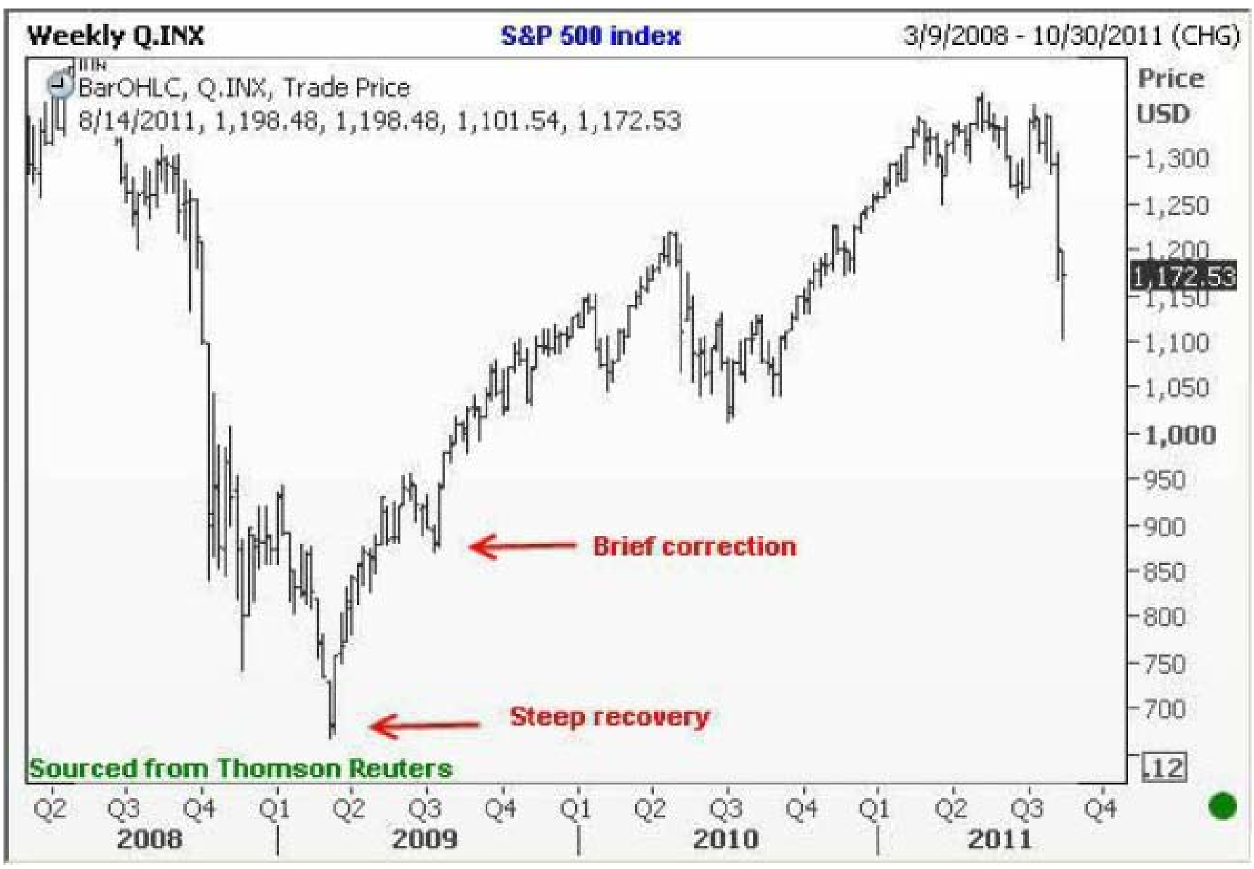

Fig 18a - S&P 500 raced higher to gain by 40% before we got wave 2

At other times, we get a long base-building process that tests our patience, and even when the first wave finally takes shape, it is difficult to be overly confident.

Fig 18b - ITC, an Indian Blue Chip company tested our patience

Clearly, the first wave does not exhibit a consistent personality. However, you need to be aware that *the markets are technically the strongest after a severe sell off.* After a steep rally, you should be looking for formations that will tell you where to sell! You will have to wait for price to move past a reflex point, and then see if you can count five tiny waves. Even then, you will usually wait for a correction of at least 50% before committing money.

This is not the case with the third wave! There will be no mistaking whatsoever about a third wave that is in progression. The steepness of the wave is distinct, and volume typically increases. You will frequently see gaps in the chart. Those who use oscillators such as the RSI will find that they show price has reached overbought territory. Yet, after a brief lull during which this situation is corrected, price continues to go higher. Traders who try to pick a top during the progression of a third wave often get hurt. The third wave also gives valuable clues about the probable extent of the fourth wave correction. For example, an extended third wave is usually corrected only by 23.6%. Also, if Wave 3 was extended, then chances are Wave 5 will be of normal proportion, perhaps equal to Wave 1. A third wave in a bear market is usually more destructive, and easier to trade off pull backs.

Fig 18c - The rally having a failed fifth at the top is not a third wave.

The best clue for you to decide if we are in a third wave or a C wave is to look at the slope of the potential third wave compared to the slope of the first wave. Here, in Fig 18c above, the second rally that followed the initial rally induced by the Swiss National Bank (The Central Bank of Switzerland) was less steep when compared to the latter. So I should have been skeptical about the up move. Of course, I was only looking for a move to around 0.7900 at that time. The fact that it didn't reach there and started coming off more or less nailed the USD/CHF and sure enough it collapsed all the way down to 0.7070 in the space of a few days.

Now let us turn to the personality of fifth waves. Elliott maintained that the fifth wave was the wave that usually extends. However, when we are dealing with a normal fifth wave, it will likely be slower than the third wave in terms of movement. This is the wave during which we get divergences in oscillators such as the RSI and Stochastic. However, the common man typically is most bullish during the fifth waves because now he is absolutely convinced that prices are going up. After having waited all this time, missing the first and third waves, he decides to get involved now, and will be swiftly penalized.

Fifth waves often develop into diagonal triangles, which is a dead giveaway of a top developing. Occasionally, when you use the channeling technique explained earlier, you can witness a ‘throw over’ above the boundary, thereby triggering a few stop loss orders. But no sooner than these orders are done, the price comes back below the line and starts moving down. In these cases you should be willing to join in the selling, and not be paralyzed by fear of loss. Of course, you should always, repeat always, operate with a stop loss. Only now your stop loss order could be placed above the boundary of the channel, which is not a bad risk reward proposition. A word about volume during the fifth wave. Elliott has observed that volume continues to rise during the progression of the fifth wave. However, you could see a period when volume increases, but price increases at a slower pace, indicating that a turn is not far off. A little later, prices could increase but volume tapers off, and when this happens, you should start looking for your first 5 wave sell off to indicate the market has topped. Divergences between volume and price are a reliable clue in the fifth wave position.

Now let us look at the personalities of the corrective waves.

In an attempt to get on board the third wave, many traders blindly place buy orders at the 50% and/or 61.8% retracement levels. While this approach is certainly superior to buying at random, I would recommend traders should try and study the sub waves that make up the second wave. If the B wave falls well short of the top of the A wave, then chances are we will get a deep correction during the C wave, and your buying could be delayed even more. However, if Wave B went back to the top of Wave A, then this is likely a Flat correction and the Wave C will probably finish around the 138.2% projection of Wave A.

If you have actually analyzed the first wave carefully, and seen it has been past a reflex point, then buying as close as possible to the start of the first wave will be a very smart trade. The risk reward trade-off will be extremely in your favor. True, you could still lose money, but trading is all about taking risks. One last point about the second wave… If Wave B goes above the top of wave A (to set up an irregular correction) you should buy very aggressively when you see the C wave approaching its natural end point. This is because the ensuing third wave will very likely be an extended third wave. The irregular B wave was your clarion call that the bulls are taking control.

Fourth waves are usually best avoided if the second wave was a simple wave. Elliott's theory of alternation tells us to expect a complex correction at the fourth wave if the second wave was a simple correction. While it is certainly possible for short term traders to trade the fourth wave by observing the internal waves of each leg, be aware that the level of complexity could increase without warning. What appears to be a triangle one day could turn out to be some other beat the next day. Just when you think that the worst is over, and a new impulse has begun, you will often see the market suddenly hesitate and start another leg of corrective move down. Of course, you should be alert to the start of the fifth wave once the fourth reaches its normal projected target. Finally, if the first and third waves were of normal length, and if the fourth wave becomes an irregular correction, you can almost be certain that the fifth wave is going to be an extension.

Within corrections, it is possible to get some clues by looking at the internal waves. For example, if wave A unfolds in a five wave sequence, you should not only expect Wave B to come back only part of the distance, maybe to 50% or 61.8%, but also for Wave C to travel deep. The whole correction will unfold as a zigzag correction, and you should anticipate for it to travel to the maximum corrective target. For example, if you are in a fourth wave position, Wave C could take it down to the 50% retracement of the third wave. (this is not to say that fourth waves cannot go down to the 61.8% level, but such an occurrence is very rare)

When you see a recovery after wave A has finished only 3 waves, be prepared for Wave B to go back to the start of the correction. Sometimes, this B wave moves above the top of the prior impulse wave, and some traders would think we have started the next impulse wave. Your clues to determining whether it was an irregular top in the making, or a new impulse wave, will depend on the speed of the move, the distance the prior Wave A had moved as well as whether any of the prior impulse waves had been an extending wave.

Wave C being the third step in the progression is almost always faster than wave A. In a bear market, wave C will frequently be a shocker of a move, and many stops will get done. The internal waves of wave C is always made up of 5 waves and you should be able to trade it comfortably. Even in a bull market, wave C travels faster than wave A, but you can differentiate it from a third wave by looking at the slope. Generally speaking, the C wave tends to have a more gentle incline. Also, during C waves, the daily charts remain bearish, even if the hourly charts have turned positive.

I would like to demonstrate to you how we could analyze a market that is in a correction.

Start by looking at the comments on the New Zealand Dollar in my blog at the following link: http://tinyurl.com/kiwiC. These comments were posted on August 4, 2011 when the NZD was trading at 0.8478 and I said that we will see a dip to its first target at 0.7970 and later to 0.7760 over the next few months. Today, as I am writing this chapter of the book, it is August 11, and I looked at the chart and found that the NZD has already been to a low of 0.7959 on August 9 and the following day it had bounced back to a high of 0.8407.

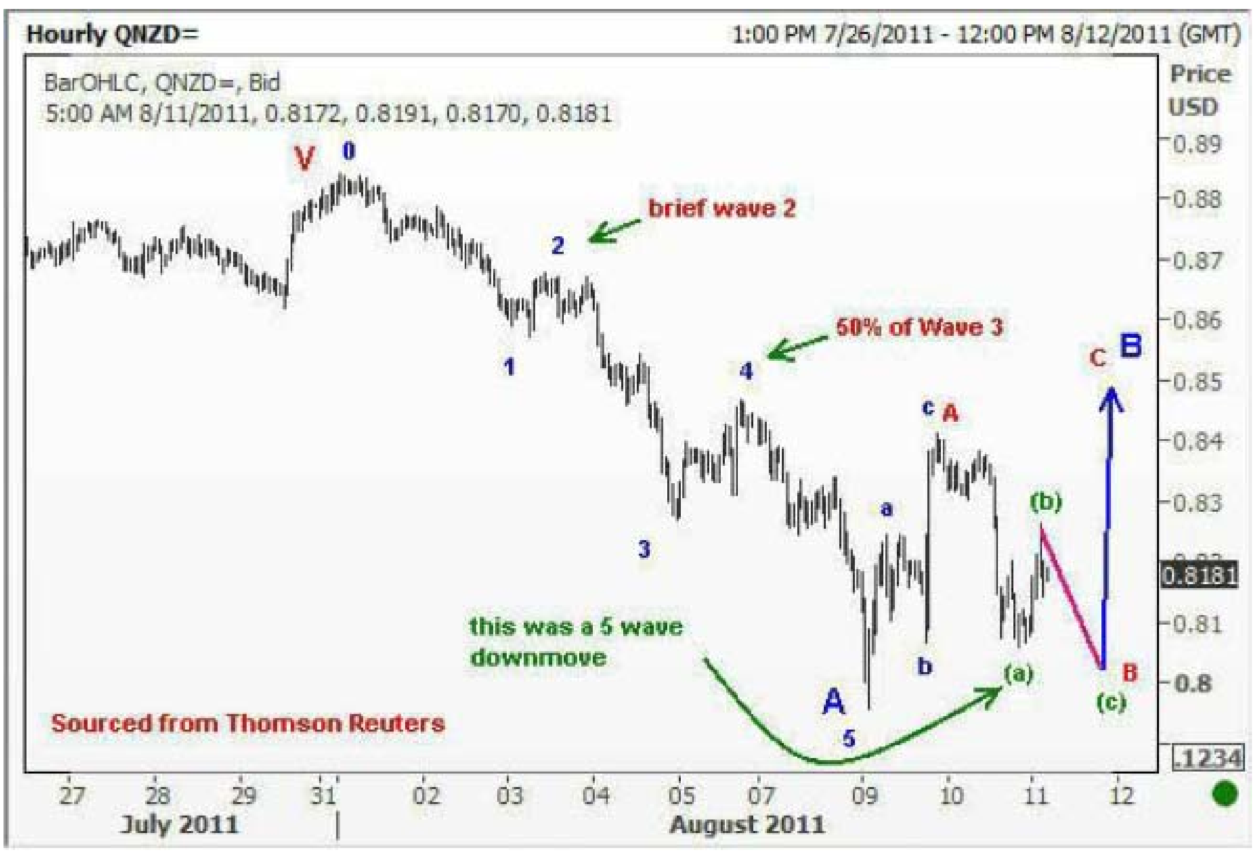

Fig 18d - Analyzing corrective waves using wave personalities

We start by going to the hourly charts. Observe that the sell off to 0.7959 has been in five waves. This being the first down move from the peak, we will call it as Wave A. When Wave A is made up of 5 waves, we know that the correction will be a zigzag. We also know that the B wave will not go back all the way to the top. And thirdly, we know that the C wave will be even more powerful than the A wave because we are in a bear trend now, and will travel some distance to the south.

Next observe that the first recovery from the low of 0.7959 has been in 3 waves (a, b, c), and the next down move has been in 5 waves (what I have tentatively labeled as Wave (a) in green). This means either we have finished the B wave already (as shown in Fig 18e below) and are ready to collapse, or the a, b, c move up was a mini Wave A and we will get a 3 step zigzag move down as wave B followed by another recovery as Wave C to complete the bigger B wave (as shown in Fig 18d above). The collapse of wave C will come later in this scenario.

Irrespective of which scenario plays out, we know that the next immediate move is going to be down, either as a mini C or as a larger C wave. So there should be no trades from the long side. **The main clue for you is going to come from the personality of the next decline. If we are in a bigger C wave, that sell off will be steeper than the 5-wave decline from the top to 0.7959. On the other hand, if we seem to hesitate near the bottom of the bigger Wave A, then we will most likely get another recovery.** In case we dip below the bottom of wave A and then start coming back up, that will be an irregular B wave, implying that after the minor B wave is finished, the next sell off will be even more severe.

Fig 18e - Alternate scenario where the three wave correction to 50% retracement level is already the end of the B wave, and so we will get a big sell off directly.

To summarize, just as I explained in the beginning of this book that you should pay more attention to the wave structure than to Fibonacci ratios, [See "4. Fibonacci Ratios"] so also should you keep in mind the personality of each wave when considering your next trade. Doing so will save you from making errors in your wave counts, and you will see an immediate positive impact on your bottom line.

Addendum: The above notes and charts were prepared on August 11, 2011. Today, it is Aug 24, and I was giving a final reading of the book to see if anything could be changed to make things clearer to you. As I had given two scenarios above, I thought it was a good time to check what really happened. Let us take a look now.

Fig 18f - Unexpected complexity in Wave B prior to next big down move

In the explanation just under Fig 18d above, I had highlighted that your clue is going to be the steepness of the decline once the correction is over. (Basically, the personality of the Wave C) What we got here, as seen in Fig18f, was a slow move *higher* to post another abc leg (in green). Then, we got one more move down, but even that decline was not a swift move. So we are still waiting to finish potentially a third abc move up. In all, we would have seen a triple zigzag making up wave B. Once that is finished, we will get the elusive Wave C down, a move that will be steeper than the first Wave A. **Let this example also serve to highlight the pitfalls of trading a complex correction. It can take unexpected turns and there is no way for you to anticipate what the pattern will be.**

Complex corrections are best left alone.

19. Magical Moments

The goal of all analysis should be to make money in the markets. As traders, we should not expend our energies in trying to capture small profits.

Remember that almost all trading activity involves costs, even if these costs are skillfully disguised. So it pays to keep the level of activity low, and wait for a particularly sweet spot in the markets where we know the odds are heavily in our favor. At these specific points, the risk-reward trade off will be very attractive. In this chapter, I will introduce you to the one of the worst kept secrets of Elliott Wave Principle. I say worst kept secret because even though this idea has been written in plain English in the works of Elliott, and mentioned again in numerous works including that of Mr. Prechter, most traders seem to be forgetful of its value.

Elliott made it clear that at least one of the three impulse waves is likely to be of abnormal length, i.e. it will be an extension. Although third waves are strong, there is a tendency for the fifth waves to extend. When you know that we are in an impulse phase, and you have already seen the first and third waves being of normal proportions, you should get ready to see a fifth wave extension. Again, if the fourth wave was an irregular correction, there is a good chance that the fifth wave will be an extension.

The window to relatively easy riches shows up AFTER the extended fifth wave has run its course. When an extended fifth wave is completed, Wave A of the ensuing correction will not only be swift but will travel to wave 2 of one lower degree.

There are two important points to note here. First, we know that the movement will be swift, and second we know approximately how far the wave A will move. This combination of information is invaluable for those who take on leveraged positions.

But there is something else you need to know about extended fifth waves. If the ensuing correction is a zigzag, the B wave will not go all the way back to near the top of wave A. This can be verified by looking at the internal waves of Wave A. If you see five sub waves inside Wave A, then the whole correction is going to be a zigzag. However, if you get Wave A in three sub waves, lookout for a move back to the top of the correction, potentially even reaching a new high to post an irregular B wave. Only after we retest the prior top will the C wave start afresh and go down to meet the target for the whole correction.

I will show you one recent example here, but at the end of this chapter I have given you several links to illustrate this phenomenon. Enjoy!

Start by viewing this video on TCS: ***http://tinyurl.com/tcsvideo***

This video was posted on my blog on 7 March when the stock was at 1109. I was suggesting that we will see a decline to 835 over the next 12 months. Shortly afterwards, the CEO of Tata Consultancy came out with some very bullish comments, and the stock went to a new high. I followed it up with another post, produced here ***http://tinyurl.com/tcsupdt***. Take a moment to read some of the comments below that post as well. I am showing this to demonstrate that we have got to believe in our analysis. While there is always a chance that we could be wrong, we have to trade our theory. Otherwise all the time and effort is a big waste of time. We protect our capital with affordable stops, but we got to trade! This is what is happening at the time of writing this chapter.

Fig 19a- TCS has suddenly turned down, and looks set to reach the target in the coming months

Here are some more links for you to gain confidence that this thing works!

Read this detailed post on WaveTimes first .

http://tinyurl.com/wav5ext

Silver reached a low of $32.22 on May 12, 2011, a drop of 21% in 8 days!

http://tinyurl.com/silverextn

Read this audacious post made around the time when leading investment banks were calling the Crude higher to $150 again. Crude Oil dipped to $75.71 on August 9, and I still think the move is not over.

http://tinyurl.com/crude5ex

Conclusion: If you wish to trade only occasionally, then all you have to do is to wait for signs that an extended fifth wave is nearing completion, and be positioned for a swift move back to wave 2 of the extension. There is no easier way to make money, in my opinion. The only problem is you don't know if the extension is over until it really does. So you cannot hope to catch the absolute top unless you are willing to try your luck a few times, with close by stops. The other way is to wait for a pull back once the first counter move unfolds in five tiny waves. Once you are committed to a position, immediately place stop loss orders above the highs or lows just seen. Over time, you are bound to come out a significant winner. (This one chapter alone should pay back your investment in this book hundreds - if not thousands – of times over!)

20. Practical Advice

I am not going to bore you with the same old advice that you have read everywhere, viz. have a stop, know what is an appropriate position size for your risk tolerance, run your profit, cut your losses bullshit. We all know what we should do, but we continue to trade poorly because of our emotional makeup. As you probably realize by now, Elliott Wave Principle works in ALL time frames, whether it is a tic chart or a monthly chart. So what is the best way to trade using Elliott Wave analysis?

<u>Don't try to force a wave count.</u> It is okay to have tentative labels, but approach the business of counting the waves with a completely open mind. Don't go there already with a preconceived notion that this is a zigzag, or diagonal triangle. Patterns could change, and if you look at the chart after a few sessions, it might look different. So the first advice is to go to your charts with the understanding you know nothing about what is in store for the future. Examine ALL the possibilities, as everything is indeed possible. Then eliminate these possibilities one by one using the rules and guidelines you have learned in this book. Finally, trade your theory.

Understand that Elliott Wave Analysis is NOT your holy grail to profits. It is only a broad road map. You could still face some pitfalls along the route. But if you are able to be patient and wait for the right kind of set up, then your risk-reward ratio shifts dramatically in your favor.

<u>*I suggest that you always keep the big picture in mind, and focus on the shorter term charts to determine where it becomes a good place to enter for the medium term*</u>. When you know which wave we are in the bigger picture, you should trade in the direction of that trend. So wait for the appropriate reaction using your knowledge of Elliott Wave Principle, and get into the trade. If the stop loss level seems too far if you were to apply the rules of Elliot, then don't get into that trade. Money not lost is money gained.

<u>Stop following others' advice. Learn the method yourself, and trade small until you gain in confidence</u>. I will be publishing a series of handbooks dealing with commodities, foreign exchange and stocks from different markets. Use those handbooks solely for the purpose of learning, and not as investment advice. When you follow your own wave count, you will know beforehand where to get out of the market. If you don't exit a trade when your charts tell you that your wave count is wrong, then you have no one but yourself to blame. And that is how you should trade if you want to be a winner.

When a wave count is unclear, step aside. Find some other instrument where the count is clear to trade. Suppose, for example, you are thinking a new uptrend has begun, and you are anticipating a third wave move up. And you are positioned correctly. As the wave unfolds you see that the pace of the move is not in keeping with that of a third wave. What should you do? When in doubt, get out. The markets are always there. Another move will show up in just a few days.

There are traders who are very eager to get into a position. But within minutes of getting into a trade, they are more eager than before to get out! Try not to get into such a mental state. With EWP, you are in a position to take calculated risks. So take those risks when the rewards are substantial. More importantly, follow through till the end of the five waves. Therein lies your real reward.

When you see a five wave move finish, you might be happily making the prediction of a correction. But far more important is to get out of your longs, and maybe turn short to capture the correction. Believe me, that is a lot more fun than the satisfaction of having made a correct forecast.

When there are different possible wave counts at a certain juncture in the market, see if they all point in the same direction. If yes, then it really doesn't matter which count is right. You have to be positioned in that direction. If there is a conflict in direction, it is better for you to stay out of the market at that time.

Here is an important tip. So long as the corrective action does not fall below the first wave of the same degree that is being corrected, the trend can still be considered intact So although you will be on the lookout for a move beyond a reflex point in order to get involved upon a reaction, you also have to keep a constant lookout to see if the first wave of the prior impulse wave was violated. Once it goes past the end of the prior first wave, your confidence in the assumption that the trend has changed should improve.

In a fast paced market, don't try to position against the move at minor Fibonacci levels. Wait for the move to run its course. It is a tendency of some traders to try their luck at the 38.2%, 50% and 61.8% retracement levels in that order, unmindful of the fact that everyone around him is selling (or buying). You should avoid this tendency. When you see a fast paced move unfolding, and you are more inclined to trade in the opposite direction, I suggest that you pick the farthest Fibonacci level, and put in a very tiny order just to satisfy your ego. The right way to trade will be for the selling (or buying) to abate, and for the market to pause sufficiently long for you to think, yes, perhaps the move is over for this session. Even if the market stops abruptly and races back in the opposite direction, you will usually get a second test of the levels you just missed. So be patient.

<u>Do not try to catch the corrective motion when the major move is going to be in the opposite direction upon completion of the correction</u>. Your time should be spent in preparing to join the major move. The same amount that you are willing to lose on trading the corrective move can be better employed when you trade with the bigger impulse wave.

<u>The final piece of advice is to use the Wave Principle to make money, rather than to make predictions</u>!

I wish you the very best of luck in this endeavor…..

Afterword

Once you have read this book, and practiced with old charts, you will soon be able to label most market movements. You will be able to demonstrate Fibonacci relationships that will impress anyone who has no knowledge of the EWP. Actually, this competence is what your first goal should be! Once you are comfortable with counting waves, you can move on to the **next challenge**, **the more important one,** in my opinion**, that of making money for yourself**.

My main advice to you is this. First of all, figure out whether the instrument you are trading is in an impulse phase or a corrective phase. If you are in an impulse phase, that is great news. All you have to do is to wait for a minor correction using the techniques I have taught you, and get on board. Even if the price goes away from you for a short while, it usually comes back. However, if you are trading a corrective wave, you need to be extra careful. The main trend can reassert itself before reaching your planned levels and you will be left wondering what mistake you made. The mistake was you traded the correction!

The best rewards go to those who are able to get on board a third wave move. The only challenge you will face is the timing of the trade.
Let us assume that you are planning on buying a stock to catch a third wave rally. What are the possible problems? You could buy it at the 50% retracement and watch it go perilously close to the bottom of the first wave. Sometimes the second wave seems to last an inordinate amount of time. Other stocks would have rallied, but the particular stock you have put your money in seems to be intent on going lower, or trading sideways. What should you do in these circumstances?

Naturally you would have placed your stop just below the starting point of what you thought was Wave 1 [*Remember the rule that Wave 2 can never go below the start of Wave 1?*]. Having protected yourself with the stop loss order, the best thing you can do is to wait. Be patient, and be inactive, no matter what the world tells you. Do NOT ask your friends for their opinions. Do not watch CNBC or read up news on this stock. Just sit tight. If your analysis is correct, the stock will eventually start moving higher. (Of course, if you are trading Options, you have the clock ticking, but we are discussing a plain vanilla cash trade here). The time to add to your original position is when it starts moving in the money. Not when it comes down a bit lower than your purchase price, in an effort to average out the purchase price.

As the price starts moving higher, start counting the minor waves. You can adjust the stop higher depending on the structure if this new minor wave up. [*Remember the guideline that any correction now should not come below the top of Wave 1?*] That should come into play.

The final piece of advice now is to hold on to your position till your profit target is reached. Most of us will heave a huge sigh of relief when the price comes to break-even levels, and get the hell out of that trade. Wrong! You should look for levels to ADD to your position now as described above, not to get out.

I realize that these steps are all easier said than done. But it is within our power to change our approach to the market. Try it for a few weeks, with small positions, and then you will gradually gain in confidence. Remember, there is no easy way to riches. Certainly, there are no QUICK ways of getting rich.

Once you know you are in the fifth wave of the impulse phase, you must become careful again. You have already learned that the correction that occurs at the end of a fifth wave will be BIGGER and last LONGER than either of the two minor corrections that preceded it. (Actually, if you like to trade corrections, you should trade the C wave of the correction that happens after a five wave move is finished!)

In the fifth wave phase, you will go back and check whether the first wave or third wave had extended. If both waves were of normal proportions, you will anticipate an extending fifth wave, and stay on board a bit longer. If one of the prior impulse waves had extended already, you will exit most of your position at the 38.2% projection target (see the chapter regarding fifth waves). In any event, you will want to get out if the first sub wave within the fifth wave is violated by any correction.

I started off on this afterword with an intention of wrapping up the book with some generalized comments, but then thought the space was better spent giving you some additional tips, even if it means repeating myself.

Anyway, the key to success in trading is a combination of luck, skill and money management in that order. Some may put money management ahead, but I am not going to quarrel with them. All three are important. You can influence your luck by improving your skill, for example, by reading this book again, and practicing often. Money management is more about common sense than anything else. Pretty soon, you should become a better trader than what you are today. I wish you good fortune.

If you would like to contact me, please post a comment on www.wavetimes.com. If you would like to follow me on Twitter: @wavetimes and if you would like to help a friend, please tell him/her about this book. It is deliberately priced very low so everyone can afford it.