

It's Elliott Wave Stupid!

This week we would like to set the record straight on a form of technical analysis some of you may have encountered known as Elliot Wave. Although a very common tool used by technical analysts, Elliott Wave is unfortunately also commonly misused as many analysts fail to adhere to all of the rules set out by both its creator and it's most prominent experts.

Elliott Wave is a form of technical analysis which uses the ebb and flow of the market to anticipate future direction. It is a theory named after Ralph Nelson Elliott (1871–1948), a professional accountant who developed the concept in the 1930s. He proposed that market prices unfold in specific patterns, which practitioners today call Elliott waves, or simply waves. Elliott published his theory of market behavior in a number of books including *Nature's Laws – the Secret of the Universe* (1946) in which he states that "because man is subject to rhythmical procedure, calculations having to do with his activities can be projected far into the future".

In recent times, Robert Pretcher has been the crowned leading expert of Elliott Wave theory. He has made some excellent forecasts using this theory, particularly the horrific stock market crash of 1987. However, before you start staking your entire trading career on Elliot Wave, we would also like to point out that that Pretcher publicly called for the end of the great bull market in 1995. This was many years too early! (1997 - LTCM, 1998 Asian Crisis, 2000 Dotcom Bubble)

So how would we like to set the record straight?

Commonly, analysts understand the wave count component of Elliot Wave:

- All patterns can be divided into two - a five-wave move, followed by a three-wave correction
- The five-wave move is always numbered 1 to 5. It consists of three waves in the direction of the trend (waves 1, 3 and 5) and two corrective waves against the trend (waves 2 and 4)
- The three wave correction is always labeled A, B and C. It consists of two corrective waves which are against the major trend (A and C) and one wave in the direction of the trend (B)

The rules which in our experience most analysts ignore, both to their detriment and to the detriment of their forecasts, are as follows:

- Wave 2 cannot extend beyond the starting point of wave 1
- Wave 4 cannot extend beyond the starting point of wave 3
- Wave 3 must not be the smallest (out of Wave 1, 3 and 5) and commonly it is the biggest wave
- Wave 4 commonly pulls back to the 38.2% retracement of Wave 3 which, if confirmed, can work as an excellent entry for a resumption of the trend

You should now be now equipped with the most prevalent rules of Elliott Wave which you can implement to test whether this form of analysis fits with your individual style of trading and adds value

to your strategy. Whichever form of technical analysis you implement, be sure to firstly understand it thoroughly, and secondly to incorporate it correctly using all the rules. With this in mind we would like to remind you that there is no holy grail in either technical analysis or trading. Any tool you implement as part of your trading strategy, such as Elliott Wave, should be used as a decision support tool (you being the ultimate decision maker) and in conjunction with other available information sources. Keep this in mind, and you will have every opportunity to forge a successful trading career.