

Figure 2.24

Source: Data courtesy TradeNavigator.com.

wave (C) would equal 1.618 times the length of wave (A) at 720.5. That calculation gave me 720.5 as one potential price target for the end of wave 5 of wave (C) of wave [Y].

I then looked at the wave (C) impulse on the daily continuation chart in silver futures to nail down some more price targets for the wave 5 top by doing

some Elliott wave analysis. I wanted to see how much progress wave 5 had made and whether there was potential for further upside.

I drew a trend channel, first by connecting the termination points of waves 2 and 4 and then by drawing a parallel line from the termination point of wave 3

KEY POINT

Within an expanded flat, it is common for wave C to equal 1.618 times the length of wave A.



Figure 2.25

Source: Data courtesy TradeNavigator.com.

(see Figure 2.25). Using a **Fibonacci expansion** guideline, I calculated the net distance traveled of waves 1 through 3, multiplied it by .618, and added that number to the end of wave 4. That calculation resulted in a price estimate of 677.5 for the end of wave 5. If wave 5 did not rise quickly, 677.5 would fall somewhere within the middle of the trend channel. Therefore, I

decided that 677.5 was a good short-term target, with 720.5 a good long-term target.

2. Formulating a Trading Plan

Next came figuring out entry and exit points. I often follow a market using a 15-minute bar chart (see Figure 2.26) to determine entry and exit points. I had

DEFINITION: Fibonacci Expansion

A Fibonacci expansion or multiple is the relationship between the net distance traveled of waves 1 through 3 and the length of wave 5.

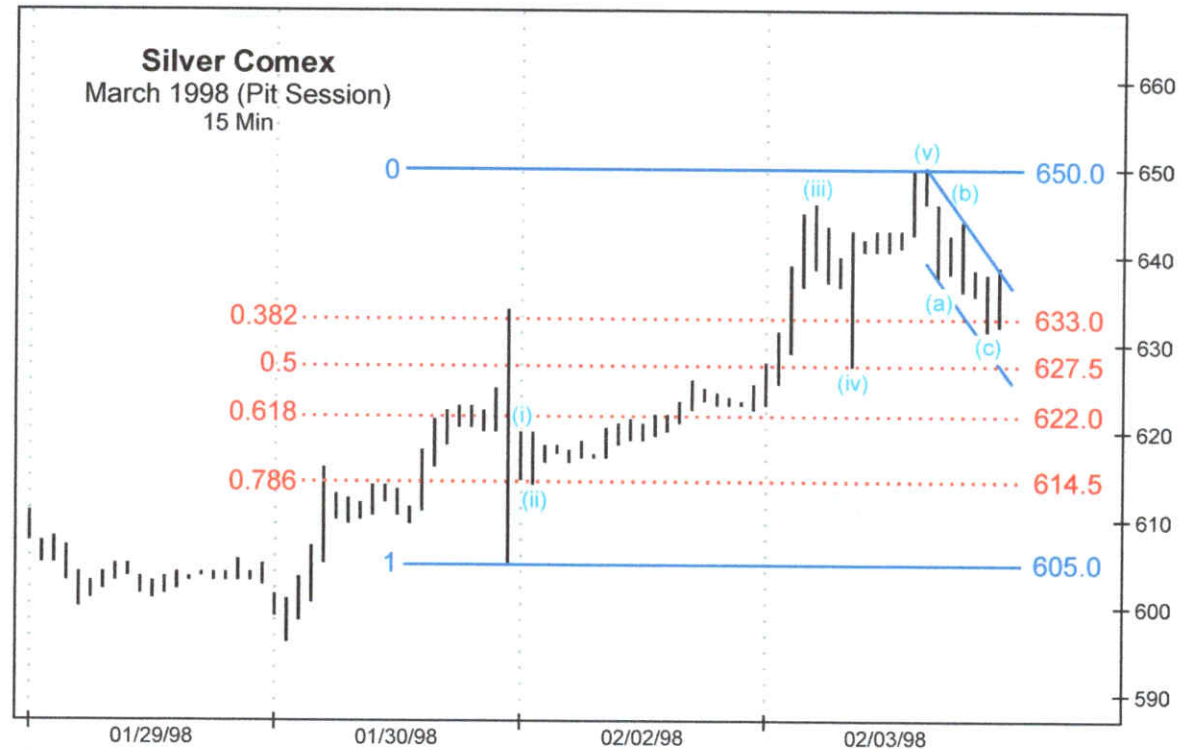


Figure 2.29

Source: Data courtesy TradeNavigator.com.

KEY POINT

The most common length relationship for wave C of a zigzag is C equals A.

shown in Figure 2.29, the zigzag adhered well to its own trend channel and achieved a nearly exact .382 retracement of the impulse wave. Also, wave (c) had almost reached the lower trendline of the channel.

In addition, Figure 2.30 shows that wave (c) equaled wave (a) at 631.5, which so far was the low for the zigzag.

Looking at the chart in Figure 2.29, silver appeared to have broken the upper trendline of the channel



Figure 2.28

Source: Data courtesy TradeNavigator.com.

There was more supporting evidence: As shown in the next chart (see Figure 2.28), if wave (v) had ended at 650.0, then the end of wave (iv) would have divided the entire price range of the impulse wave into two equal parts, which is a Fibonacci relationship in

completed impulse waves called a Fibonacci price divider. More commonly, fourth waves divide the entire price range into the **Golden Section**.

Other evidence also supported the idea that the zigzag on the 15-minute chart was complete. As

DEFINITION: Golden Section

The beginning or end of wave 4 will often divide an impulse wave into the Golden Section (.618 and .382) or two equal parts. This relationship is called a Fibonacci price divider.

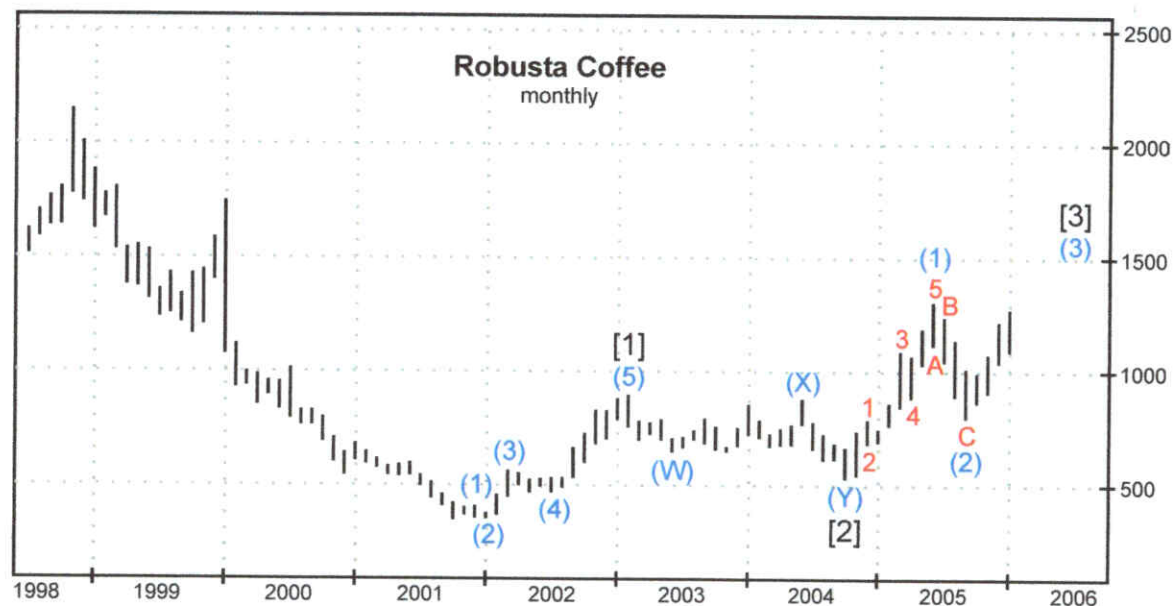


Figure 2.37

Source: Data courtesy TradeNavigator.com.

trading a combination. We're going to start trading on the current bar, January 2006. On the daily chart it is January 19. First, though, we will look at the big picture and then work down to lower degrees to find evidence that supports the wave count before we take a position.

It's best to start looking for a recognizable wave pattern at a major low or a major high. On this chart, we can start counting from the major bottom in

late 2001 at 345. There's a completed Primary wave [1] impulse wave followed by a completed Primary wave [2] double zigzag. Now, prices are in Primary wave [3]. Within Primary wave [3], robusta coffee has completed Intermediate waves (1) and (2), and is now into Intermediate wave (3), or so it appears at this juncture. (As an alternate count, we can label this move as Primary waves [A], [B], and [C].)



Figure 2.49

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Another viable and less aggressive strategy would be to go long after a move beyond the [b]-[d] trendline. Given the potential swiftness of thrusting out of the triangle, it would be best to leave an order with the broker (or electronic trading platform) to buy “on a stop” a few ticks beyond the [b]-[d] trendline.

Let’s fast-forward to June 28 to see how the trade went (see Figure 2.49).

Prices have broken through the [b]-[d] trendline, indicating the end of the triangle and the resumption of the uptrend in wave (3). But there’s more to do. We still

need to identify the end of wave [e] in order to raise the stop to one tick below the end of wave [e]. If the triangle is finished, prices should not go below wave [e]. Identifying the end point of wave [e] would also help us to accurately count the first impulse wave within wave (3).

Therefore, we should set our stop one tick below 1,123 and use it as the starting point for the next impulse wave to the upside. A more conservative stop would be just below the [b]-[d] trendline. *Note:* You don’t have to wait for the break of the [b]-[d] trendline to trade. It all depends on your own personal risk tolerance.



Figure 2.50

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Let's go forward to July 7 and see what would have transpired (see Figure 2.50).

The price has gapped up and created a beautiful thrust out of the triangle. The pattern now has a count of Minute waves [i], [ii], [iii], [iv], and [v] of Minor wave 1 of Intermediate wave (3). The high is 1,327. It could still go farther, but considering how far prices have gone beyond the target and

considering that there are now five waves up, it would be a good time to close this position within the price range of 1,327 to 1,250. The middle of that range is 1,289, which would produce a profit of 164 points.

Next should come a pullback for Minor wave 2, which would give us the opportunity to go long again at a price below 1,289.



Figure 5.12

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As it happened, SLW continued down to a final low of \$29.79 in the days that followed (see Figure 5.12). Had we held the position for a few more days, it would have been possible to exit with more than a 375 percent return, as the bid for the June 2011

\$34.00 put at that time was \$3.90. Although some people would be upset about missing that extra gain, when a minimum target is reached, it's usually best to follow the old advice that a bird in the hand is worth two in the bush.



Figure 5.13

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1.618
2.618
3.618

Let's look at this same SLW price chart (see Figure 5.13) from an analytical perspective rather than a trading perspective. You will see that it adheres to many guidelines of the Wave Principle, one of which

is called *alternation*. This guideline applied to corrective waves tells you to look for different forms in waves two and four. For example, if wave two is a sharp correction, expect wave four to be a drawn-out,



Figure 5.16

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When the \$36.94 entry was triggered, the initial protective stop was set at the high of the move at \$38.09 (see Figure 5.16). If only the minimum objective for this trade had been achieved with a move below \$33.61, the risk-reward ratio for this position was a very acceptable 3:1.

At this point, as shown in Figure 5.17, I decided to scale into another 100 shares on a move below \$35.13, using the more conservative strategy, discussed in Chapter 1, of selling shares at the extreme of wave 4 of the ending diagonal.



Figure 5.15

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On May 2, 2012, TCK made a moderate new high above the extreme of wave 3 (see Figure 5.15). At that point, the minimum requirements of a completed wave pattern were in place, and the stage was set for a sizable decline in price. In order to take advantage of this trade setup, I decided to employ a modified ending diagonal entry technique.

Rather than selling as wave 5 developed or entering on a break of the 2–4 trendline, I decided to take a small position on a break of the extreme of wave [b] of 5 at \$36.94. Doing so was slightly aggressive, but it did still allow me to use confirming price action, because it required a move below a prior swing low. Also, to offset the risk of entering this trade too early, I took only a small position.

Smart Investor Tip

To offset the risk of entering a trade too early, take a small position.



Figure 5.19

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Four days later on May 8, TCK fell below \$33.61, the origin of the ending diagonal (see Figure 5.19). Since the minimum expectation for this trade had been met, I dramatically lowered the protective stop on the position to \$34.00. When lowering the stop, I

also considered that it was now possible to count five waves down from \$38.09 to \$32.67. With a five-wave sell-off apparently in place, I knew that the downside was limited over the short term and that the next significant move would be up.



Figure 5.20

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The next day (see Figure 5.20), I lowered the stop on this trade from \$34.00 to \$33.00, to lessen my risk and protect my open profits. Later in the day on May 9, TCK traded through \$33.00, stopping out the trade. The result was a \$2.73 drop in share price, a 7.64 percent decline. Not a bad return for a trade that lasted only six days.

Trading an Ending Diagonal in the Euro

In April 2008, an interesting situation developed in the euro against the U.S. dollar in the foreign exchange market. After the October 2000 low of .8245, based on



Figure 5.21

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the nearest futures contract, the euro rose relentlessly, making one record high after another. Was there any way to know when this market would finally become exhausted? The Elliott wave model had the answer. Ending diagonals in the euro at two different degrees flashed two major sell signals at the record high. But let's start at the beginning.

On this daily continuation chart (see Figure 5.21) of the euro futures contract as of April 22, 2008, we see a decisive move up in waves (i), (ii), and (iii). Within

wave (iii), we can count waves i through v as one probable scenario, with wave v peaking at 1.5985. Observe that wave v contains five overlapping waves that contract and form a wedge shape. That is the signature of an ending diagonal, which signals a swift and sharp reversal ahead.

According to Elliott wave guidelines, the reversal will travel at least to where the diagonal began and possibly further. In this case, that level is indicated by the end of wave iv at 1.5273.

KEY POINT

After an ending diagonal is complete, the reversal back to where the diagonal began should take from one-third to one-half the time it took for the diagonal to unfold.

In a diagonal, wave 4 almost always overlaps wave 1.

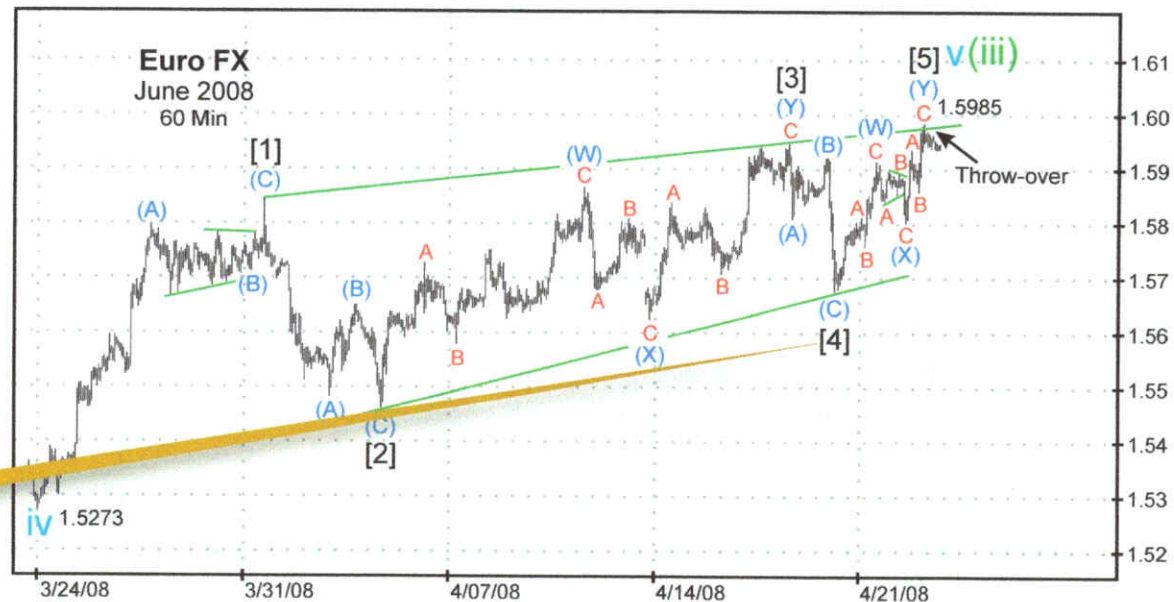


Figure 5.22

Source: Data courtesy TradeNavigator.com.

One key characteristic of ending diagonals is that all the initial subwaves form either single or multiple zigzag patterns. Here is a close-up view of this diagonal on an hourly bar chart (see Figure 5.22) in order to reveal these zigzag patterns.

Waves [1], [2], and [4] appear to be single zigzags, while waves [3] and [5] appear to be double zigzags.

Wave [5] makes a throw-over, because it travels slightly beyond the 1-3 trendline. A throw-over often indicates that the diagonal has finished. Once prices move below the 2-4 trendline, we would have strong evidence that the diagonal had terminated at 1.5985. The next event should be a swift move to at least 1.5273 and probably beyond.



Figure 5.24

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particularly if I have strong evidence that the diagonal has ended.

Let's say that we decided to sell the euro at the closing price on April 22 at 1.5957 (see Figure 5.24). Our price target is 1.5273, where the diagonal began. Our

protective stop is 1.6161, the price at which wave [5] would be longer than wave [3], which would make the diagonal invalid. Our potential risk would be 204 points and our potential reward would be 684 points, resulting in a risk-reward ratio of more than 3:1.

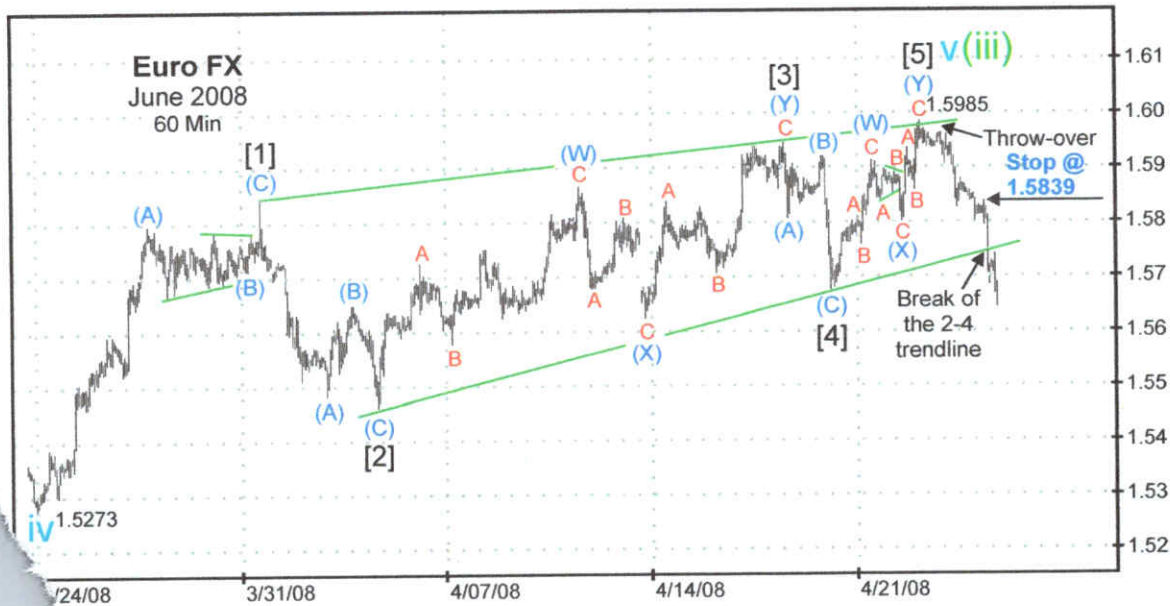


Figure 5.25

Source: Data courtesy TradeNavigator.com.

On this hourly bar chart (see Figure 5.25) as of April 24, the euro has broken the 2-4 trendline, strongly suggesting that the diagonal terminated at 1.5985. At this juncture, we could move our stop further down.

We would not want to see a significant move back above the 2-4 trendline, so we would place the stop at 1.5839, which is the last significant high before the break of the trendline.



Figure 5.26
Source: Data courtesy TradeNavigator.com.

Here we are a week later (see Figure 5.26), with the euro continuing to decline. This is an opportunity to lower our stop below the 2-4 trendline. One reasonable level to choose would be 1.5663 because it

represents the high of a recent correction. We could have also placed a market order to buy the euro at 1.5273 on a stop with a protective stop at 1.5663, OCO (one cancels the other).



Figure 5.28

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degree. Regardless, once you had seen the second diagonal, you would have known that a reversal was in the offing and that 1.5255 would have been a good start for the initial price target on your next trade.

Overall, two ending diagonals occurred at different degrees and peaked at about the same price level, signaling exhaustion in the main trend. In the second ending diagonal, the throw-over was greater than the first one and the reversal more violent.

KEY POINT

The greater the throw-over, the more violent the reversal.

For More Information

Learn more at your exclusive Reader Resources site. You will find lessons on recognizing diagonal patterns in your charts and positioning yourself for the market action to come, plus more free resources designed to help you incorporate Fibonacci and technical indicators into your wave analysis. Go to: www.elliottwave.com/wave/ReaderResources.



Figure 5.27

Source: Data courtesy TradeNavigator.com.

On May 7, the euro reached a low of 1.5255, and the order would have been filled at 1.5273 for a net profit of 684 points (see Figure 5.27).

This daily chart (see Figure 5.28) shows the euro's further price moves through August 8. Wave (iv) ended at 1.5255. What is interesting is that wave (v) also unfolded as an ending diagonal. It, too, displayed a throw-over

and then peaked at 1.5988, only a few ticks beyond the previous all-time high. A swift and sharp reversal followed, and the euro never looked back. Could you have known that the euro would continue to decline past 1.5255, which was the beginning of the diagonal on the daily chart? Yes, but only by analyzing the wave structure of the decline as well as the wave pattern at higher

Test Yourself

- Where can ending diagonals occur?
 - Wave 5 of an ending diagonal
 - Wave A of a zigzag or flat
 - Wave 5 of an impulse wave and wave C of flats and zigzags
 - At the end of a corrective pattern
- True or False: An ending diagonal is a sign that the main trend will continue for a while.
- After the termination of an ending diagonal, what can you expect?
 - The trend should be sideways.
 - The market should reverse sharply to where the diagonal began.
 - A triangle should unfold.
 - There should be another diagonal in the opposite direction.
- What do ending diagonals, truncated fifth waves, and fifth-wave extensions have in common?
 - They always move to the downside, which is a faster move.
 - They are extended waves, which offer more profit opportunities.
 - They are all followed by a swift and sharp reversal.
 - They are all impulse waves.
- True or False: In a contracting ending diagonal, wave 3 is shorter than wave 1.

Answers: 1. C 2. False 3. B 4. C 5. True

**Figure 6.8**

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Possibly, but it's debatable. After all, your goal as a trader is to do one thing—make money. Your goal is not to sell at top tick or buy at bottom tick. Your goal is not to be perfect on every trade or to have the most optimal stop on every trade. In fact, if the \$30.05 stop had been hit on May 22, this trade would still have

been profitable. Don't berate yourself for imperfection. If you make money, get up from your computer grinning like the Cheshire cat. Remember, the person on the other side of your trade took a loss.

Although you might want to squeeze all the money you can out of each and every trade, that attitude can



Figure 6.12

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represents the difference between the MACD line and the MACD signal line.

The momentum signature exhibited in both MACD and the MACD histogram is a bullish divergence. Notice that the MACD readings were higher during wave C of our flat fourth wave in WMT than during wave A. This bullish divergence implies that the market is strengthening.

With a bullish wave count, a bullish engulfing pattern on the weekly chart level and bullish divergence present using MACD and MACD histogram, we now have three pieces of corroborating evidence to go long WMT.

In this example (see Figure 6.12), I thought it would be both fun and educational to trade WMT two different ways. First, we will buy 100 shares

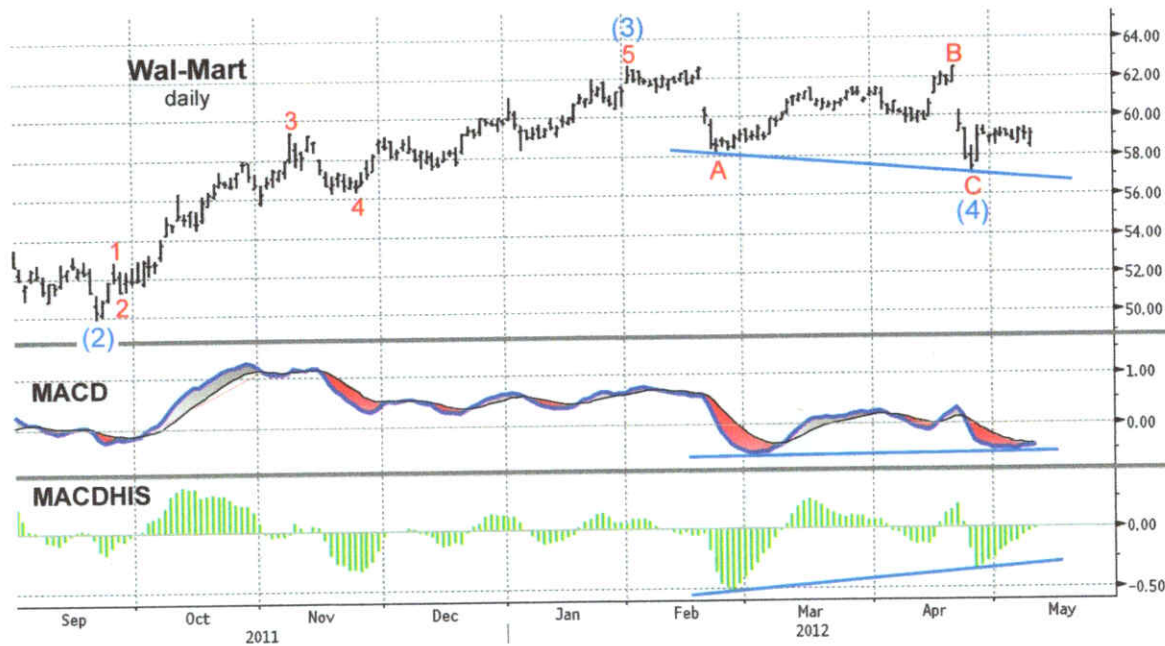


Figure 6.11

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strength. Combine this candlestick pattern with the equally compelling and bullish wave count, and we have begun to make a solid case for a buy-side trade.

Now, let's add another study. This price chart (see Figure 6.11) includes two indicators: MACD

(comprising the MACD line in blue and the MACD signal line in black) and the MACD histogram. The MACD line is the difference between a 12-period and 26-period exponential moving average. The MACD signal line is merely a 9-period exponential moving average of the MACD line. The MACD histogram



Figure 6.14

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we raise our initial protective stop from \$58.27 to \$59.80, just above our entry price. We also let go of five of our September calls at \$3.65 apiece for \$1,825, excluding commissions. This allows us to pocket our original \$1,700 investment plus \$125.00 in profit.

Moreover, we still have five September calls that look promising.

After prices gapped up, WMT pushed even higher (see Figure 6.14), so we sold our remaining option position at \$4.40 apiece. On our option play, we made



Figure 6.13

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of WMT at \$59.10 with a protective stop at \$58.27. Excluding commissions, the purchase price is \$5,910. Second, we will use options and buy 10 September 2012 \$60 calls at \$1.70 a piece.

Excluding commissions, the purchase price for our option position is \$1,700.

Figure 6.13 shows that following our purchase, WMT gapped up significantly on May 17. In response,



Figure 6.24

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In the two weeks that followed our initial entry, WYNN fell almost 20 percent, as seen in Figure 6.24. Due to the speed of the decline, it was difficult to manage a trailing stop. In situations like this, I keep things simple

by using the previous day's high or low. In WYNN, the previous day's high was exceeded on May 18, when prices traded above \$106.01. Thus, this trade was stopped out for a profit of \$202.90, or 16.06 percent in just 10 days.



By combining multiple forms of technical analysis to arrive at a trading decision, you increase the odds for a successful outcome.

Figure 6.23

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In early May, a *dark cloud cover* candlestick pattern formed in WYNN. A dark cloud cover is a bearish reversal pattern that forms when a white (or green) candle is followed by a black (or red) candle that opens above the previous candle's high and then closes well into the white (or green) candle's body.

We now have yet another piece of evidence for taking a short position. This is what I call evidence-based analysis and trading. By combining multiple forms of technical analysis to arrive at a trading decision, you increase the odds for a successful outcome. (Even so, it is important to remember that the risks of trading can only be reduced, never eliminated.)

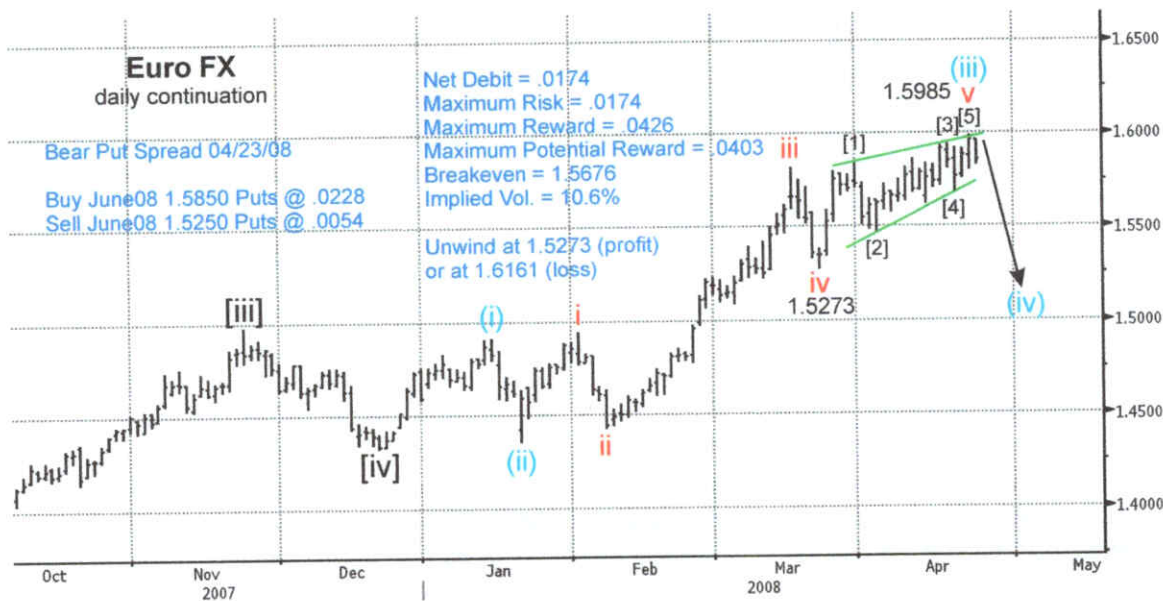


Figure 7.3

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the difference between the strike price and the closing price of the underlying asset. Prior to expiration, an option's value is a function of several variables, including price of the underlying asset, implied volatility, and time to expiration. Figure 7.3 summarizes the details.

In this contract, the price high is 1.5964, the low is 1.5826, and the close is 1.5854. Based on the actual closing option prices, you buy an at-the-money June 2008 put with a strike price of 1.5850 at a cost of .0228, and you sell an out-of-the-money June 2008 put with a strike price of 1.5250 that generates revenue of .0054.

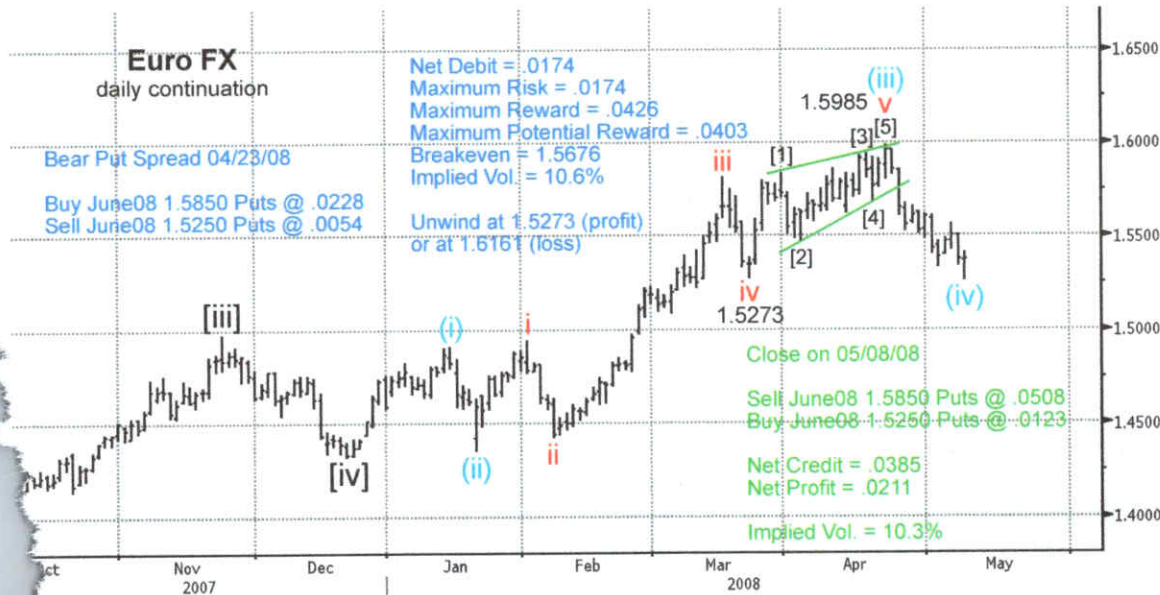


Figure 7.4

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hope that it will happen near expiration. If, before reaching 1.5273, the euro rises to 1.6161, the strategy instead is to get out and salvage whatever option premium is left, in order to avoid incurring the maximum loss. Let's see what transpires in the next few days on the next chart (see Figure 7.4).

The fifth-wave ending diagonal does indeed deliver a swift reversal. As you can see, prices reach the target of 1.5273 on May 8. As expected, the retracement took about half the time for the diagonal to unfold. The high

that day is 1.5415, and the low is 1.5255. From a risk point of view, there is no reason to stay in this position any longer, so it is time to unwind the options trade.

On the close of May 8, it is possible to sell the June 1.5850 put at .0508 and buy back the 1.5250 put at .0123, which results in a net credit of .0385 and a total net profit of .0211. Why buy back the short put? Once the long put is cashed in, the short put becomes "uncovered." If the forecast turns out to be wrong and the euro declines further, you lose money on the short put and

A bear put spread at this juncture is too conservative, because of the completion of a fifth wave at high degree. Given the greater downside potential, the preferred options strategy is a put ratio backsread.



Figure 7.5

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possibly all or more of the profit. As shown in Figure 7.5, the euro does rally back to the all-time high.

Having achieved the expected move to 1.5273, why does this trade earn only .0211 and not the maximum potential reward of .0403? Half of that difference is because, on May 8, the euro closes at 1.5366, which is 93 points higher than the target. (We are simulating this trading example based on real closing prices because historical intraday option prices are not readily available.)

In reality, your strategy would be to place an order with your broker to close out your options

position when the June euro futures contract trades at 1.5273. That action would result in a profit closer to your maximum potential reward but still not exactly, because the broker execution for this type of order cannot always be perfect in option markets, and prices hit the price target sooner than the ideal time: One month still remains before the expiration date of the puts. With options, that much time can be costly. Because the long put at 1.5850 eventually becomes deep in-the-money, you earn the **intrinsic value** of the put when you sell it but do not make

DEFINITION: intrinsic value

Intrinsic value refers to the difference between the strike price and the price of the underlying asset for in-the-money options.

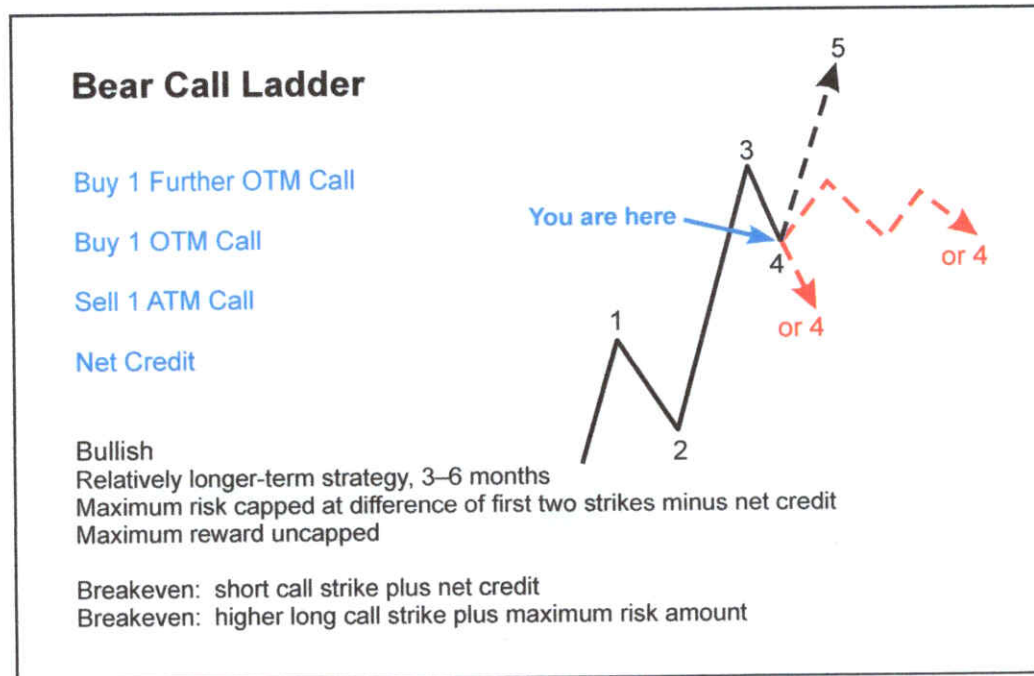


Figure 8.6

Figure 8.6 illustrates both the various Elliott-wave scenarios and shows the structure of this options strategy.

In options literature, people categorize the bear call ladder as somewhat ambiguous and confusing. Are you bullish? Are you bearish? You are selling an at-the-money (ATM) call, but you are also buying two different out-of-the-money (OTM) calls. What's going on? The irony is that from an Elliott wave perspective, it is not ambiguous at all. It helps to protect against the possibility that an alternate wave count may occur. Let's see why this strategy helps in this situation.

The bear call ladder is basically bullish. It is a relatively longer-term strategy, applicable for trades lasting three to six months. You structure it by selling one in-the-money or ATM call and using that revenue to buy one OTM call and one further OTM call. You should try to generate a total net credit or net cash inflow in order to maximize the effectiveness of this strategy. Your maximum risk is capped; it is the difference between the first two strikes minus the net credit. The maximum reward is uncapped. The strategy provides two breakeven price levels: the short

call strike plus the net credit, and the higher long call strike plus the maximum risk amount (in the area beyond the further OTM call). If the market goes down or goes sideways (at the level that you sold your calls) between now and options expiration, you keep your net credit and walk away. If the market rallies strongly between now and options expiration, your further OTM calls will increase in value. If the market only goes higher marginally, you will lose money.

In a nutshell, you are betting on a big move up. Your bias is in the direction of the main trend. Either way, though, you have some protection if prices

move down or sideways. You get hurt only if prices go in the direction of the main trend for only a small move. In other words, you sacrifice a small up move in exchange for a big up move, a sideways move, or a down move. This strategy comes in handy when you are bullish but equally nervous about the prospects of the market going down or sideways. (In bear markets, its counterpart is called the “bull put ladder” and is constructed in the same way, but using puts.)

Let’s apply this strategy to a situation in heating oil.

Figure 8.7 displays a close-up view of wave 4 in heating oil futures on the daily continuation chart.

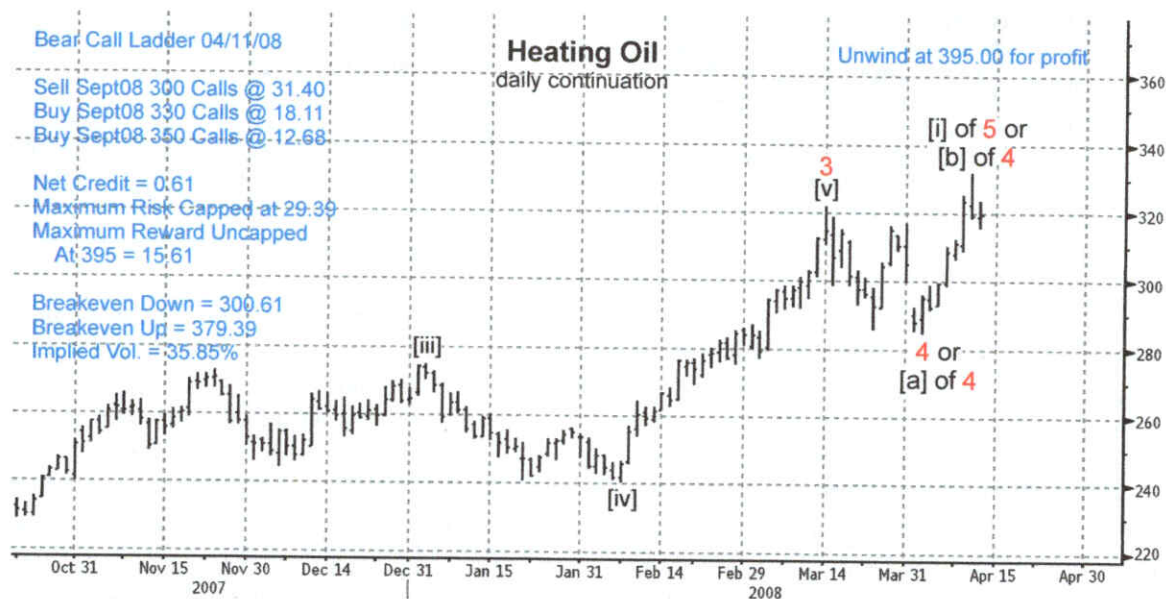


Figure 8.7

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To learn more about the importance of methodology, discipline, money management, patience, and realistic expectations, I highly recommend *The Disciplined Trader* by Mark Douglas and *Super Trader* by Van K. Tharp, PhD.

Parting thoughts from Wayne Gorman . . .

Each trader has a trading style. For instance, I like to take a somewhat risky posture. I prefer to use Elliott wave patterns to set up my trades as early as possible in anticipation of a trend change rather than waiting for further confirmation. In other words, I look for the best level and the tightest protective stop possible in lieu of waiting for evidence that the trend has indeed changed.

In anticipating where the market is headed, I am willing to take the risk that sometimes I will be wrong. If I were going short, I would rather go short at a high level with my stop just above the recent high, even if I were not certain that the trend had actually turned down. I do not like waiting for confirmation and then going short at a lower level with a stop that incurs greater risk, even though I might be more certain that the trend has turned.

This approach depends on accumulating enough evidence to support the case for an imminent trend change. Others who have a different trading style will argue that it is best to wait for an impulse wave in the opposite direction that decisively breaks a trend

channel or major trendline of the previous pattern. That is a valid strategy, too. In deciding between these two approaches, is it simply a matter of personal risk tolerance, or can one make an analytical determination which to use? The answer is “Yes” to both questions. Let’s look at an example.

In Figure 9.1, we have identified a Fibonacci cluster that satisfies three key Fibonacci relationships at the market’s current level. In this type of situation, I would go short with a stop one tick beyond the beginning of wave (1). Why does this seem risky despite the evidence? To use courtroom jargon, the evidence is only circumstantial. No smoking gun suggests that the trend has changed, although some strong evidence suggests that it will.

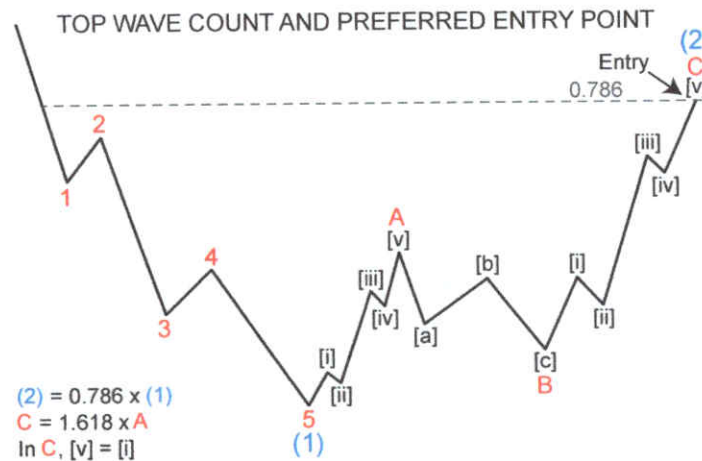


Figure 9.1

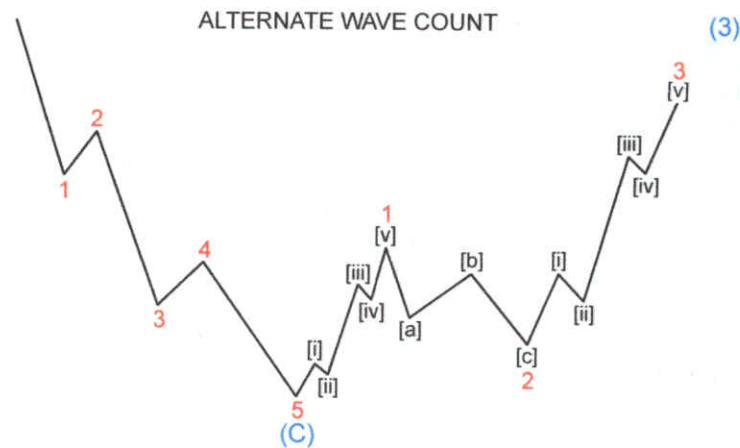


Figure 9.2

I could have made a mistake. If the trend has not changed, what might be the correct wave count? It is possible that the low on the chart (see Figure 9.2) completed wave (C) of an expanded flat, so the market is trending to the upside in wave 3 of wave (3). I have seen this scenario play out a number of times. For those who are somewhat risk-averse, Figure 9.3 offers an alternate strategy.

You could wait for an impulse wave to the downside that breaks the lower line of the trend channel

formed by the wave (2) zigzag. Then go short in wave [i] of wave 3 of wave (3), when it breaks the trend channel formed by wave 2. Without strong evidence that a turning point is near, it would be prudent to wait for further confirmation, as illustrated in Figure 9.3. Using this same logic, you would wait for a break of the B-D trendline of a triangle and wait for a break of the 2-4 trendline of an ending diagonal.

When I traded for a living with my own capital, people used to ask me, “What tools do you use besides

TOP WAVE COUNT AND ALTERNATE ENTRY POINT

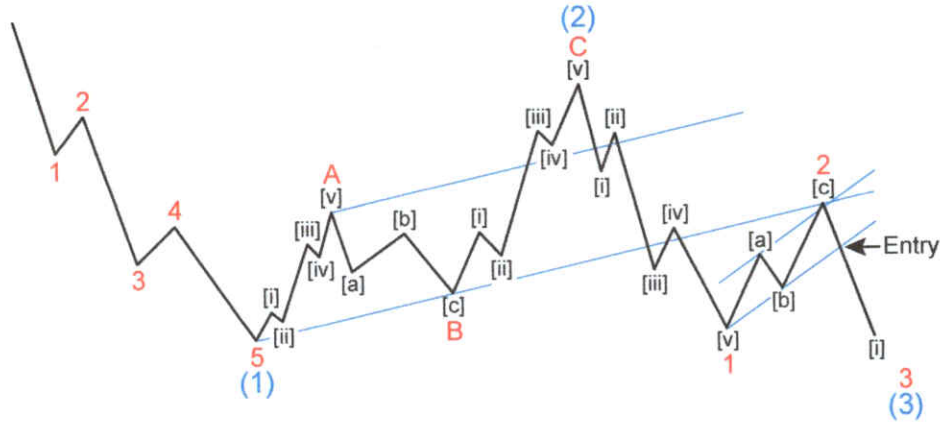


Figure 9.3

Elliott wave?" I always replied, "I use anything I can get my hands on, if it makes sense."

Using other technical indicators can help reinforce your Elliott wave analysis or warn you that something is wrong with it (see Chapter 6). Technical indicators fall into three categories: sentiment (measures of investor psychology), momentum (changes in price, breadth, and volume), and patterns outside of Elliott wave (such as time cycles and head-and-shoulders formations). Just keep it

simple and use what works best for you. Using a large array of indicators can be more of a hindrance than a help.

Finally, keep in mind that our knowledge about Elliott wave analysis is still growing. What we know about wave patterns is fascinating and useful, but there will always be more to discover. You do not have to wait for someone else to make a discovery. As you analyze and trade, see if *you* can add to our body of knowledge.