Elliot Wave Theory and Fibonacci Retracements

Elliot Wave Theory

Basic Tenets: Wave theory consists of three concepts – pattern, ratio, and time.Stock markets follow a repetitive pattern of a five wave advance followed by a three wave decline.During an uptrend, each of the five waves is numbered 1 through 5.Waves 1, 3, and 5 are impulse waves, moving with the trend.Waves 2 and 4 are corrective waves, moving against the trend.Following 5 waves, the three wave corrections are labeled as a, b, and c.(Slides 3-5)

Wave Subdivisions: Each wave subdivides into waves of one lesser degree.Each wave is part of the wave of the next higher degree.2 waves subdivide into 8 waves, which can subdivide into 34 waves, which can subdivide into 144 waves, and so on.(Slides 6-7)

Corrective Waves: The impulse waves (i.e. the ones in the direction of the major trend) come in fives.Corrective waves almost always come in threes. Three types of corrective waves include Zig-Zags, Flats, and Triangles.(Slides 8-11)

Rule of Alternation: The market doesn't usually act the same way two times in a row.If a certain pattern occurred (e.g. head and shoulders top), it is unlikely to occur the following time.(Slide 12)

Price Channels: Waves often take place within channels.A channel consists of two lines, which encompass the price movement.We can draw a price channel during an uptrend or downtrend and wave sequences should take place within these channels.(Slide 13)

Fibonacci Numbers: The Fibonacci number sequence is 1, 1, 2, 3, 5, 8, 13, 21, 34, 55, 89, 144, 233, and so on.The sum of two consecutive numbers equals the next higher number.The ratio of one number to its next higher number approaches 0.618.The ratio of one number to its next lower number approaches 1.618.The ratio of alternative numbers approaches 2.618, or its inverse of 0.382.(Slide 14)

Fibonacci Ratios

1. One of the three impulse waves often extends, and the other two are equal in time & magnitude.
2. A minimum target for the top of wave 3 is obtained by multiplying 1.618 by the length of wave 1, and adding it to the bottom of wave 2.
3. The top of wave 5 can be found by multiplying the length of wave 1 by 2 times 1.618, and adding that to the top or bottom of wave 1, for the maximum and minimum targets, respectively.
4. If waves 1 and 3 are equal, wave 5 will extend. The final price is equal to the distance from the bottom of wave 1 to the top of wave 3, multiplied by 1.618, and added tothe bottom of wave 4.
5. In a 5-3-5 Zig-Zag correction pattern, wave a is equal to the length of wave c.
6. Another method we can use to find the length of wave c is to multiply the length of wave a by 0.618 and subtract that from the bottom of wave a.
7. If we have a flat 3-3-5 correction pattern, wave c will equal 1.618 times the length of wave a.
8. In a symmetrical triangle, each wave is related to the prior wave by a factor 0.618.(Slides 15-17)

Fibonacci Retracements: Fibonacci retracements are used to determine the length of a price correction.The common numbers used are 62%, 50%, and 38%.During a trend, the price will retrace between 38% and 62% of the move.Retracements greater that 62% indicate a change in the trend.(Slides 18-19)

Fibonacci Time Targets: Time targets are the third aspect of Wave theory and they are usually hardest to predict.We can use Fibonacci time targets to predict when significant tops or bottoms will occur.For example, on a daily chart, after an important turning point, we should look out for the next significant point on a day equal to one of the Fibonacci numbers.We can expect future tops and bottoms to occur on 13th, 21st, 34th, 55th day etc.(Slide 20)

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