Elliot Wave Theory

Unit 3-Topic 11

Introduction

- The Elliott wave principle is a form of technical analysis that analyze financial market cycles and forecast market trends by identifying extremes in investor psychology, highs and lows in prices, and other collective factors.

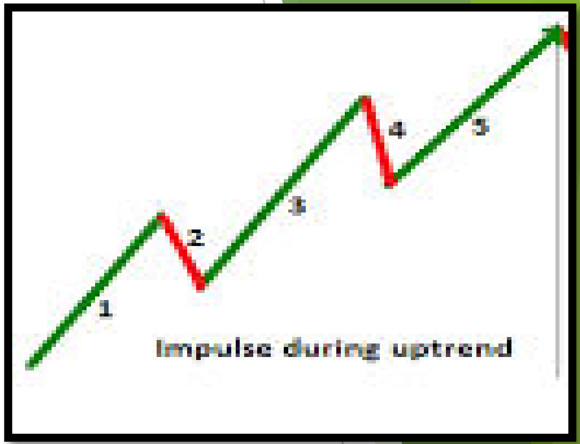
- Ralph Nelson Elliott, discovered the underlying social principles and developed the analytical tools in the 1930s.

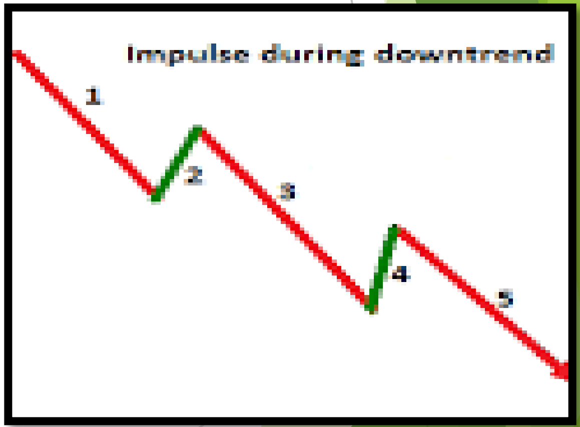
- He proposed that market prices unfold in specific patterns, called as "Elliott waves", or simply "waves".

- The Elliott Wave Principle suggests that collective investor psychology, or crowd psychology, moves between optimism and pessimism in natural sequences. These mood swings create patterns in the price movements of markets at every degree of trend or time scale.

Elliot Wave Structure

- In Elliott's model, market prices alternate between Dominant(5 waves) and a Corrective phase(3 waves) on all time scales of trend.
- Impulses are always subdivided into a set of 5 waves, alternating again between Dominant and Corrective Waves.
- When 5 wave direction is Up(Up Dominant Wave), then waves 1, 3, and 5 which are advancing waves are Impulsive , and waves 2 and 4 are smaller retraces of waves 1 and 3,which are declining waves are Corrective.
- When 5 wave direction is Down(Down Dominant Wave), then waves 1, 3, and 5, which are declining waves are Implusive, and waves 2 and 4, which are advancing waves are Corrective.



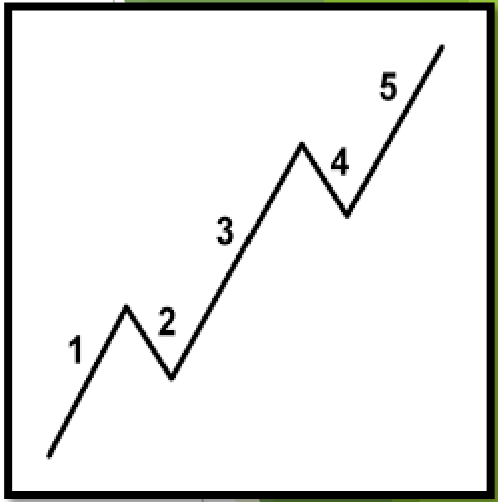


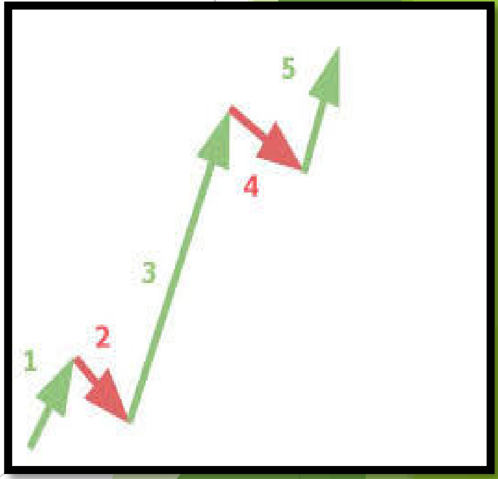
Characteristic of Dominant trend (Uptrend)

- **Wave 1:** Wave 1 is usually a weak rally with only small number of traders participating in the market. This is because fundamental news is still negative and above all, previous trend which was declining is still considered strong to be in force.

- **Wave 2:** Wave 2 is a sell off once wave 1 is over and this sell off is very vicious (sharp). Market participants, who are on bearish side, gain confidence that the down trend is still intact. But wave 2 never extends beyond the starting point of wave I. Wave 2 finally ends without making new lows and prices turn for another positive rally. This is the time when bears feel confused about the presence of down rally.

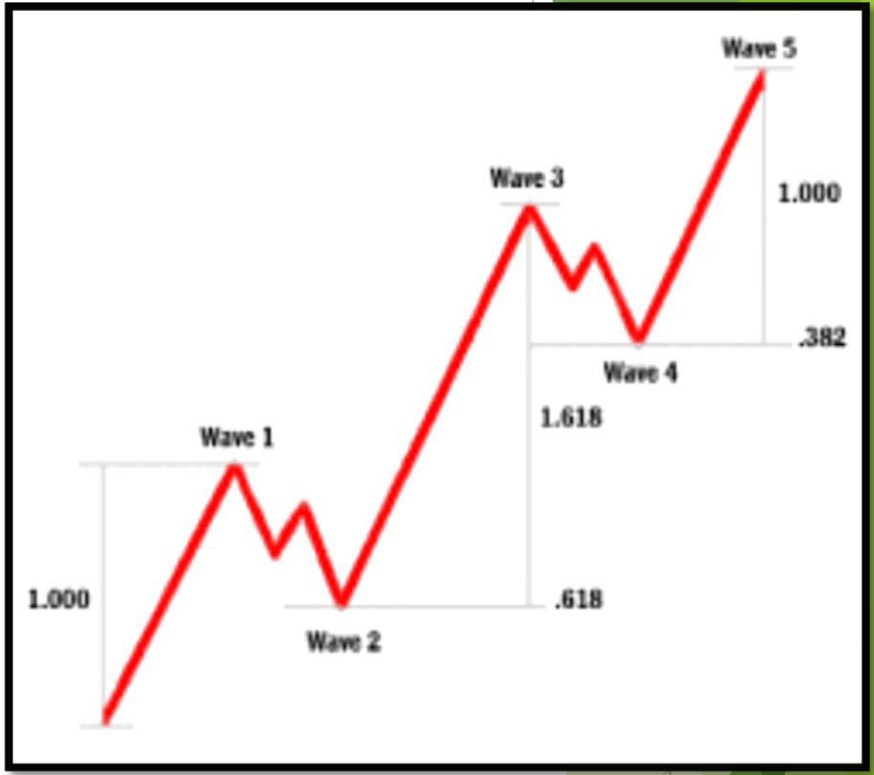
- **Wave 3:** The initial stage of the wave 3 is a slow rally as market participants are not convinced about the rally. Bears are confused on downfall as wave 2 didn't make new low and bulls are too in confusion until the high of wave 1 is not taken out. When markets rally and finally top of wave 1 is crossed, This is the time when top of wave 1 is crossed, market participants are convinced about the rally and there is sudden buy side interest in the market and squaring off of shorts .Wave 3 is usually the largest and most powerful wave of dominant trend.





- **Wave 4:** Finally, wave 3 ends as traders, who were long from the lower levels, takes out part profits. Basically, wave 4 is a clear correction on lesser volume than wave 3. By now, every participant is clear about the present strong up rally. So very less participation comes in during this phase. While profit taking is on, majority of the market participants are convinced that trend is up, so correction is considered as 'buy on dips'.

- **Wave 5:** Wave 5 is the last wave of dominant trend. Although prices make new high above wave 3 but volume is usually lesser than volume in wave 3.At this stage, market tops out. Media chaos is very strong. Everyone is thinking of new highs and majority of the crowd is still in the mood of buying on dips. But as the smart money is chasing momentum somewhere else, markets will likely top out.



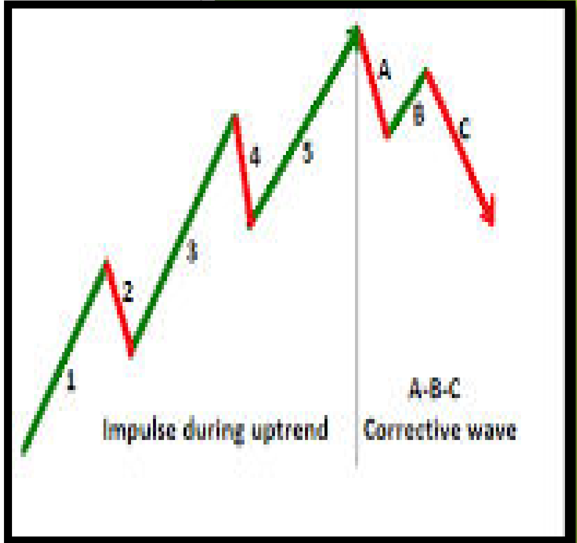
Characteristic of Corrective trend (Uptrend)

- Corrective waves start after the rally of 5 waves. There are 3 corrective waves, two are in opposite direction of primary up wave and one in opposite direction of corrective down waves.

- **Wave A:** Wave A is the beginning of a new bear market, fundamental news is still positive and nobody is ready to accept the fact that markets can decline and markets have topped out. Everyone is still convinced of buying on dips.

- **Wave B:** Wave B is a pullback in the fall. Small rally which is in the direction of main trend gives the feeling that Bull Run has again started. But prices fail to make new high. Volume is also very low in the rally, which is a confirmation of a selling opportunity.

- **Wave C:** Here, prices again start declining and volume also picks up and it's in Wave C, that everyone realizes that market decline is likely to continue and hence market participation on the sell side increases. By now, bull market confidence is lost. Participants start exiting market and have firm belief that market is in the control of strong bear hands.

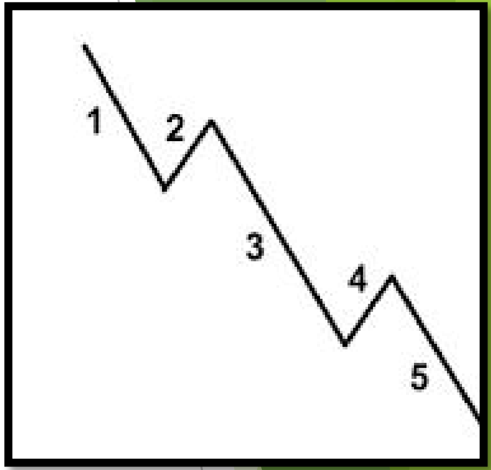


Characteristic of Dominant trend (Downtrend)

- **Wave 1:** Wave I is usually a small correction with only small number of traders participating in the market. This is because fundamental news is still positive and above all previous trend which was rising is still considered to be strong in force.

- **Wave 2:** Wave 2 is a strong rally once wave 1 is over. But wave 2 never extends beyond the starting point of wave 1. Wave 2 finally ends without making new highs and prices starts declining again.

- **Wave 3:** The initial stage of the wave 3 is a slow decline as market participants are not convinced about the decline. Practically lot of buy side positions are there in the market and these get squared off as and when markets declines and finally buy side positions are closed when bottom of wave 1 is crossed. This is the time when bottom of wave 1 is crossed, market participants are convinced about the decline and there is sudden sell side interest in the market. Wave 3 is usually the largest and most powerful wave of dominant trend.

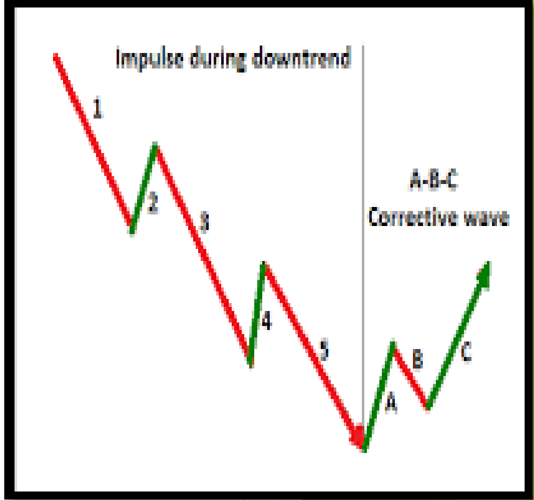


- **Wave 4:** Finally wave 3 ends as traders who were short from the higher levels takes profit, hence profit taking starts. Basically wave 4 is a clear pull back on lesser volume than wave 3. While profit taking is on, majority of the market participants are convinced that trend is down. There are two schools of thoughts here to trade Wave 4. One is to sell on rally if one understands the potential ahead for wave 5. The other is to wait for wave 4 to end and sell when market declines again.

- **Wave 5:** Wave 5 is the last wave of dominant trend. Although prices make new low below the wave 3 but volume is usually lesser than volume in wave 3. The wave 5 lacks weakness found in wave 3 declines and finally markets bottoms out and enter new phase.

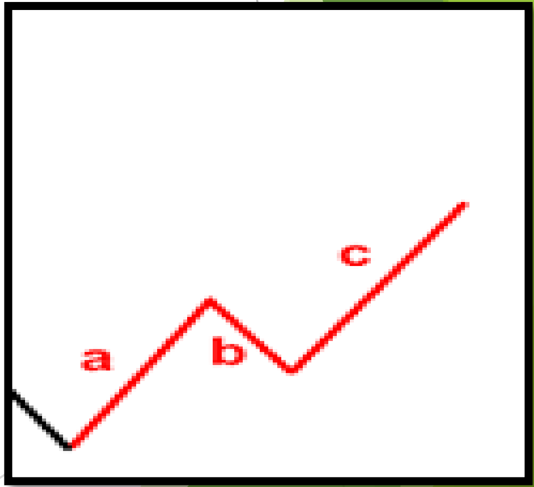
Characteristic of corrective trend (Downtrend)

- Corrective waves start after the rally of 5 waves. There are 3 corrective waves, two are in opposite direction of primary down wave and one in opposite direction of corrective rally.



- **Wave A:** Wave A is the beginning of a new bull market, fundamental news is still negative and nobody is ready to accept the fact that markets could rally.

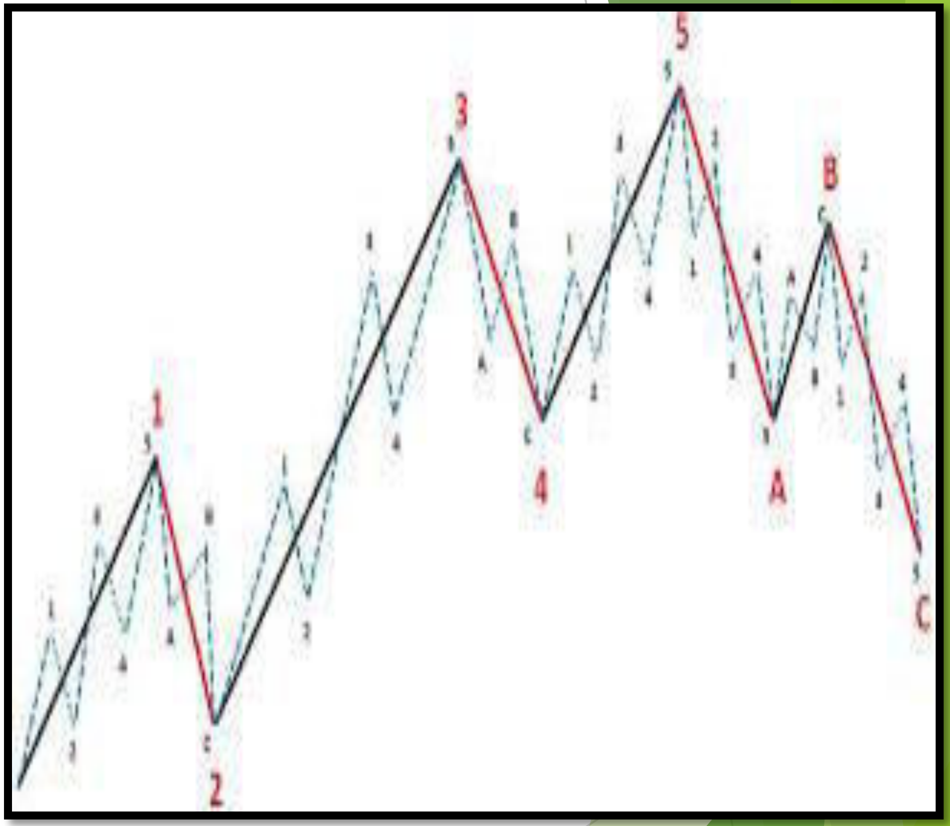
- **Wave B:** Wave B is basically a small decline which gives the feeling that decline has again started but prices fail to make new low and typical volume characteristic here is that Volume in Wave B is lesser than Wave A.



- **Wave C:** Here prices again start rising and volume also pick up and it's in Wave C that everyone realizes that market rally is likely to continue and hence market participation on the buy side increases.

Fractal

- The theory suggests that irrespective of size of the wave, all impulse waves are subdivided into five smaller waves and all corrective waves are subdivided into three smaller waves. The pattern of the smaller degree waves is seen in smaller degree timeframe too. Hence Elliot Wave is known as fractal in nature.
- It is clearly evident from the chart that small wave comprises of large wave.
- Impulse within impulse are forming bigger impulse and moving in the same fashion. This kind of price behaviour is very common in price movements and is known as fractal behaviour.



Elliott Wave Rules

- **Rule 1:** Wave 2 cannot retrace more than 100% of Wave 1: i.e. in the rising market Wave 2 would not break bottom of Wave 1 and similarly in declining market Wave 2 would not break top of Wave 1.

- **Rule 2:** Wave 3 is never the shortest: This means that Wave 3 is always longer than other two waves i.e. Wave 1 or Wave 2. Practically Wave 3 is longer than other two waves. If you find wave 3 shorter than other two waves, then it means something is wrong with the wave count and there is a need for a wave re-count. Wave 3 may end up being equal in length but never shortest.

- **Rule 3:** Wave 4 can never overlap Wave 1: This means that end of wave 4 should not trade below the peak of wave 1.

Elliott Wave Guidelines

- **Guideline 1:** When Wave 3 is longest wave, mostly wave 5 is equal in length to Wave 1. This is also known as 'Rule of equality'. This provides target for end of Wave 5.

- **Guideline 2:** The form of Wave 2 and Wave 4 corrections are alternate i.e. if Wave 2 is vicious (sharp) sell off then Wave 4 would be flat correction and if Wave 2 is flat correction then Wave 4 would be vicious (sharp) sell off. This is also known as 'Rule of alteration'.

- **Guideline 3:** Three Wave corrective pattern (A, B, C) after five wave dominant pattern (1, 2, 3, 4, 5) ends prior to end of Wave 4 of dominant trend.

Thank you