



Guide to Elliott Wave Analysis

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What is Elliott Wave?

Elliott Wave is a form of technical analysis that was developed by Ralph Nelson Elliott in the 1930s. Elliott observed that financial markets move in recognizable patterns which are created by underlying investor behaviors of fear and enthusiasm.

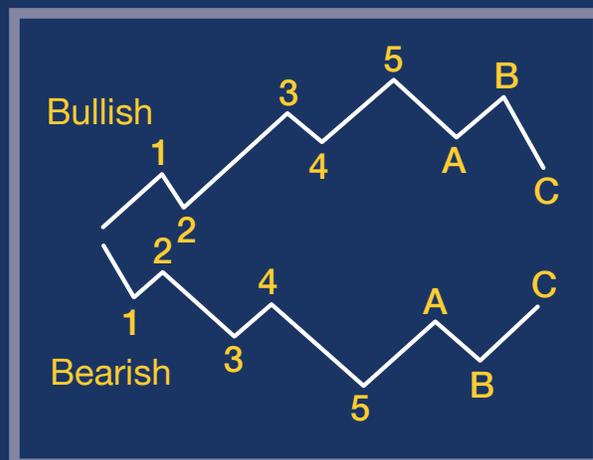
Elliott used the data from the Dow Jones Industrial Average to discover that the ever-changing path of stock market prices reveals a structural design that in turn reflects a basic harmony found in nature. From this discovery, he developed a rational system of stock price analysis. He isolated patterns, or “waves”, of directional movements that recur in markets and are repetitive in nature, but are not necessarily repetitive in time or amplitude. He then described how these structures link together to form larger versions of the same patterns, and how those in turn are the building blocks for patterns of the next larger size, and so on. His descriptions constitute a set of empirically derived rules and guidelines for interpreting market movement.

The Elliott Wave Theory

An Elliott Wave has two basic phases: an impulse or motive phase, and a reactionary or corrective phase. The impulse phase always moves in the direction of the trend, whereas the corrective phase moves against it. This would mean in a bullish market, the impulse phase will be moving upward while the corrective phase will be moving downward. In a bearish market the opposite will occur, meaning the impulse phase will move downward and the corrective phase will angle up.

Each phase is made up of waves. A complete Elliott wave is made up of eight waves which consist of five waves in the impulse phase (1, 2, 3, 4 and 5) and three waves in the corrective phase (A, B and C).

As with the phases, each wave is either impulsive or corrective in nature, meaning impulse waves move in the direction of the trend, and conversely, corrective waves move against it. The impulsive phase waves 1, 3 and 5 move with the trend, while waves 2 and 4 are corrective and move against the trend. Within the corrective phase, waves A and C move against the trend and are corrective, and B is an impulse wave. Each wave, whether impulsive or corrective, can be broken down further into another set of sub-waves following the same pattern, and those sub-waves can also be broken down, and so on.



Elliott Wave Rules

In addition to the basic wave structure, there are also a variety of counting rules that go along with Elliott Wave analysis. For example, Wave 3 cannot be the shortest wave and Wave 4 cannot overlap the price territory of Wave 1. There are many such rules which constrain the wave counts possible for a given instrument. In the past, the complexity and variety of the wave counting rules made it difficult for a non-professional to effectively use Elliott Wave analysis in their trading.

Recognia has developed a sophisticated, yet easy to use wave analysis solution that uses the quantitative characteristics associated with waves appearing in market data to allow each wave to be identified uniquely. Recognia's analytics apply and interpret the wave counting rules in an automated fashion, thereby creating a more level playing field between professional and retail investors. Now, everyday investors and traders can get the Elliott Wave count for any instrument with just one click.

Wave Count Revisions

One difference between Elliott Wave and other forms of technical analysis is the need for wave count revisions. In traditional technical analysis, events are permanent and indisputable once they have occurred. For example, when the price of an instrument crosses its 50 day moving average, this is considered an event; no subsequent moves in the price can ever change the fact that this has happened.

Elliott Wave analysis is different in that it sometimes requires a re-examination of past events based on new price data. For example, we may believe that a particular instrument is currently in Wave 4. However, if the price drops too far and overlaps the price territory of Wave 1, this is not permitted by the rules of Elliott Wave analysis. This essentially invalidates the current wave count, thereby requiring a re-examination of past price action to determine a new "allowable" count.

Recognia's Elliott Wave analysis deals with this issue by considering many possible wave counts and ranking their probability using mathematical algorithms. The wave count presented is not necessarily the only one, but rather is the most likely one given the current price action. As new price data is received, probabilities are continuously evaluated. If a new wave count becomes more probable than the previous count, a revision to the wave count will be issued. Traders are encouraged to think of the Elliott Wave count for an instrument not as the only count, but rather, the most likely count at the current time based on past price action.



Wave Patterns

Wave 1

The formation of Wave 1 is an indicator that the previous trend has ended and symbolizes the start new emerging trend; whether pointing upward (bullish) or downward (bearish), it will be opposite to the previous trend. This signal indicates that the price may rise (fall) from the previous close. Initially it can be difficult to recognize the "first wave" because if it is starting in a bull market, the news around the market is generally negative and traders believe that the previous trend is still intact.



With the start of Wave 1, volume should pick up as the prices rise. This is true unless the bear trend ended with a capitulation move, and is not very high. If so, then the rally is more likely part of a bear market correction, and a downtrend could resume shortly. A slow and steady price increase fits more closely with the start of a new bull market.

Wave 3

Wave 3 is usually the longest and strongest in the five wave pattern of an Elliott wave cycle. It is during Wave 3 that most investors will realize that the previous trend is over and the news around the market is positive. In a bullish market, Wave 3 prices rise rapidly and volume is usually extremely high. In a bearish market the opposite can be expected.



In price terms, Wave 3 is often the longest but can never be the shortest of waves 1, 3 and 5. This rule is a good way to help validate the wave count. Wave 3 is usually at least 1.618 times as large as Wave 1, but will probably take less than 1.618 times as long to complete since it is very strong. Wave 3 is not a straight up move, but should develop in five clear impulsive waves, three up and two down.

Wave 5

Wave 5 is the last move in the direction of the trend and it is not nearly as dynamic as the third wave of an Elliott wave cycle. This wave marks the last burst of buying before a new trend starts. At this point the stock has already had a good run up, there is not much steam left, and opening new positions can prove to be very costly.



Wave 5 is characterized by a momentum divergence. Volume is usually lower in this leg than what was observed in Wave 3 but can be higher than it was in Wave 4. As Wave 5 is an impulse wave it should traverse through a full five-leg subwave advance.

Wave B

Wave B tends to be the most difficult to identify. The volume of Wave B tends to be lower than that of Wave A. Wave B will consist of three subwaves and should retrace at least 62 percent of Wave A. This signal indicates that the price may rise (fall) from the previous close.



Wave 2

Wave 2 is the first pull back from Wave 1 in the direction of previous trend and generally suggests that the previous trend is still intact. As a rule, Wave 2 can never re-trace more than 100 percent of Wave 1. Wave 2 retracement can exceed 62 percent, but if it does, that could mean the wave count was incorrect and the bear market is still intact. These guidelines can help identify whether the previous trend is still intact or not.



Wave 2 generally experiences lower volume than what was seen during Wave 1. Prices typically move between 38 and 62 percent of the height of the wave 1, the drop commonly reflected in three sub-waves. When part of a corrective wave, Wave 2 is not likely to be as powerful as one that is correcting the initial wave of a major reversal.

Wave 4

Wave 4 is corrective in nature and is a signal that the best part of the trend is over. Wave 4 is difficult to count and can take a long time to develop, but normally should not take longer than the previous Wave 3. Even though prices are dropping, volatility probably will not pick up very much. Volume is much lower than that of Wave 3.



Wave 4 retraces 38 percent or less of Wave 3 but never retraces it more than 100 percent. Wave 4 can also never overlap Wave 1 because Wave 2 will never move beyond Wave 1.

Wave A

Wave A is the first of three waves in the corrective phase. Corrections are almost always more difficult to identify than impulse waves and most investors confuse them as interim corrections. Volume might increase in wave A and volatility will also rise, although not nearly enough to imply a bottom. It is possible for Wave A to complete in either three or five subwaves. This bearish (bullish) signal indicates that the price may fall (rise) from the close.



Wave C

Wave C is often very impulsive and marks end of the current corrective phase. Volume may be higher in Wave C than in Wave A. Wave C is made up of five subwaves and terminates beyond the end of Wave A. Some studies suggest that Wave C should not continue beyond 1.618 times Wave A, but this is not a rule.



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