BRIDGE the global financial information company

Tips on Technicals

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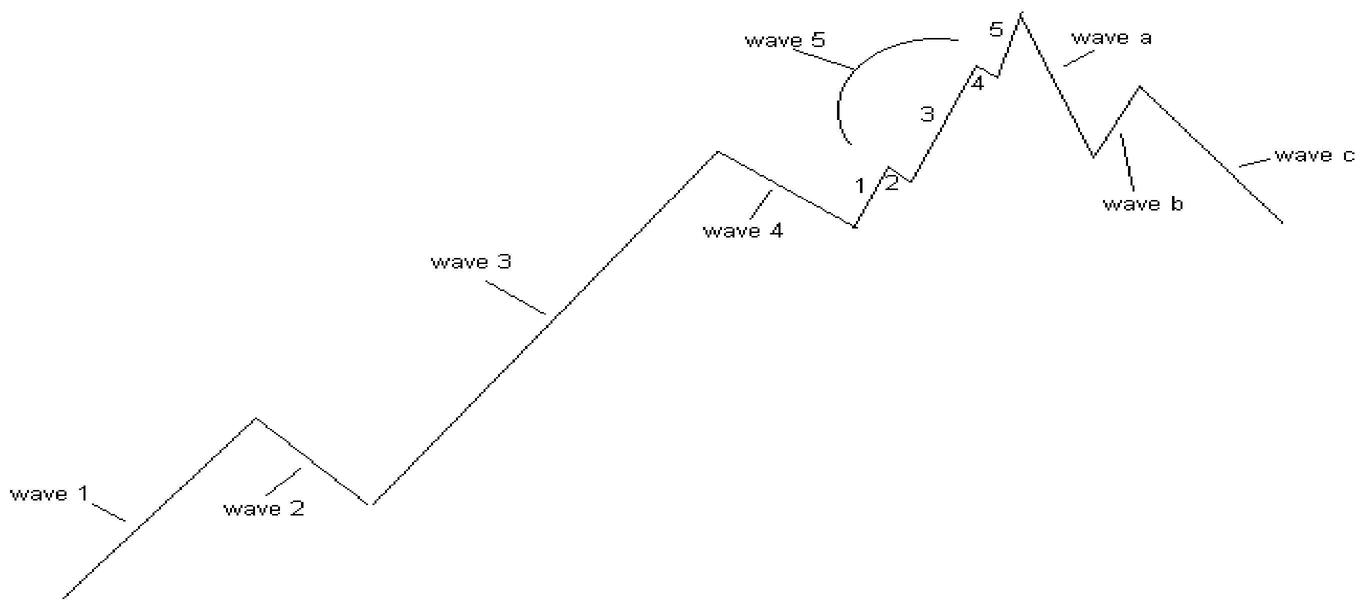
Introduction to Elliot Waves

The Elliot Wave Theory was proposed in the early 1930s by R.N. Elliot, a stock market speculator, as the next logical step after Dow Theory[1]. Elliot focused on classifying market activity according to a set of cycles and ratios of movements. As with the waves on the ocean, market activity ebbs and flows in cycles that repeat and can be subdivided into smaller cycles.

The theory states that markets move in repetitive patterns; a five wave advance (impulse waves) and a three wave decline (corrective waves, labeled with letters). This cycle of eight waves can be seen in all time frames from intraday to what Elliot called the "Grand Supercycle" of over 200 years. Each wave in a cycle can be subdivided into smaller cycles.

The diagram below shows how an eight wave cycle advances in five waves and declines in three. One of the rising impulse waves has been broken down into five smaller waves.

Fig. 1



One important concept to remember that will tie together several advanced technical analyses is that the wave counts of the cycles and their sub-cycles follow the Fibonacci sequence (see Tips Vol 2, No 13). The two part cycle has three corrective waves and five impulse waves for a total of eight waves. That is the sequence 1,2,3,5,8 where any number in the sequence is the sum of the two numbers preceding it. Further subdivision of the waves will yield wave counts that follow the Fibonacci sequence higher.

Logical Rationale

While the mathematics of waves and Fibonacci sequences are critical in understanding Elliot Waves, the human behavior underlying the resultant cycles is also important. The "personalities" of waves, as first interpreted by Elliot Wave specialist Robert Prechter, categorize why the waves rise and fall like they do.

Wave **"1"** includes the changing of market opinion from bearish to bullish. It often is driven by a rebound from depressed prices and is the shortest of the rising impulse waves. Basically, the bargain hunting has begun.

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[1] *Dow Theory breaks the markets down into short, medium and long term trends and, for stocks, requires movement in the industrial sector to be confirmed by movements in the transportation sector.*

Wave **"2"** is a retracement of wave **"1"**. Most, if not all of the gains from wave **"1"** are erased because market participants have used this rally to sell their losing positions at slightly better prices. This wave often presents itself as the right shoulder of a head and shoulders pattern.

Wave **"3"** represents when the reversal patterns completed by the first two waves break into the new trend. This is the longest and strongest of the impulse waves, at least in the financial markets, as most technical patterns have signaled the new trend and market participants now rush in to follow it.

Wave **"4"** is the consolidation phase of the advance. Its structure is also fairly complex, yielding many common continuation patterns such as triangles. This wave may never drop below the peak of wave **"1"**.

Wave **"5"** is final stage of the advance and often shows a divergence with such technical indicators as cumulative volume and relative strength (RSI).

Wave **"a"** at first appears to be a normal correction to the rally. Elliot Theory says that wave **"a"** will break down into five, not three, sub-waves. A market move in five waves indicates a new dominant market direction.

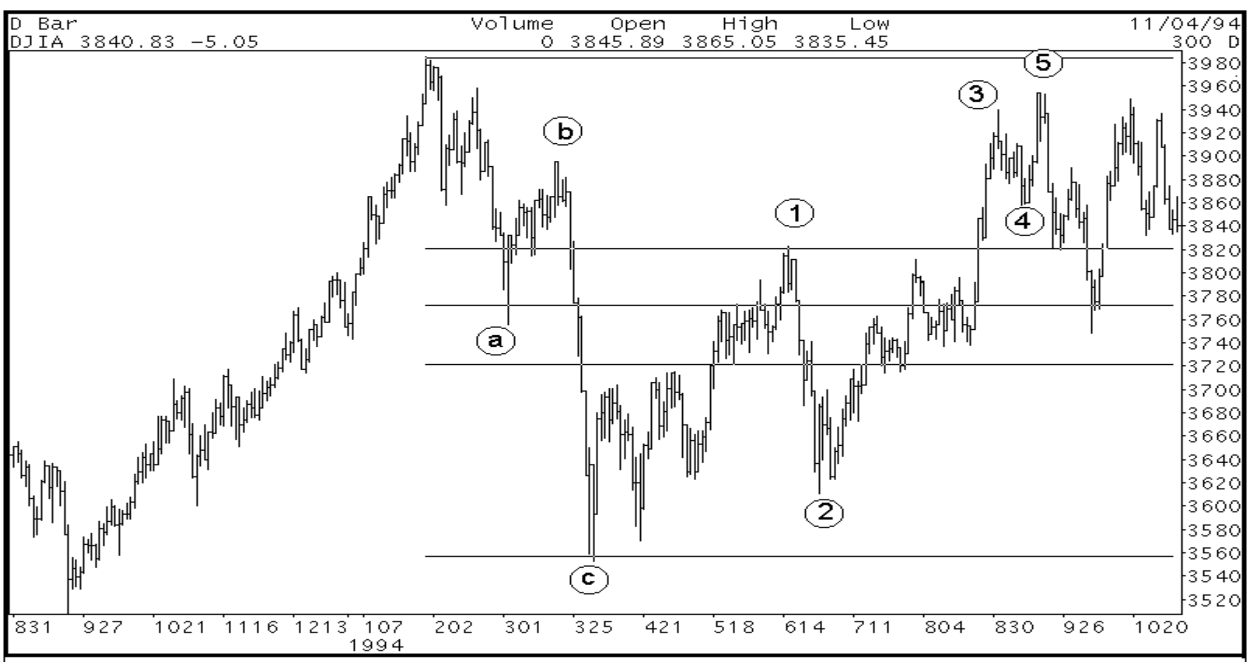
Wave **"b"** is the bear market correction allowing a second chance for sellers to sell.

Wave **"c"** typically breaks support and the peak of wave **"3"**. Here, many technical indicators confirm that the original rally is over.

Identifying waves is often a difficult activity because there are a number of exceptions and variations in the waves. These deserve a separate discussion for themselves.

The final point to mention is that Fibonacci ratios provide targets for price moves and typically coincide with wave peaks and troughs. The chart below of the Dow Industrials for 300 days shows the bull market interpretation of the US stock market. The peak near 4000 can be considered the end of wave **"5"** and the start of wave **"a"**. Notice how the Fibonacci retracement levels of the corrective phase (a,b,c) provided resistance to the following impulse waves. The danger here is that our simple interpretation (no consideration of other technical indicators or Elliot extensions and other variations) does not take into account that wave **"1"** does not rise above the peak of the previous wave **"5"**. This could be cause for revising the bull case to a bear case.

Fig. 2



Elliot Waves are far too complex to be covered adequately in this format. Please use this edition of Tips as an introduction to some of the concepts and terms of Elliot Waves but not as a lesson on how to trade with them.