

Overview of Elliott Wave Theory

In the thirties, Ralph Nelson Elliott made a remarkable discovery. He found that the emotional state of a crowd of traders moves in recognizable patterns and that these patterns are reflected in the price movement of traded securities. The larger the crowd of traders, the more predictable the patterns.

Using the Elliott Wave Principle, a detailed analysis of market action will show the underlying swings between pessimism and optimism that occur in mass trader psychology.

Elliott recognized eleven different wave patterns and spent many years documenting and quantifying them into a strict, systematic set of rules and guidelines.

Elliott also found that the prices move in five wave patterns in the direction of the larger trend, and (generally) in three wave patterns when moving against it. He called the patterns moving in the direction of the larger trend Impulse patterns, and those moving against it, Corrective patterns.

For a particular pattern to be verified as an Elliott Wave, all its rules must be obeyed precisely. In contrast, its guidelines do not have to be strictly obeyed. However, when market movement can be interpreted in two or more ways according to the rules, the pattern obeying the most guidelines is preferred. This pattern becomes known as the preferred count and has the highest probability of being correct.

Wave patterns form in different sizes, called degrees. Smaller degree patterns form the waves of larger degree patterns. The interaction between degrees of patterns may be likened to the movement of the ocean. Many ripples together form a wave. Many waves form an ocean swell.

It is important to understand that patterns of all degrees are operating in the market at the same time. Because they interact continually, they will never appear exactly as they did in the past.

Elliott found that the waves relate to each other in specific mathematical relationships. At any moment the market will be full of such relationships. Using these relationships, it is possible to project the price range in which a particular wave will terminate, often with a great deal of accuracy.

The Elliottician is concerned with probabilities. The Wave Principle does not show us the future with absolute certainty; it allows us to see what is likely to happen. As the market unfolds, waves can distort, probabilities can change and target ranges will need to be altered. This is a normal day at the office for an Elliottician.