

AEEIC Group



AEEIC



Lesson 11

by
Madiba
Malebo

Elliot wave theory

The background features abstract, overlapping geometric shapes in various shades of green, ranging from light lime to dark forest green. These shapes are primarily located on the right side of the frame, creating a modern, layered effect. The rest of the background is plain white.

BASIC ELLIOTT THEORY

Elliott:

Ralph Nelson Elliott is the father of the Wave Theory, which is commonly called and more accurately described as the Elliott Wave Principle. Born on July 28, 1871 in Marysville, Kansas, Elliott reached his ultimate achievement late in life by a circuitous rout.

Elliott examined yearly, monthly, weekly, daily, hourly and half-hourly charts of the various indexes covering 75 years of stock market behavior. By November 1934, R.N. Elliott's confidence in his ideas of what is sometimes called the Wave Theory had developed to the point that he presented them to Charles J. Collins of Investment Counsel, Inc. in Detroit.

Elliott:

Although it is the best forecasting tool in existence, the Wave Principle is not primarily a forecasting tool; it is a detailed description of how markets behave.

Nevertheless, that description does impart an immense amount of knowledge about the market's position within the behavioral continuum and therefore about its probable ensuing path. The primary value of the Wave Principle is that it provides a context for market analysis. This context provides both a basis for disciplined thinking and a perspective on the market's general position and outlook. At times, its accuracy in identifying, and even anticipating, changes in direction is almost unbelievable. Many areas of mass human activity follow the Wave Principle, but the stock market is where it is most popularly applied

Elliott:

Indeed, the stock market considered alone is far more important than it seems to casual observers. The level of aggregate stock prices is a direct and immediate measure of the popular valuation of man's total productive capability. That this valuation has form is a fact of profound implications that will ultimately revolutionize the social sciences. That, however, is a discussion for another time.

Elliott:

Under the Wave Principle, every market decision is both produced by meaningful information and produces meaningful information. Each transaction, while at once an effect, enters the fabric of the market and, by communicating transactional data to investors, joins the chain of causes of others' behavior. This feedback loop is governed by man's social nature, and since he has such a nature, the process generates forms. As the forms are repetitive, they have predictive value.

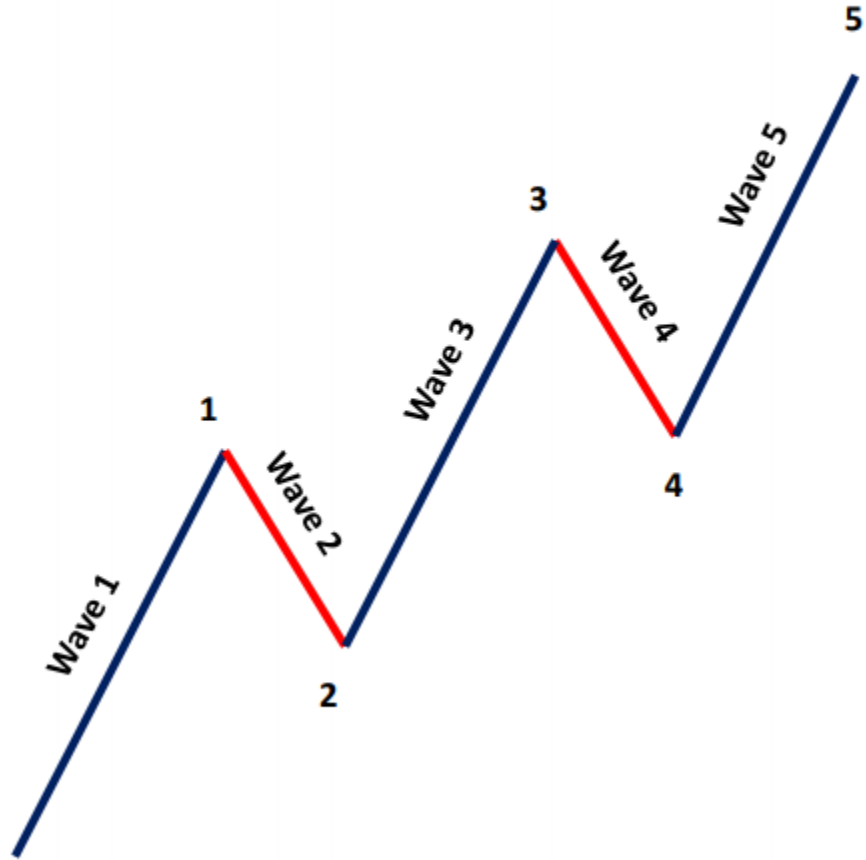
Sometimes the market appears to reflect outside conditions and events, but at other times it is entirely detached from what most people assume are causal conditions. The reason is that the market has a law of its own. It is not propelled by the linear causality to which one becomes accustomed in the everyday experiences of life. Nor is the market the cyclically rhythmic machine that some declare it to be. Nevertheless, its movement reflects a structured formal progression.

Elliott Theory:

In markets, progress ultimately takes the form of five waves of a specific structure. Three of these waves, which are labeled 1, 3 and 5, actually effect the directional movement. They are separated by two countertrend interruptions, which are labeled 2 and 4, as shown in Figure 1-1. The two interruptions are apparently a requisite for overall directional movement to occur.

Elliott did not specifically state that there is only one overriding form, the "five wave" pattern, but that is undeniably the case. At any time, the market may be identified as being somewhere in the basic five wave pattern at the largest degree of trend. Because the five wave pattern is the overriding form of market progress, all other patterns are subsumed by it.

Elliott Theory:



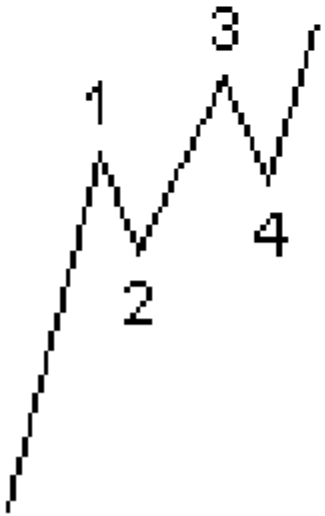
Wave 4 never enters the price territory of wave 1

Wave 3 is never the shortest wave.

Wave 2 never moves beyond the start of wave 1.

Elliott Theory:

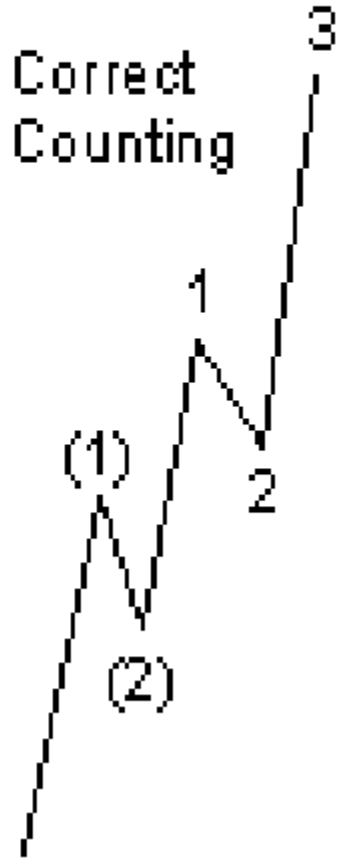
Incorrect
Counting



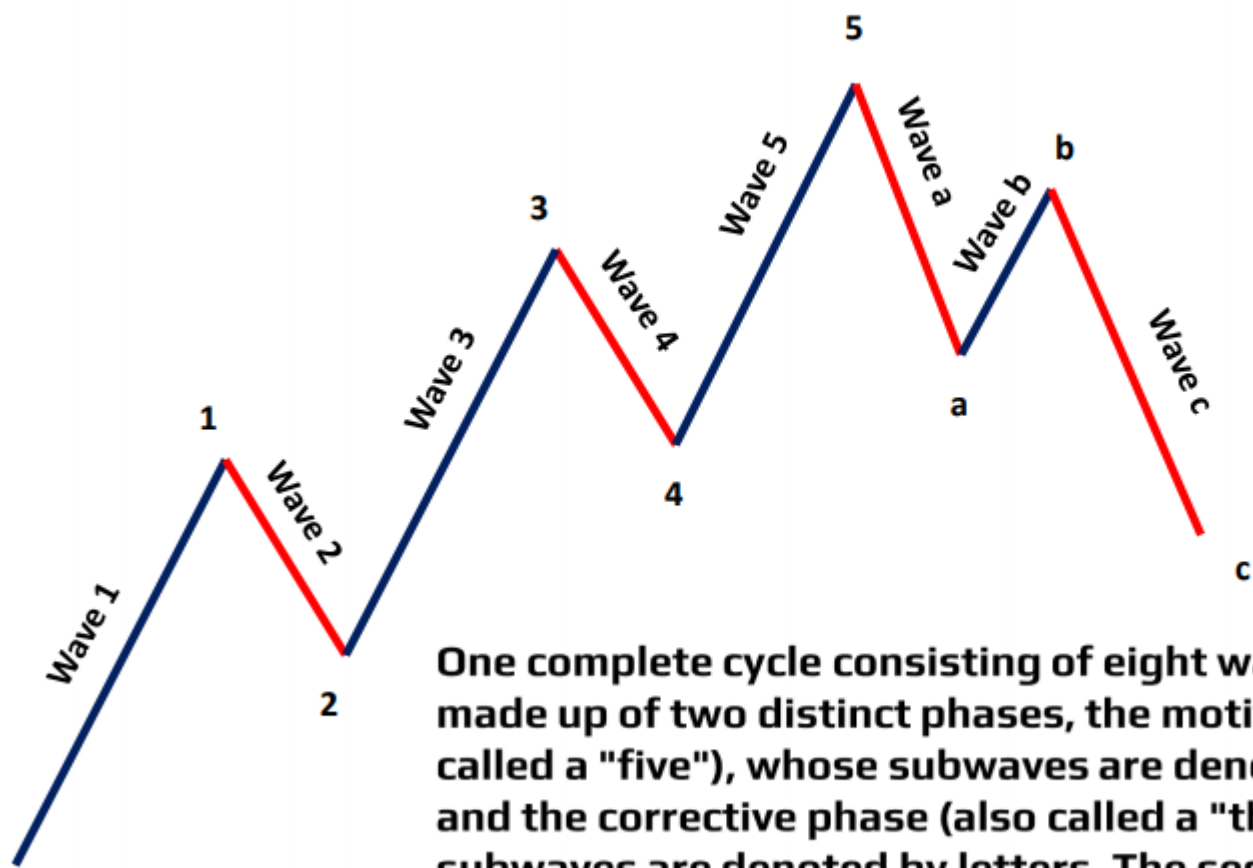
Incorrect
Counting



Correct
Counting

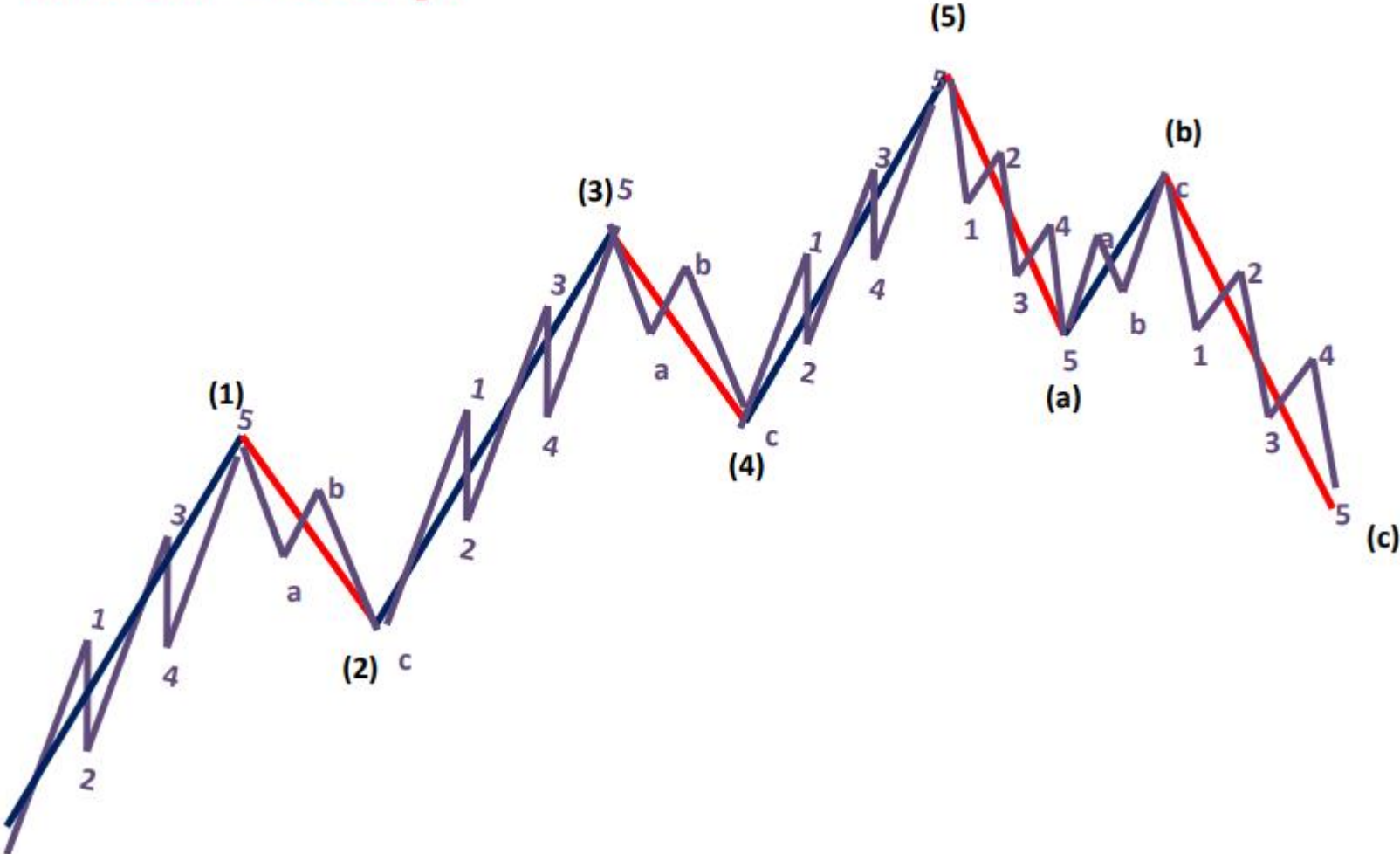


Elliott Theory:

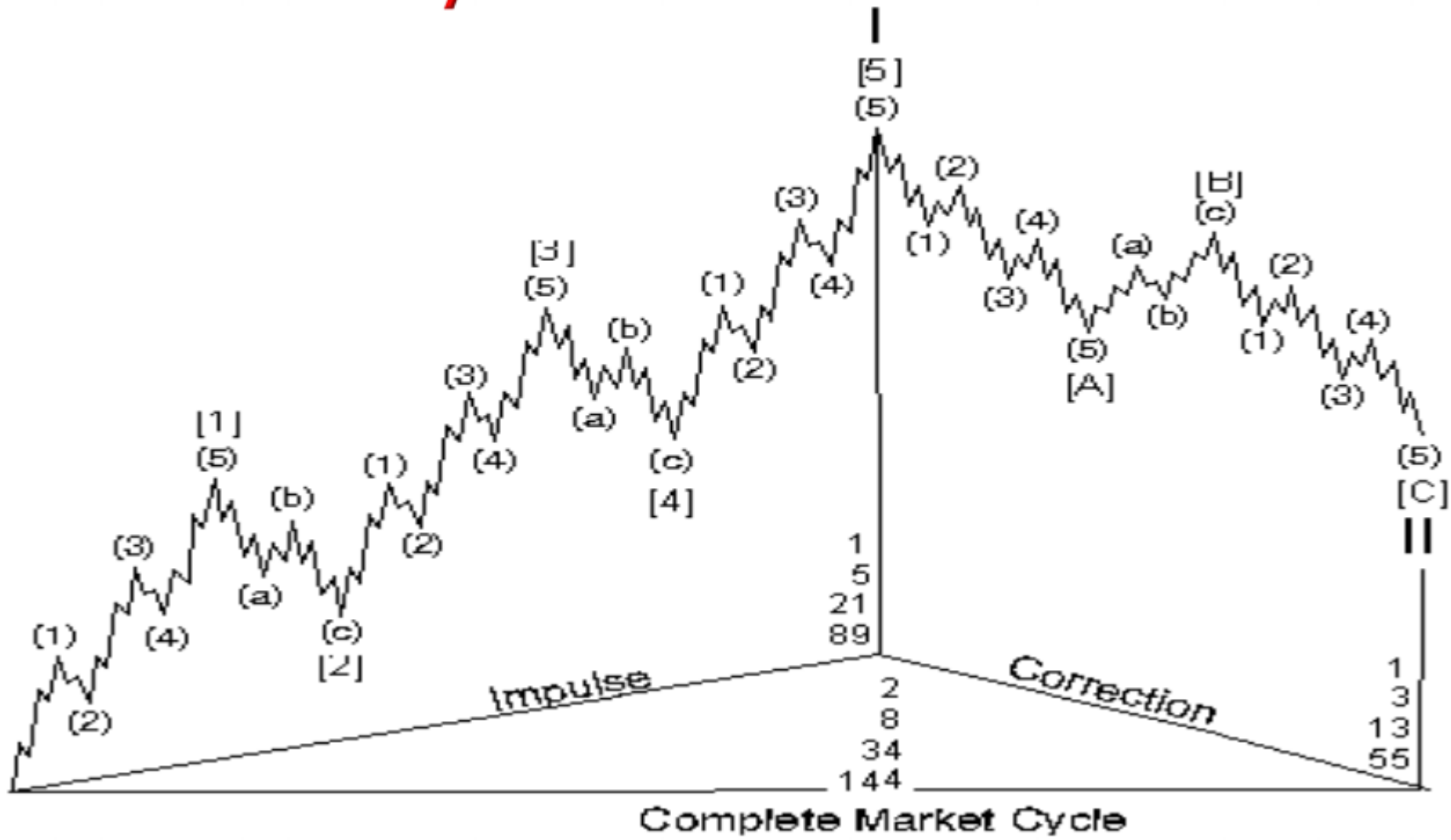


One complete cycle consisting of eight waves, then, is made up of two distinct phases, the motive phase (also called a "five"), whose subwaves are denoted by numbers, and the corrective phase (also called a "three"), whose subwaves are denoted by letters. The sequence a, b, c corrects the sequence 1, 2, 3, 4, 5

Elliott Theory:



Elliott Theory:



Elliott Theory:

Number of Waves at Each Degree

Impulse	+ Corrective	= Cycle
1	1	2
5	3	8
21	13	34
89	55	144

all waves both have and are component waves

Elliott Theory – Wave Degree:

All waves may be categorized by relative size, or degree. Elliott discerned nine degrees of waves, from the smallest wiggle on an hourly chart to the largest wave he could assume existed from the data then available. He chose the names listed below to label these degrees, from largest to smallest:

**Grand Supercycle
Supercycle
Cycle
Primary
Intermediate
Minor
Minute
Minuette
Subminuette**

Elliott Theory:

Cycle waves subdivide into Primary waves that subdivide into Intermediate waves that in turn subdivide into Minor and sub-Minor waves. By using this nomenclature, the analyst can identify precisely the position of a wave in the overall progression of the market, much as longitude and latitude are used to identify a geographical location. To say, "the Dow Jones Industrial Average is in Minute wave v of Minor wave 1 of Intermediate wave (3) of Primary wave [5] of Cycle wave I of Supercycle wave (V) of the current Grand Supercycle" is to identify a specific point along the progression of market history.

Elliott Theory:

When numbering and lettering waves, the scheme shown below is recommended to differentiate the degrees of waves in the stock market's progression:

Wave Degree	5s With the Trend					3s Against the Trend		
Grand Supercycle	Ⓘ	Ⓜ	Ⓜ	Ⓜ	Ⓜ	ⓐ	ⓑ	ⓒ
Supercycle	(I)	(II)	(III)	(IV)	(V)	(a)	(b)	(c)
Cycle	I	II	III	IV	V	a	b	c
Primary	Ⓘ	Ⓜ	Ⓜ	Ⓜ	Ⓜ	ⓐ	ⓑ	ⓒ
Intermediate	(1)	(2)	(3)	(4)	(5)	(A)	(B)	(C)
Minor	1	2	3	4	5	A	B	C
Minute	ⓐ	ⓑ	Ⓜ	Ⓜ	Ⓜ	ⓐ	ⓑ	ⓒ
Minuette	(i)	(ii)	(iii)	(iv)	(v)	(a)	(b)	(c)
Subminuette	i	ii	iii	iv	v	a	b	c

Elliott Theory:

Degree is not based upon specific price or time lengths but upon form, which is a function of both price and time.

The precise degree is usually irrelevant to successful forecasting since it is relative degree that matters most.

To know a major advance is due is more important than its precise name.

Later events always clarify degree..

Elliott Theory:

Every wave serves one of two functions: action or reaction. Specifically, a wave may either advance the cause of the wave of one larger degree or interrupt it. The function of a wave is determined by its relative direction. An actionary or trend wave is any wave that trends in the same direction as the wave of one larger degree of which it is a part. A reactionary or countertrend wave is any wave that trends in the direction opposite to that of the wave of one larger degree of which it is part. Actionary waves are labeled with odd numbers and letters. Reactionary waves are labeled with even numbers and letters.

Elliott Theory – Motive waves:

Motive waves subdivide into five waves with certain characteristics and always move in the same direction as the trend of one larger degree. They are straightforward and relatively easy to recognize and interpret.

Within motive waves, wave 2 never retraces more than 100% of wave 1, and wave 4 never retraces more than 100% of wave 3. Wave 3, moreover, always travels beyond the end of wave 1. The goal of a motive wave is to make progress, and these rules of formation assure that it will.

Elliott further discovered that in price terms, wave 3 is often the longest and never the shortest among the three actionary waves (1, 3 and 5) of a motive wave. As long as wave 3 undergoes a greater percentage movement than either wave 1 or 5, this rule is satisfied. It almost always holds on an arithmetic basis as well. There are two types of motive waves: impulses and diagonal triangles.

Elliott Theory – Motive waves:

The most common motive wave is an *impulse*.

In an impulse, wave 4 does not enter the territory of (i.e., "overlap") wave 1. This rule holds for all non-leveraged "cash" markets.

Futures markets, with their extreme leverage, can induce short term price extremes that would not occur in cash markets. Even so, overlapping is usually confined to daily and intraday price fluctuations and even then is extremely rare. In addition, the actionary subwaves (1, 3 and 5) of an impulse are themselves motive, and subwave 3 is specifically an impulse. Figures 1-2 and 1-3 in Lesson 2 and 1-4 in Lesson 3 all depict impulses in the 1, 3, 5, A and C wave positions.

Elliott Theory – Motive waves:

Motive waves subdivide into five waves with certain characteristics and always move in the same direction as the trend of one larger degree. They are straightforward and relatively easy to recognize and interpret.

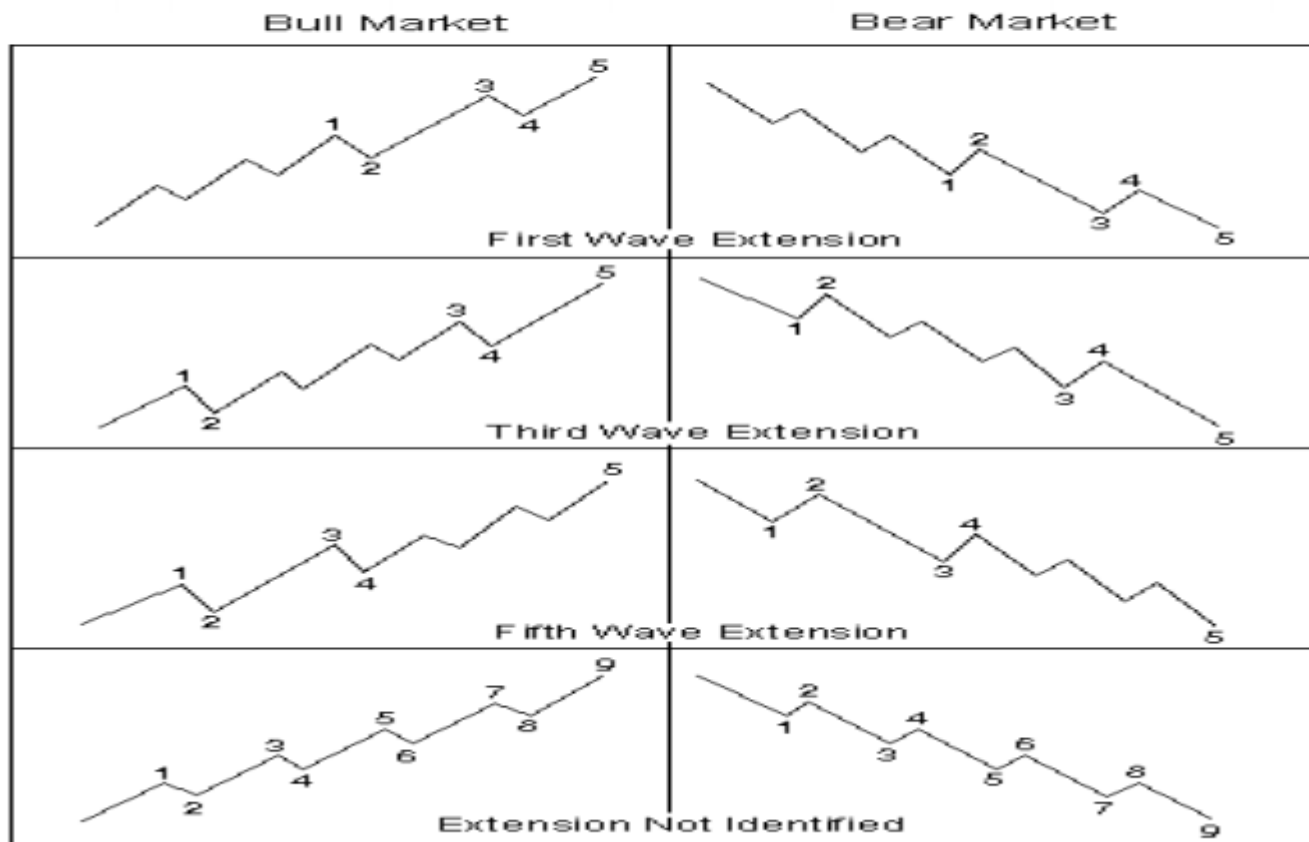
Within motive waves, wave 2 never retraces more than 100% of wave 1, and wave 4 never retraces more than 100% of wave 3. Wave 3, moreover, always travels beyond the end of wave 1. The goal of a motive wave is to make progress, and these rules of formation assure that it will.

Elliott further discovered that in price terms, wave 3 is often the longest and never the shortest among the three actionary waves (1, 3 and 5) of a motive wave. As long as wave 3 undergoes a greater percentage movement than either wave 1 or 5, this rule is satisfied. It almost always holds on an arithmetic basis as well. There are two types of motive waves: impulses and diagonal triangles.

Elliott Theory – Extensions:

Most impulses contain what Elliott called an extension. Extensions are elongated impulses with exaggerated subdivisions. The vast majority of impulse waves do contain an extension in one and only one of their three actionary subwaves. At times, the subdivisions of an extended wave are nearly the same amplitude and duration as the other four waves of the larger impulse, giving a total count of nine waves of similar size rather than the normal count of "five" for the sequence. In a nine-wave sequence, it is occasionally difficult to say which wave extended. However, it is usually irrelevant anyway, since under the Elliott system, a count of nine and a count of five have the same technical significance.

Elliott Theory - Extensions:

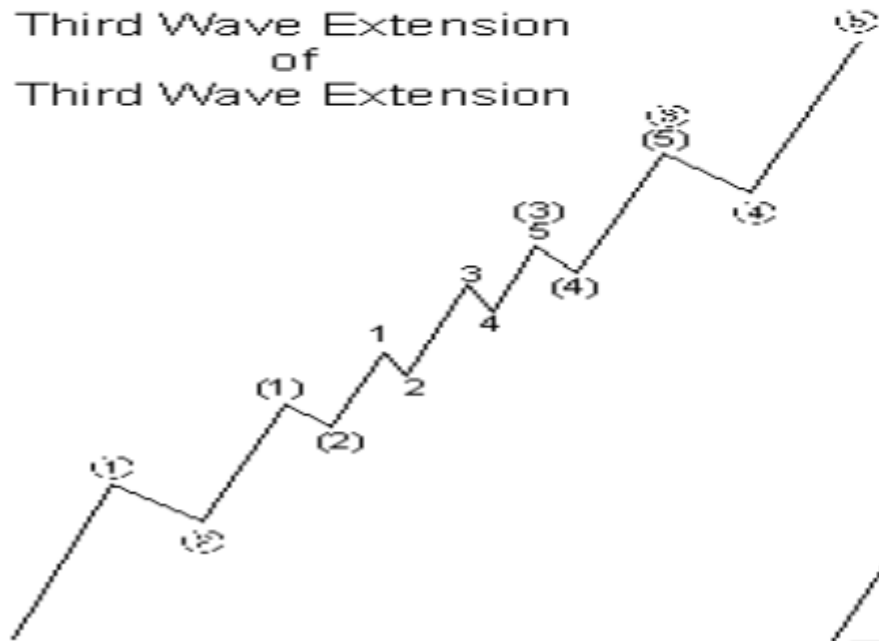


Elliott - Extensions within Extensions:

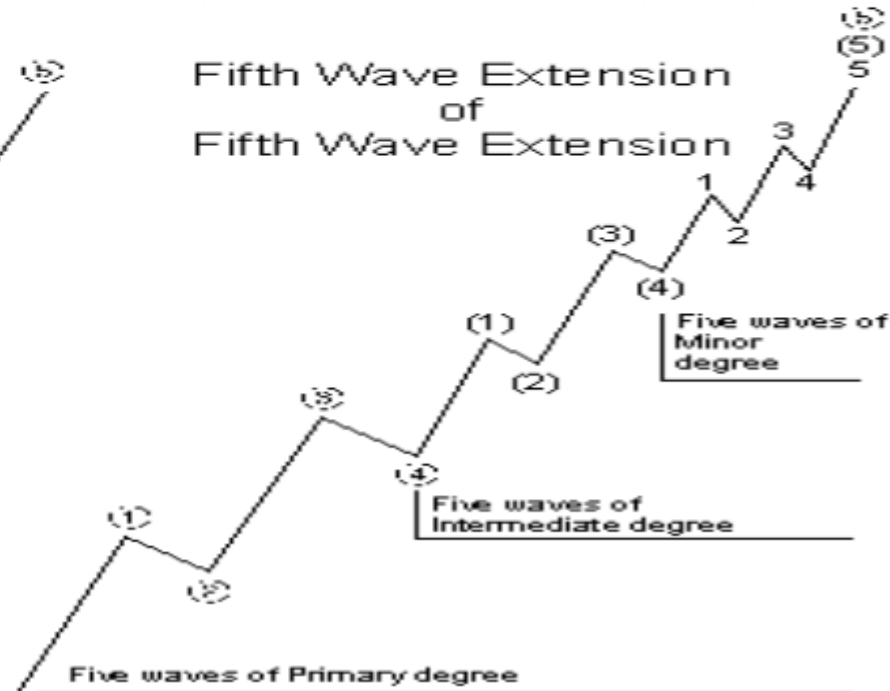
In the stock market, the third wave of an extended third wave is typically an extension as well

Figure below illustrates a fifth wave extension of a fifth wave extension. Extended fifths are fairly uncommon except in bull markets in commodities

Third Wave Extension of Third Wave Extension



Fifth Wave Extension of Fifth Wave Extension



Elliott Theory – Corrective waves:

Markets move *against* the trend of one greater degree only with a seeming struggle. Resistance from the larger trend appears to prevent a correction from developing a full motive structure. This struggle between the two oppositely trending degrees generally makes corrective waves less clearly identifiable than motive waves, which always flow with comparative ease in the direction of the one larger trend

Elliott Theory – Corrective waves:

As another result of this conflict between trends, corrective waves are quite a bit more varied than motive waves. Further, they occasionally increase or decrease in complexity as they unfold so that what are technically subwaves of the same degree can by their complexity or time length appear to be of different degree. For all these reasons, it can be difficult at times to fit corrective waves into recognizable patterns until they are completed and behind us. As the terminations of corrective waves are less predictable than those for motive waves, the Elliott analyst must exercise more caution in his analysis when the market is in a meandering corrective mood than when prices are in a persistently motive trend.

Elliott Theory – Corrective waves:

The single most important rule that can be gleaned from a study of the various corrective patterns is that corrections are never fives. Only motive waves are fives. For this reason, an initial five-wave movement against the larger trend is never the end of a correction, only part of it.

Corrective processes come in two styles. Sharp corrections angle steeply against the larger trend. Sideways corrections, while always producing a net retracement of the preceding wave, typically contain a movement that carries back to or beyond its starting level, thus producing an overall sideways appearance.

Elliott Theory – Corrective waves:

Specific corrective patterns fall into four main categories:

Zigzags

(5-3-5; includes three types: single, double, and triple);

Flats

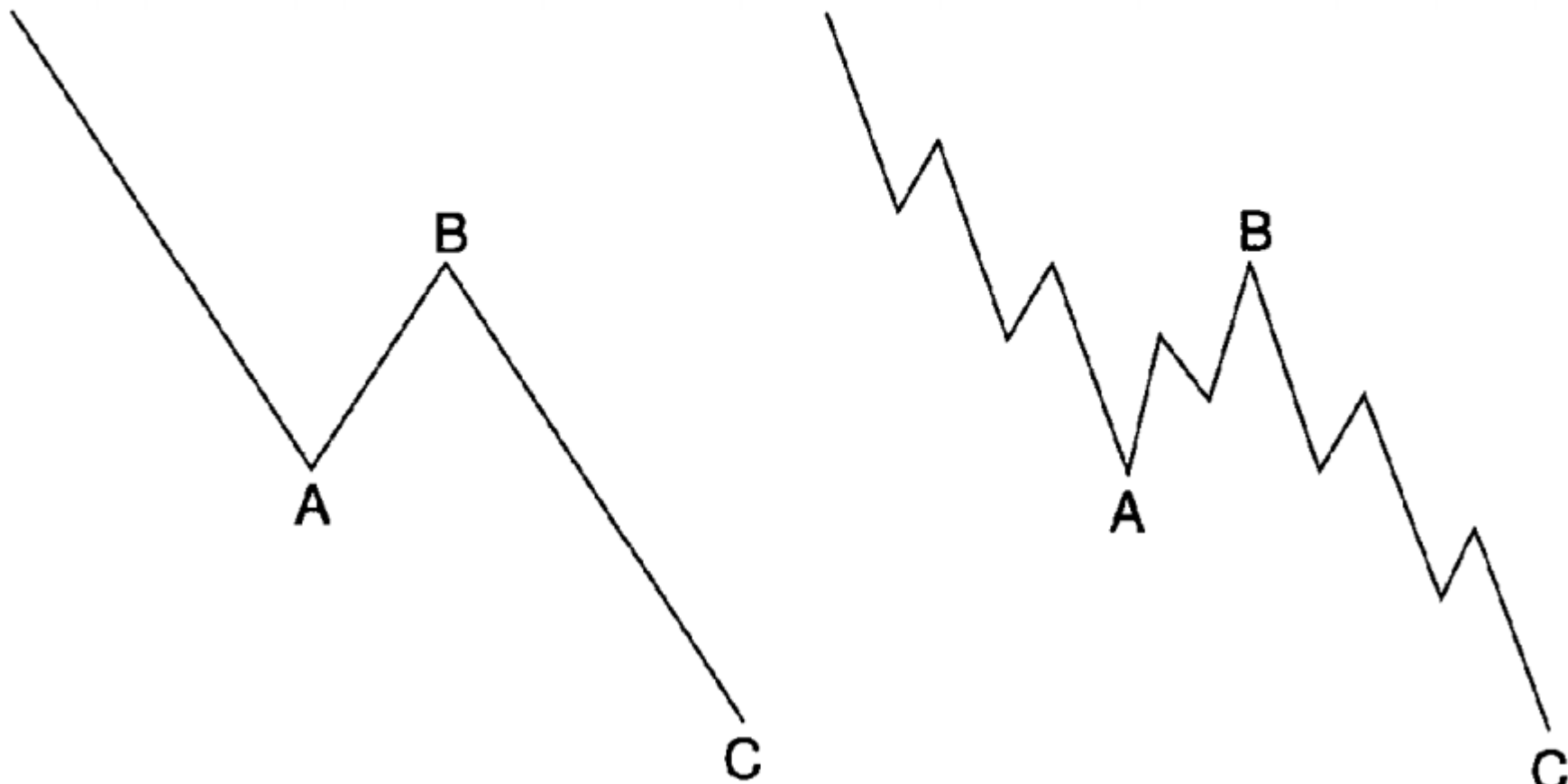
(3-3-5; includes three types: regular, expanded, and running);

Triangles

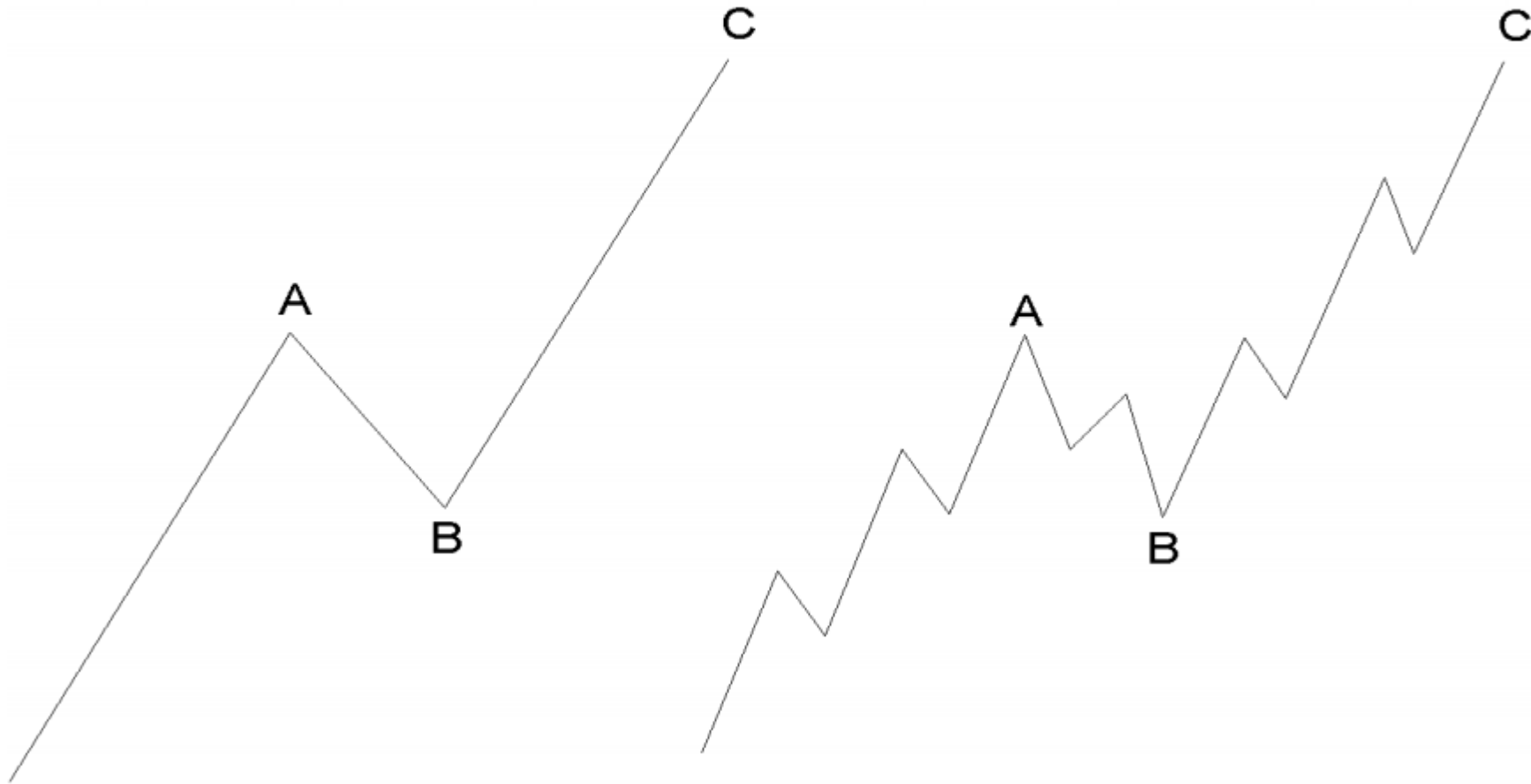
(3-3-3-3-3; four types: three of the contracting variety (ascending, descending, and symmetrical) and one of the expanding variety (reverse symmetrical);

Double threes and *triple threes* (combined structures).

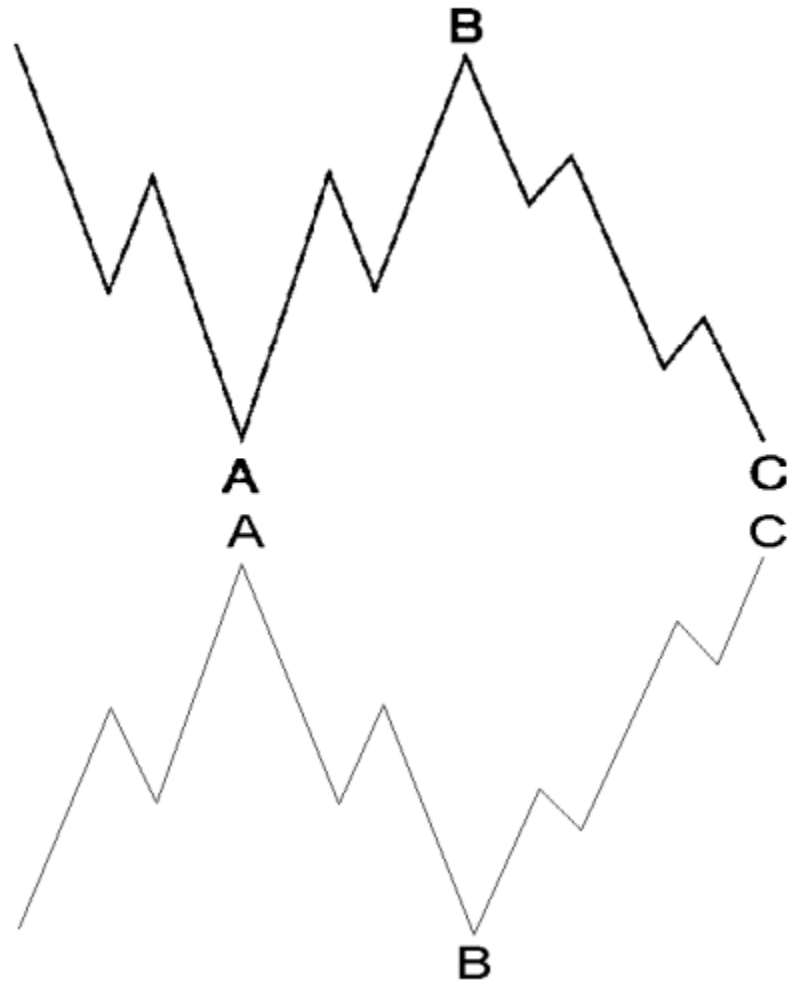
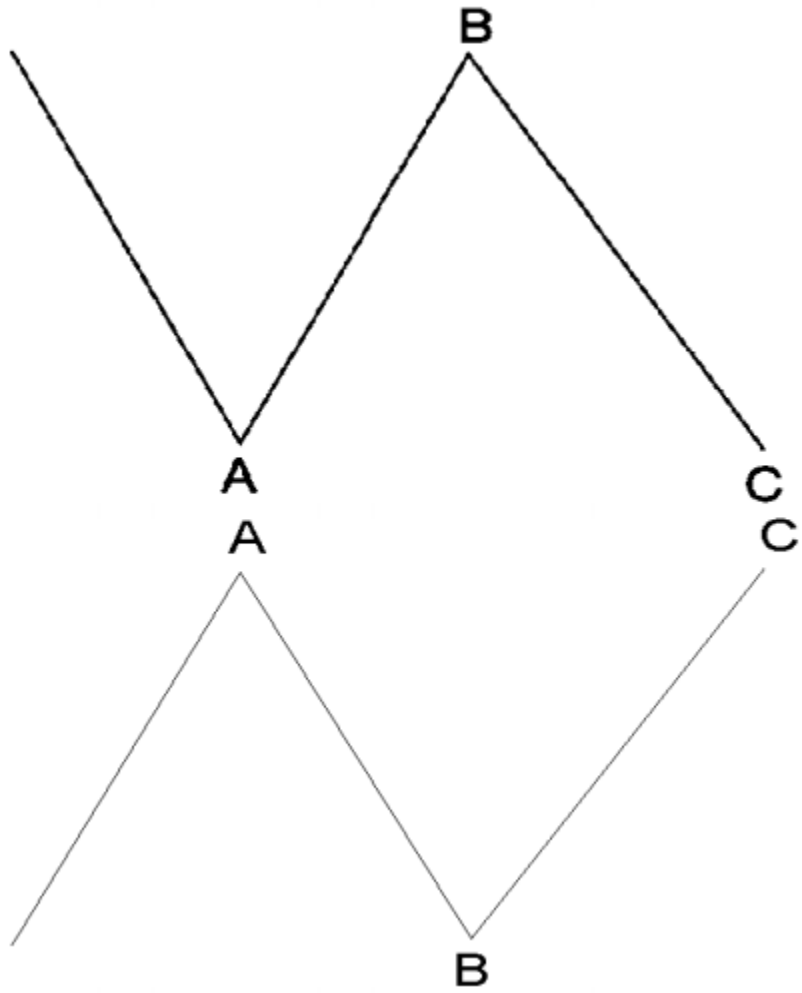
Corrective waves – Zig Zags:



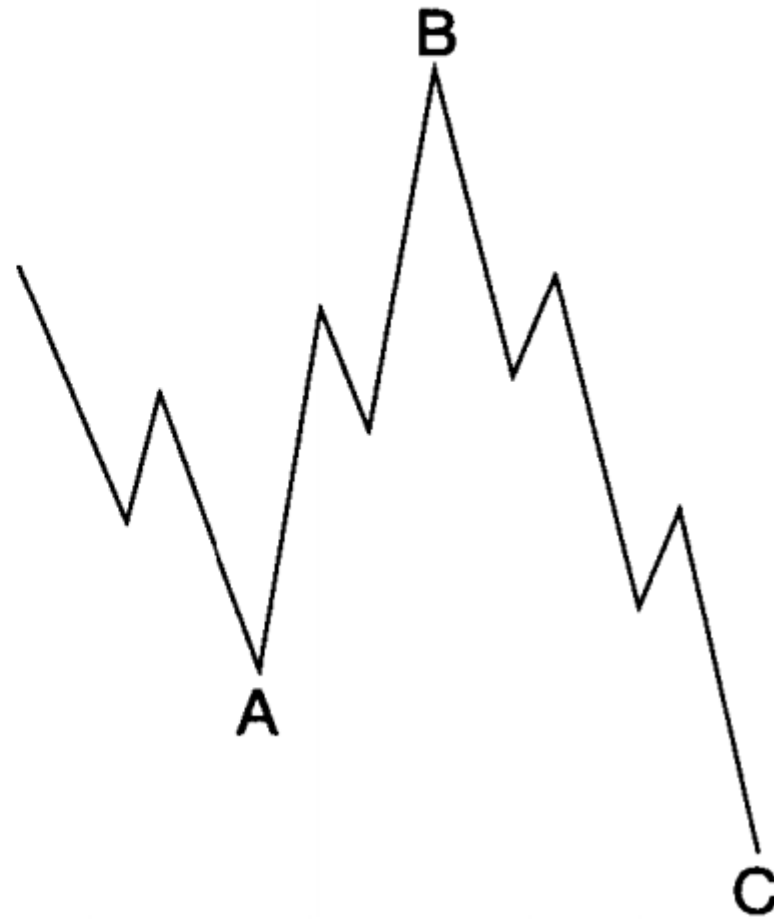
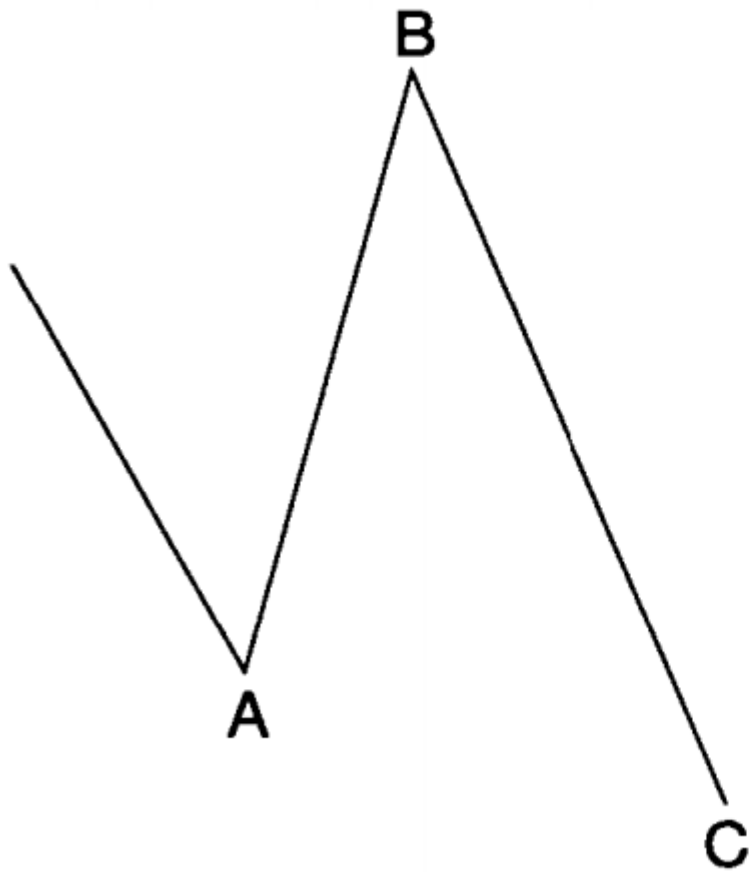
Corrective waves - Zig Zags (5-3-5):



Corrective waves – Flats (3-3-5)



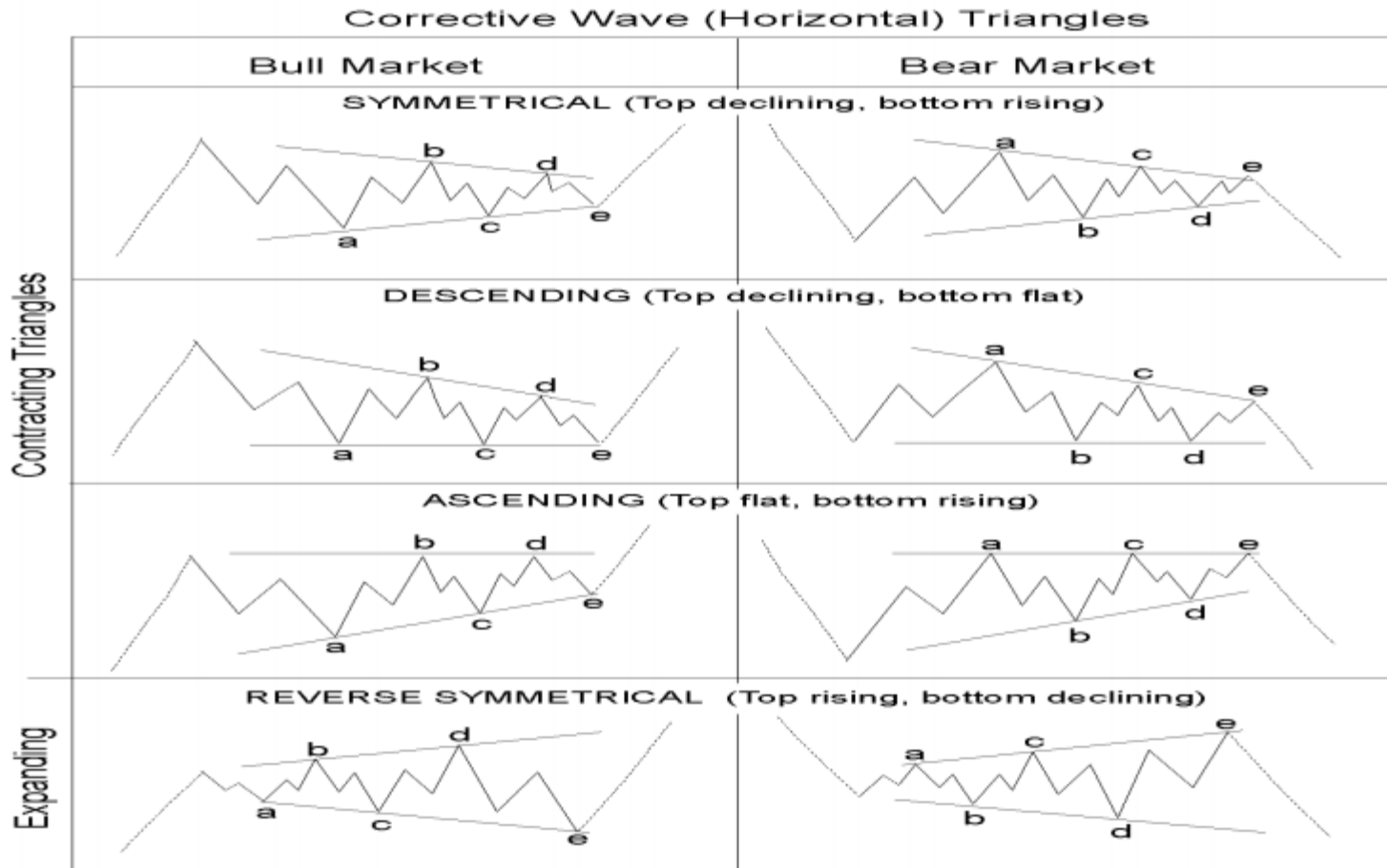
Corrective waves – Expanded Flats



Corrective waves - Triangles:

Triangles appear to reflect a balance of forces, causing a sideways movement that is usually associated with decreasing volume and volatility. Triangles contain five overlapping waves that subdivide 3-3-3-3-3 and are labeled a-b-c-d-e. A triangle is delineated by connecting the termination points of waves a and c, and b and d. Wave e can undershoot or overshoot the a-c line, and in fact, our experience tells us that it happens more often than not.

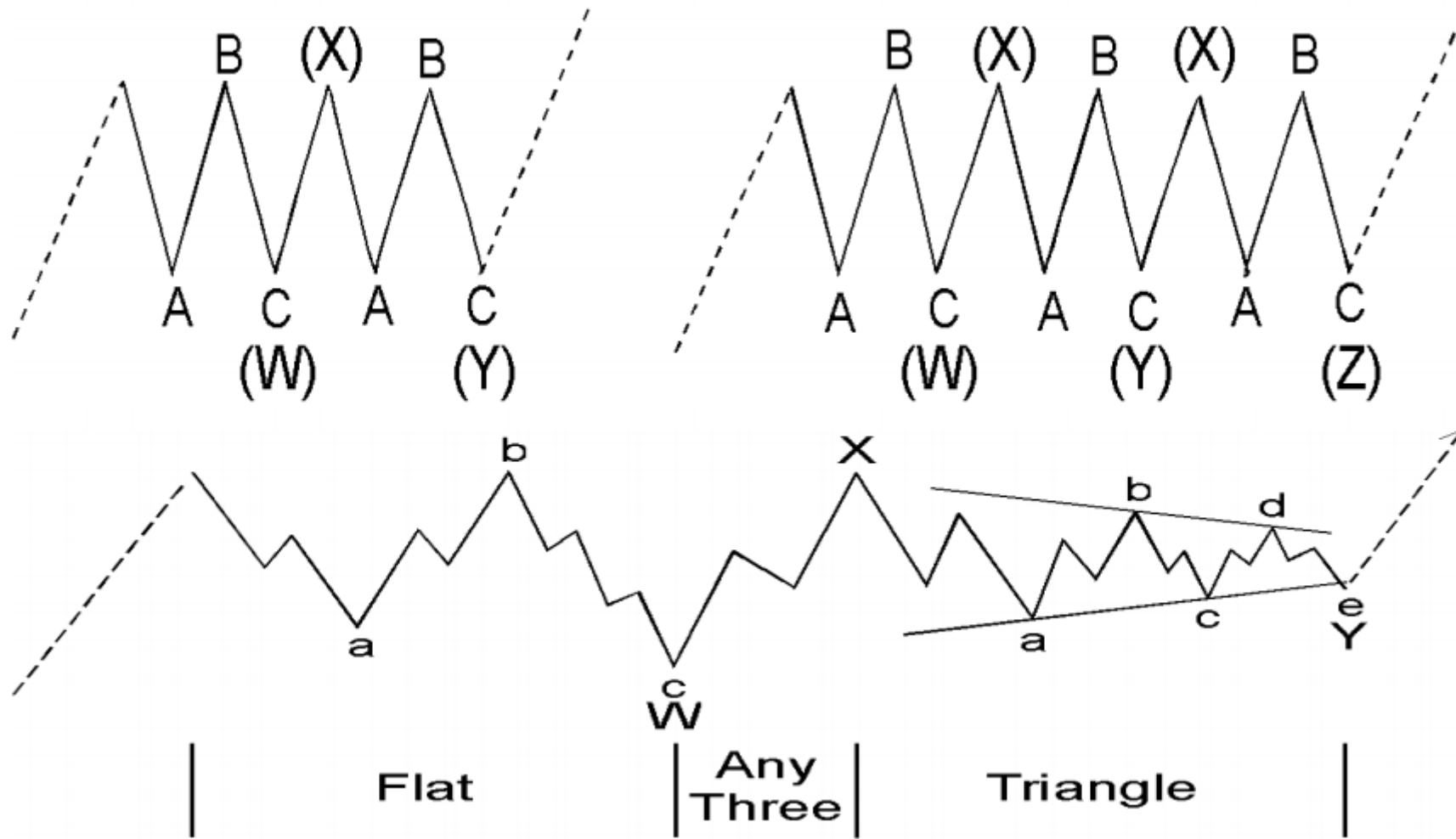
Corrective waves - Triangles:



Corrective waves double & triple threes:

Elliott called sideways combinations of corrective patterns "double threes" and "triple threes." While a single three is any zigzag or flat, a triangle is an allowable final component of such combinations and in this context is called a "three." A double or triple three, then, is a combination of simpler types of corrections, including the various types of zigzags, flats and triangles. Their occurrence appears to be the flat correction's way of extending sideways action. As with double and triple zigzags, each simple corrective pattern is labeled W, Y and Z. The reactionary waves, labeled X, can take the shape of any corrective pattern but are most commonly zigzags..

Corrective waves double & triple threes:



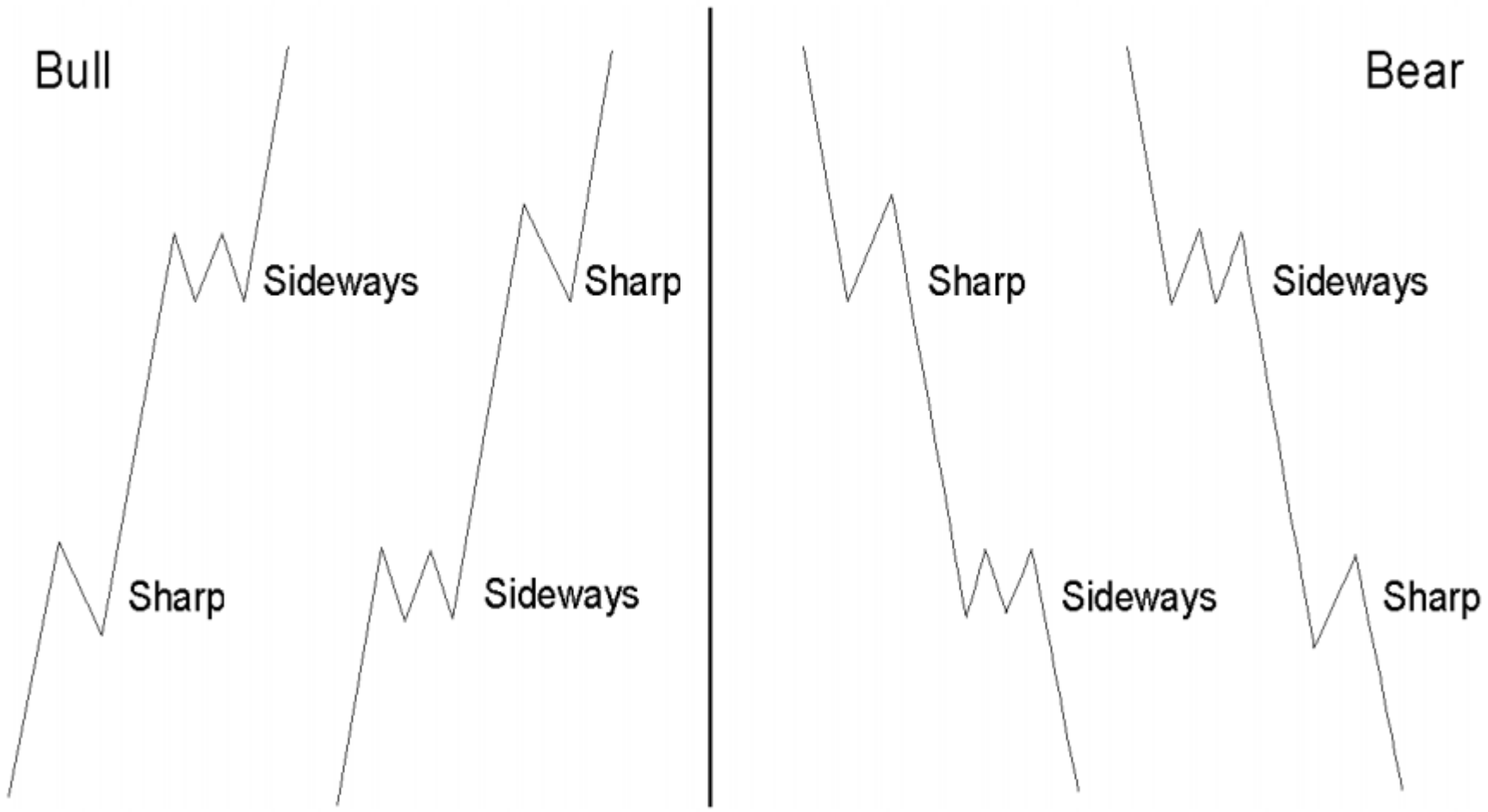
Guidelines of Wave formation:

Guidelines – Alternation:

If wave two of an impulse is a sharp correction, expect wave four to be a sideways correction, and vice versa.

Sharp corrections never include a new price extreme, i.e., one that lies beyond the orthodox end of the preceding impulse wave. They are almost always zigzags (single, double or triple); occasionally they are double threes that *begin* with a zigzag. Sideways corrections include flats, triangles, and double and triple corrections. They usually include a new price extreme, i.e., one that lies beyond the orthodox end of the preceding impulse wave. In rare cases, a regular triangle (one that does not include a new price extreme) in the fourth wave position will take the place of a sharp correction and alternate with another type of sideways pattern in the second wave position. The idea of alternation within impulses can be summarized by saying that one of the two corrective processes will contain a move back to or beyond the end of the preceding impulse, and the other will not.

Guidelines - Alternation:



Guidelines - Corrective Waves:

Depth of Corrective Waves (Bear Market Limitations)

No market approach other than the Wave Principle gives as satisfactory an answer to the question, "How far down can a bear market be expected to go?" The primary guideline is that corrections, especially when they themselves are fourth waves, tend to register their maximum retracement within the span of travel of the previous fourth wave of one lesser degree, most commonly near the level of its terminus.

Guidelines – Wave Equality:

One of the guidelines of the Wave Principle is that two of the motive waves in a five-wave sequence will tend toward equality in time and magnitude. This is generally true of the two non-extended waves when one wave is an extension, and it is especially true if the third wave is the extension. If perfect equality is lacking, a .618 multiple is the next likely relationship.

Guidelines – Channels:

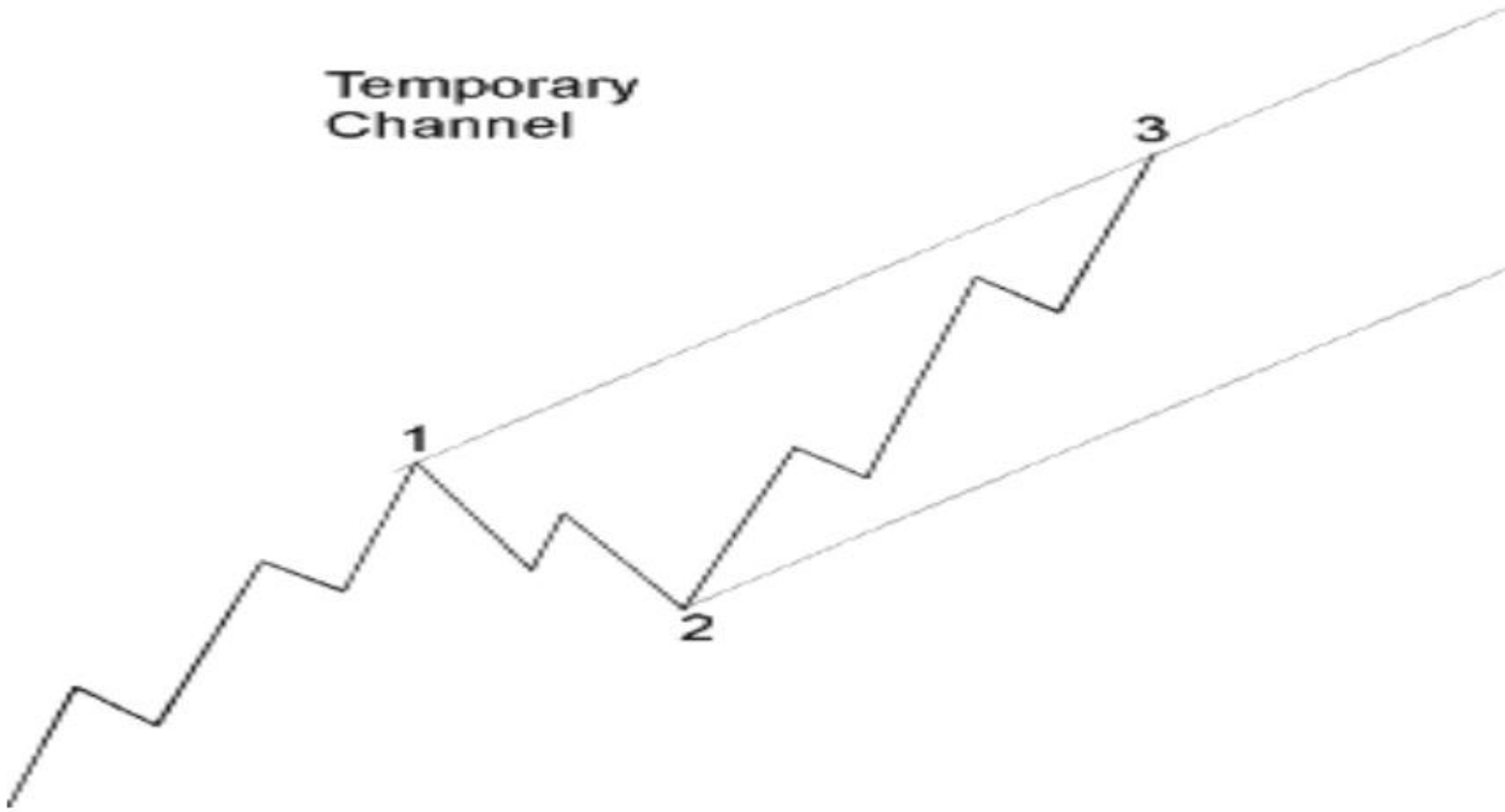
A parallel trend channel typically marks the upper and lower boundaries of an impulse wave, often with dramatic precision.

The initial channeling technique for an impulse, requires at least three reference points.

If the fourth wave ends at a point not touching the parallel, we must reconstruct the channel in order to estimate the boundary for wave five

Guidelines - Channels:

Temporary
Channel



Guidelines – Volume:

Elliott used volume as a tool for verifying wave counts and in projecting extensions. He recognized that in any bull market, volume has a natural tendency to expand and contract with the speed of price change. Late in a corrective phase, a decline in volume often indicates a decline in selling pressure. A low point in volume often coincides with a turning point in the market. In normal fifth waves below Primary degree, volume tends to be less than in third waves. If volume in an advancing fifth wave of less than Primary degree is equal to or greater than that in the third wave, an extension of the fifth is in force. While this outcome is often to be expected anyway if the first and third waves are about equal in length, it is an excellent warning of those rare times when both a third *and* a fifth wave are extended.

Guidelines – Volume:

At Primary degree and greater, volume tends to be higher in an advancing fifth wave merely because of the natural long term growth in the number of participants in bull markets. Elliott noted, in fact, that volume at the terminal point of a bull market above Primary degree tends to run at an all-time high. Finally, as discussed earlier, volume often spikes briefly at points of throw-over at the peak of fifth waves, whether at a trend channel line or the terminus of a diagonal triangle. (Upon occasion, such points can occur simultaneously, as when a diagonal triangle fifth wave terminates right at the upper parallel of the channel containing the price action of one larger degree.) In addition to these few valuable observations, we have expanded upon the importance of volume in various sections of this course.

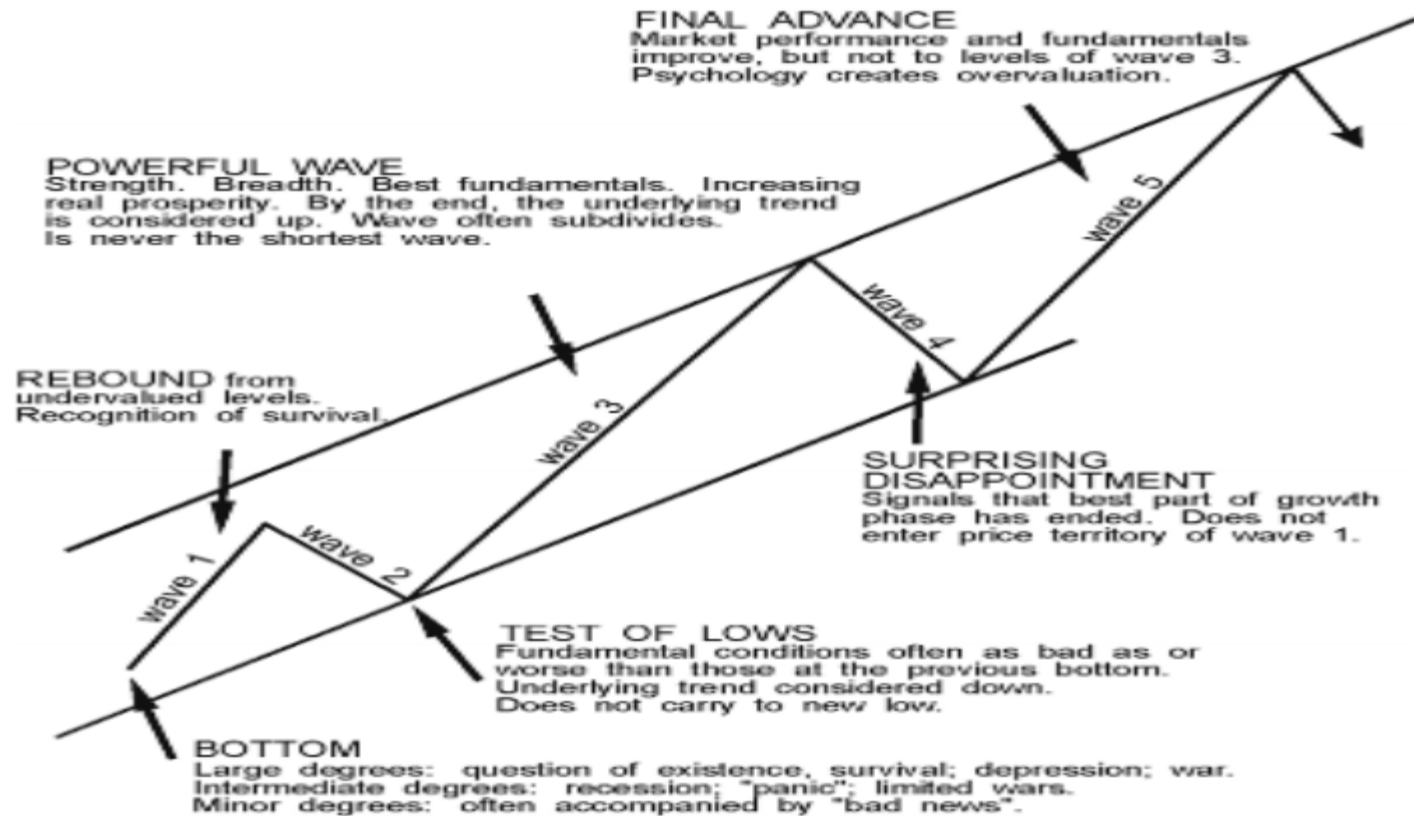
Wave Personality

The idea of wave personality is a substantial expansion of the Wave Principle. It has the advantages of bringing human behavior more personally into the equation and even more important, of enhancing the utility of standard technical analysis.

Wave Personality

Idealized Elliott Wave Progression

© 1980 Robert R. Prechter, Jr.



Wave Personality

1) First waves — As a rough estimate, about half of first waves are part of the "basing" process and thus tend to be heavily corrected by wave two. In contrast to the bear market rallies within the previous decline, however, this first wave rise is technically more constructive, often displaying a subtle increase in volume and breadth. Plenty of short selling is in evidence as the majority has finally become convinced that the overall trend is down. Investors have finally gotten "one more rally to sell on," and they take advantage of it. The other fifty percent of first waves rise from either large bases formed by the previous correction, as in 1949, from downside failures, as in 1962, or from extreme compression, as in both 1962 and 1974. From such beginnings, first waves are dynamic and only moderately retraced.

Wave Personality

2) Second waves — Second waves often retrace so much of wave one that most of the advancement up to that time is eroded away by the time it ends. This is especially true of call option purchases, as premiums sink drastically in the environment of fear during second waves. At this point, investors are thoroughly convinced that the bear market is back to stay. Second waves often produce downside non-confirmations and Dow Theory "buy spots," when low volume and volatility indicate a drying up of selling pressure.

Wave Personality

3) Third waves — Third waves are wonders to behold. They are strong and broad, and the trend at this point is unmistakable. Increasingly favorable fundamentals enter the picture as confidence returns. Third waves usually generate the greatest volume and price movement and are most often the extended wave in a series. It follows, of course, that the third wave of a third wave, and so on, will be the most volatile point of strength in any wave sequence. Such points invariably produce breakouts, "continuation" gaps, volume expansions, exceptional breadth, major Dow Theory trend confirmations and runaway price movement, creating large hourly, daily, weekly, monthly or yearly gains in the market, depending on the degree of the wave. Virtually all stocks participate in third waves. Besides the personality of "B" waves, that of third waves produces the most valuable clues to the wave count as it unfolds.

Wave Personality

4) Fourth waves — Fourth waves are predictable in both depth (see Lesson 11) and form, because by alternation they should differ from the previous second wave of the same degree.

More often than not they trend sideways, building the base for the final fifth wave move. Lagging stocks build their tops and begin declining during this wave, since only the strength of a third wave was able to generate any motion in them in the first place. This initial deterioration in the market sets the stage for non-confirmations and subtle signs of weakness during the fifth wave.

Wave Personality

Idealized Corrective Wave



Wave Personality

6) "A" waves – During "A" waves of bear markets, the investment world is generally convinced that this reaction is just a pullback pursuant to the next leg of advance. The public surges to the buy side despite the first really technically damaging cracks in individual stock patterns. The "A" wave sets the tone for the "B" wave to follow. A five-wave A indicates a zigzag for wave B, while a three-wave A indicates a flat or triangle.

Wave Personality

7) "B" waves — "B" waves are phonies. They are sucker plays, bull traps, speculators' paradise, orgies of odd-lotter mentality or expressions of dumb institutional complacency (or both). They often involve a focus on a narrow list of stocks, are often "unconfirmed" (Dow Theory is covered in Lesson 28) by other averages, are rarely technically strong, and are virtually always doomed to complete retracement by wave C. If the analyst can easily say to himself, "There is something wrong with this market," chances are it's a "B" wave. "X" waves and "D" waves in expanding triangles, both of which are corrective wave advances, have the same characteristics.

Wave Personality

8) "C" waves — Declining "C" waves are usually devastating in their destruction. They are third waves and have most of the properties of third waves. It is during this decline that there is virtually no place to hide except cash. The illusions held throughout waves A and B tend to evaporate and fear takes over. "C" waves are persistent and broad. 1930-1932 was a "C" wave. 1962 was a "C" wave. 1969-1970 and 1973-1974 can be classified as "C" waves. Advancing "C" waves within upward corrections in larger bear markets are just as dynamic and can be mistaken for the start of a new upswing, especially since they unfold in five waves. The October 1973 rally (see Figure 1-37), for instance, was a "C" wave in an inverted expanded flat correction.

Wave Personality

The *Desiderata*, by poet Max Ehrmann, reads, "You are a child of the Universe, no less than the trees and the stars; you have a right to be here. And whether or not it is clear to you, no doubt the Universe is unfolding as it should." Order in life? Yes. Order in the stock market? Apparently.

Wave Personality

The *Desiderata*, by poet Max Ehrmann, reads, "You are a child of the Universe, no less than the trees and the stars; you have a right to be here. And whether or not it is clear to you, no doubt the Universe is unfolding as it should." Order in life? Yes. Order in the stock market? Apparently.

Website: www.aeeic.site123.me

Email: madibam@aeeic.co.za



or energy

Saving energy, saving the environment

A proud company of AEEIC Group