Guidelines for Applying Elliott Wave Theory

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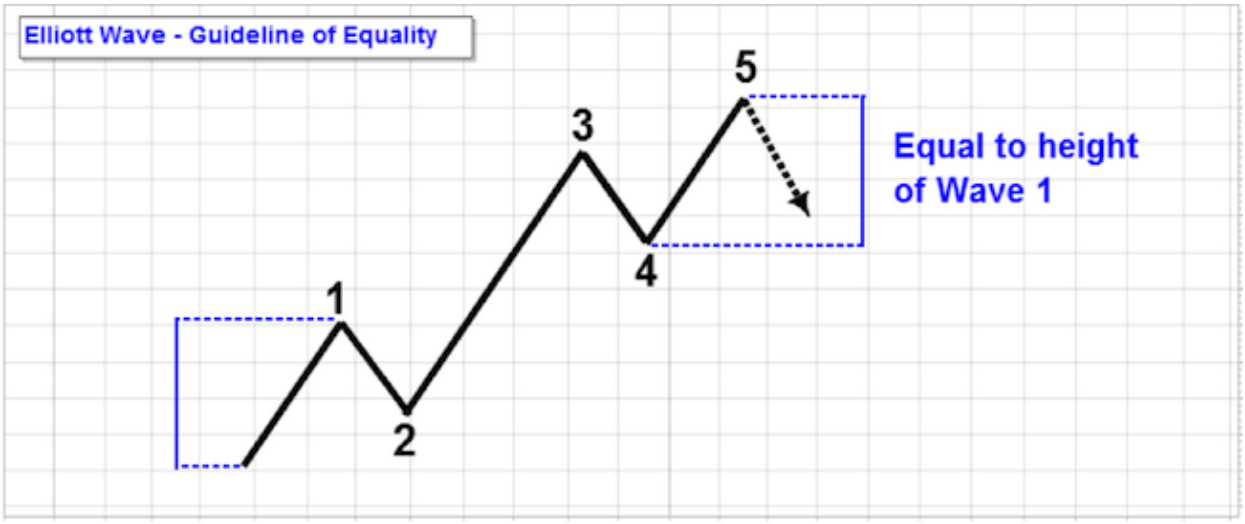
A guideline is not a hard and fast rule that can't be broken. It is a tendency - something that happens so often that it can almost qualify as a rule, except for the times it doesn't work as expected. The guidelines described below are useful ways of applying Elliott Wave analysis that have shown their validity over time. But as they are not rules, they may not work out every time.

Guideline 1

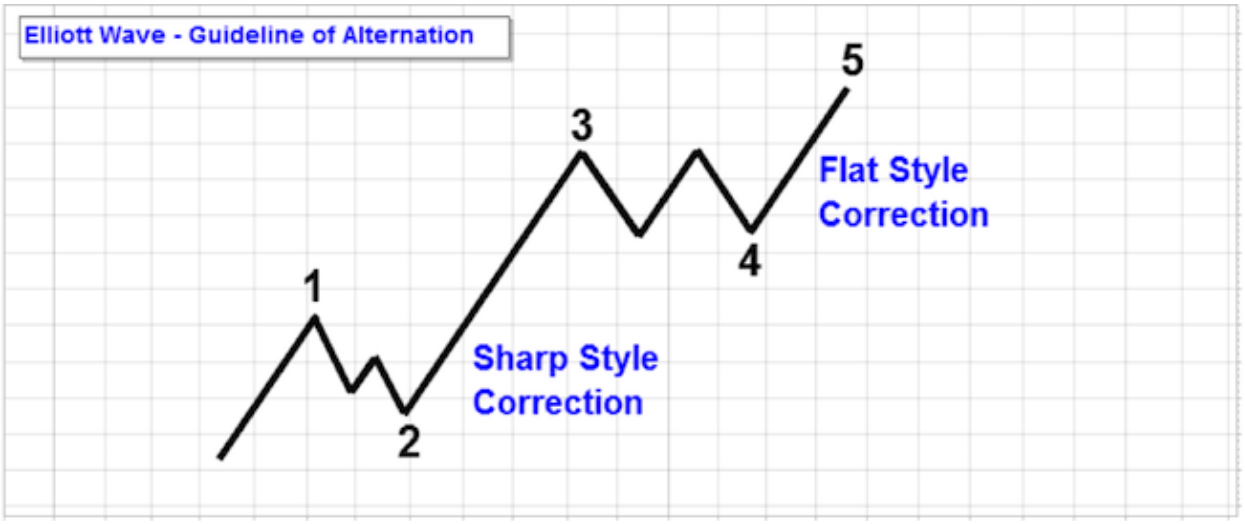
The **Guideline of Equality** says that two of the motive sub-waves in a five wave sequence will tend toward equality, and is generally true of the non-extended waves.

This means that when Wave 3 of an impulse wave is the extended wave, Wave 5 will approximately equal Wave 1 in price. This is useful for potentially projecting the end of Wave 5 in an impulse if you recognize Wave 3 as an extended wave.



Guideline 2

The **Guideline of Alternation within an Impulse** says that the forms for Wave 2 and Wave 4 will alternate. If Wave 2 is a sharp style of correction, Wave 4 will be a sideways style of correction. If Wave 2 is sideways, Wave 4 will be sharp. This is useful for anticipating the end of a Wave 4 correction within a suspected impulse.

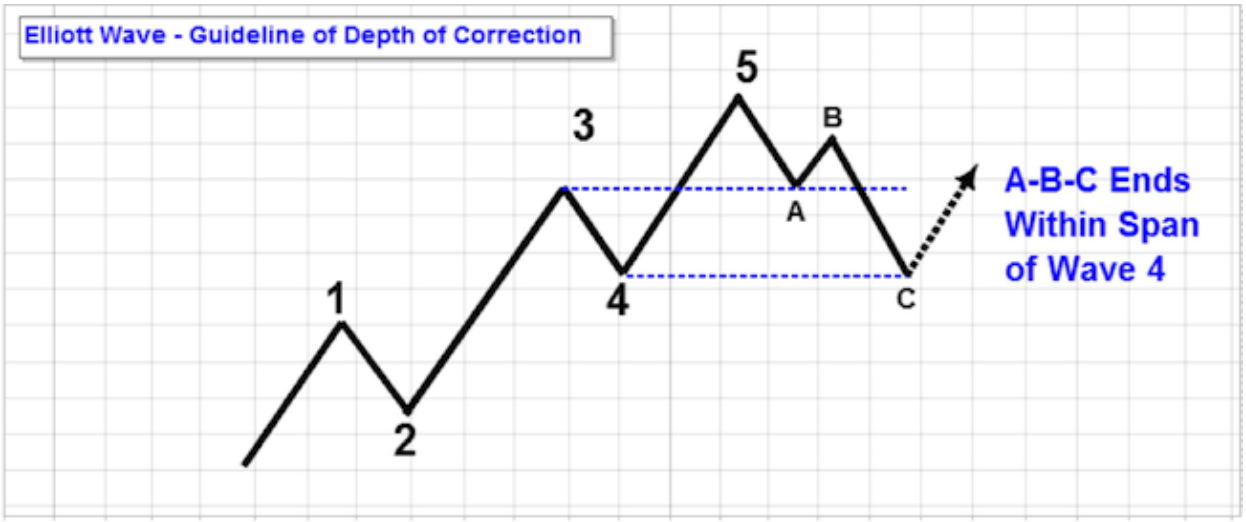


Guideline 3

The **Guideline of Alternation within a Correction** says that the forms for Wave A and Wave B will alternate within a 3-wave correction. If Wave A is a flat type of correction, Wave B may be a zigzag type of correction and vice versa. It also states that if the correction begins with a more simple wave for Wave A, expect the following Waves B and C to be more complex.

Guideline 4

The **Guideline of Depth of Corrective Waves** says that when the market goes into a correction, it often will correct to the territory of the previous Wave 4 of lesser degree. This does not necessarily mean that it will reach the bottom of the previous 4th wave, but rather that we should expect it will reach the span of the previous Wave 4 of lesser degree. This is often a good place for a market to find support (or resistance) before the trend moves on.



Guideline 5

The **Guideline of Channeling** is really a technique to project the potential end of waves within impulses. Although channeling can be used for corrective waves, it really boils down to the application of trend lines and doesn't have any hard tendencies for corrective

applications. As for impulse waves, Elliott noticed that channel lines often mark their boundaries with sometimes dramatic precision.

There are three ways that channeling can be used for projecting the end of waves, but they all use the same technique. They all require three points - beginning and ending of waves - to create their channels. This technique can be used for projecting the end of Wave 3, the end of Wave 4, and the end of Wave 5.

Projecting the end of Wave 3: Draw a trend line from the beginning of Wave 1 to the end of Wave 2. Project a parallel line off the end of Wave 1. There is a potential for Wave 3 to end when it reaches the projected trend line.

Projecting the end of Wave 4: Draw a trend line from the beginning of Wave 2 to the end of Wave 3. Project a parallel line off the end of Wave 2. There is a potential for the Wave 4 correction to end when it reaches the projected trend line.

Projecting the end of Wave 5: Draw a trend line from the beginning of Wave 3 to the end of Wave 4. Project a parallel line off the end of Wave 3. There is a potential for Wave 5 to end when it reaches the projected trend line.

Guideline 6

The **Guideline of Scale** is really a technique of looking at the market and is often applied when creating channel projections. It simply states that one should use both an arithmetic scale chart and a semi-log scale chart when looking at Elliott Waves. Arithmetic scale charts are good for looking at waves on lower degrees, but semi-log scale charts are good for bringing large trends (higher degrees) into perspective. A channel may work nicely on a semi-log scale, whereas on an arithmetic scale it may not.

The Personality of Elliott Waves

Wave “personality” is the reflection of mass psychology acting in the market - the emotions that flow from optimism to pessimism, creating the structures we see in the market. The personality of each wave type is the same whether it is a higher-degree wave or a lesser one. This section will expand on the characteristics of some of the waves. Please keep in mind the eight-wave cycle when going over this section.

First Waves (Wave 1)

About half of the first waves seen are part of the basing process and tend to be heavily corrected by Wave 2. Many people feel that this is one more opportunity to trade in the direction of the previous trend, and, if that was down, many will sell short. However, market breadth and volume will subtly increase.

The other 50% of first waves will rise from large basing price movement formed by the previous correction and these tend to be dynamic and only moderately retraced. This is a good probable spot to have a Wave 1 extension.

Second Waves (Wave 2)

Second waves tend to retrace so much of Wave 1 that most of the profits gained are eroded. They tend to end on low volume and low volatility. In a bear market, this indicates a drying up of selling pressure. However, during Wave 2 most investors are convinced that the bear market is here to stay.

Third Waves (Wave 3)

Third waves tend to be strong and broad. They are typically unmistakable, as confidence in the direction of the new trend is clearly evident. Wave 3 usually generates the most volume and price movement, and they are the most likely wave to extend. The third wave of an extended third wave will likely be the most volatile point of strength in the new trend and things like price breakouts, continuation gaps, volume expansions, and increased breadth will accompany it. In Wave 3 for a stock index, nearly all stocks will participate. Because of the dynamics of this wave, it will provide the greatest clues to the correct wave count as it unfolds.

Fourth Waves (Wave 4)

Fourth waves can be predictable in both depth and form because of the guideline of alternation. They tend to differ with the previous Wave 2 of the same degree. They often trend sideways, building a base for the final Wave 5 to spring from. In Wave 4 for a stock index, lagging stocks will tend to build their tops and start declining.

Fifth Waves (Wave 5)

Fifth waves tend to be less dynamic and display slower speed of price change than the previous waves. It will usually be accompanied by lesser volume and breadth.

Of course, if the fifth wave is the extended wave, this will not be the case in terms of price change. In advancing fifth waves, optimism is extremely high despite a narrowing of breadth. However, the fifth wave of an extended fifth will lack the change of the previous waves and give clues about a change in direction.

A Waves (Wave A)

During Wave A, the public is convinced that this is just a correction of the previous trend and will rush in to capitalize on it, despite any technically damaging signals. This sets things up for the next wave to follow. If Wave A is divided into five sub-waves, it will be a zigzag. If it is divided into three sub-waves, it will be a flat or a triangle.

B Waves (Wave B)

Wave B catches people in the wrong direction. It performs the task of enticing the suckers to jump into the market. This is where bear or bull traps happen. As a general rule, B Waves tend to show lower volume.

C Waves (Wave C)

Wave C tends to break the illusions of Wave A and Wave B. In a declining market, it can be devastating and fear takes over with broad participation. An advancing Wave C as an upward correction in a larger bear market can be just as dynamic and it fools investors into thinking that it is the start of a new upswing. The fact that Wave C may do this in five sub-waves helps the deception.

D Waves (Wave D)

Wave D shows up in horizontal triangles. If the triangle is contracting, it often is accompanied by an increase in volume. This is because it does not fully retrace the previous wave and is moving in the direction that the market is about to take after the following Wave E.

E Waves (Wave E)

Wave E shows up as the last wave in horizontal triangles. It will often stage a false break of the trend line on the boundary of the triangle before the market takes off in the opposite direction. If the triangle was a Wave 4 in a rising impulse, it would instill a bearish conviction before the market shot up to produce Wave 5. Thus Wave E is often attended with emotional psychology playing against the investor.

Conclusion

These three articles have gone over the rules of Elliott Wave Theory in some detail. However, as stated before, putting Elliott Wave to use will take some practice. Nevertheless, if you persist in applying the rules, eliminating non-conforming counts, and looking at the personality of the waves you are counting, you will find satisfaction in applying the Elliott Wave theory. You will prove to yourself that the market indeed does conform to these patterns and that there is meaning behind them.

You will often find that it is necessary to adjust the count you made to conform to new data. Don't get frustrated by having to make adjustments – it paves the way to a more accurate wave-count and helps to refine your skills. This is something that is expected in doing Elliott Wave analysis as the skills in applying it come through practice.

Not every nuance of Elliott Wave Theory has been discussed here. There are many books written on the subject. Here are a few book recommendations that are considered by many to be excellent resources in helping one to apply Elliott Wave:

One subject that is not discussed is the use of Fibonacci counts and ratios that are applied to Elliott Waves. This is a broad and important subject, but it is not only applied to Elliott Waves, and it is too large to cover here. The books mentioned above will go into some detail on how this subject can help when applying Elliott Wave. It is a worthwhile study.

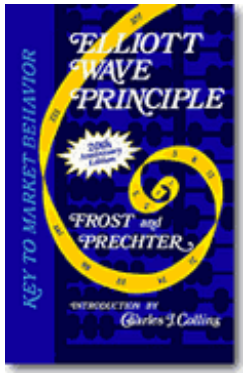
Adding Elliott Wave Notation to SharpCharts

You can use our ChartNotes annotation tool to add Elliott Wave notations to your charts. Below, you'll find an example of a chart annotated with Elliott Wave notations.

To learn more about how to add these annotations to your charts, check out our Support Center article on ChartNotes' Text Annotation Tools.

Further Study

Elliott Wave Principle
Robert Prechter



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