

**HOW TO USE
THE WAVE PRINCIPLE
TO BOOST YOUR
FOREX TRADING**

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How to Use the Wave Principle to Boost Your Forex Trading

By Jim Martens, Elliott Wave International

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Introduction

Over the years, I have received many questions from subscribers who want to learn how to improve their trading success in the forex market. This eCourse Book incorporates several webinars I gave during 2007 and 2008 that were designed to answer those questions.

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Editor's note: Jim Martens covers currency relationships for *Global Market Perspective* and provides full coverage of dollar rates and major cross rates in EWI's *Currency Specialty Service*.

Chapter 1

A Useful Trading Methodology

How the Wave Principle Improves Trading

1. It identifies the trend.

2. It identifies countertrend moves within the trend.

3. It confirms the resumption of the trend.

4. It identifies the termination of the trend.

5. It provides high-probability objectives.

6. It provides specific points of ruin.

Figure 1-1

Of the many ways the Wave Principle can improve trading success, for me, points 1, 2, and 6 are the most important. I like to trade with the trend, and the Wave Principle allows me to identify that trend. It will tell me not only when the move *is* countertrend but also when to *expect* a countertrend move. The Wave Principle also helps confirm when the trend resumes and identifies when it terminates.

If you don't know when your outlook is wrong, you can get into a lot of trouble. So, the Wave Principle can also help by allowing you to determine high-probability objectives and, most importantly, points of ruin.

Figure 1-2

Here you see an idealized Elliott wave with five waves trending up and three waves trending down. Which waves offer trading opportunities? Waves 3, 5, A and C offer the best opportunities, though I typically do not trade wave A. If I had to choose just one wave, it would be wave 3, because the third wave is usually the longest and the most powerful of the impulse waves. Trading the most powerful wave also offers the opportunity to trade with the best risk-reward ratio.

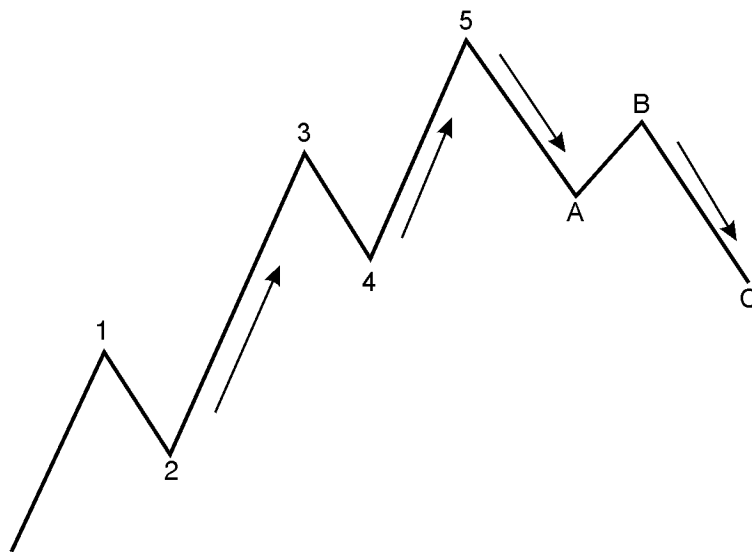


Figure 1-3

The setup waves — the waves we’re trying to identify in order to prepare for the trading opportunities — are wave (2), wave (4), and wave (B). You can see that I have marked them as either bullish or bearish trade set-ups on this more detailed wave chart. Let’s concentrate on trading wave (3), since it is usually the strongest and longest wave, and its trend is clear. That means that we want to identify the wave (2) that will lead into a strong third wave.

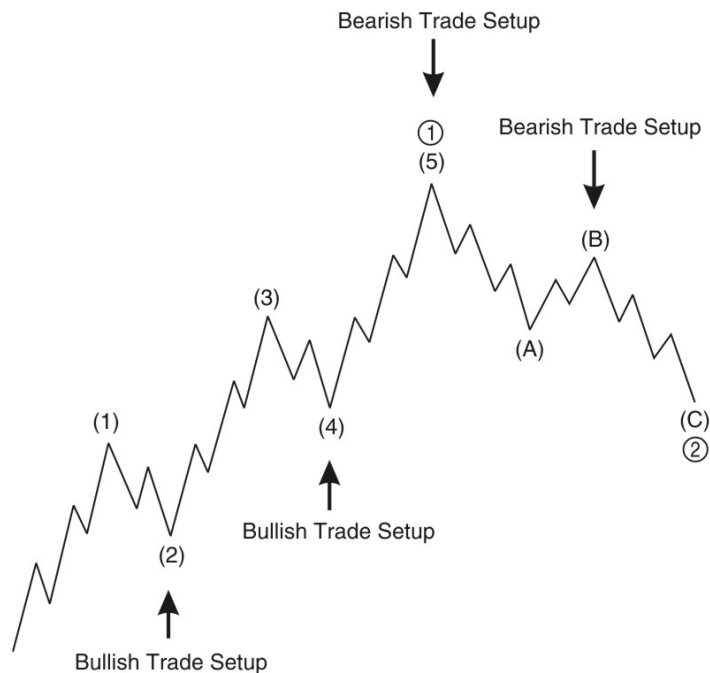
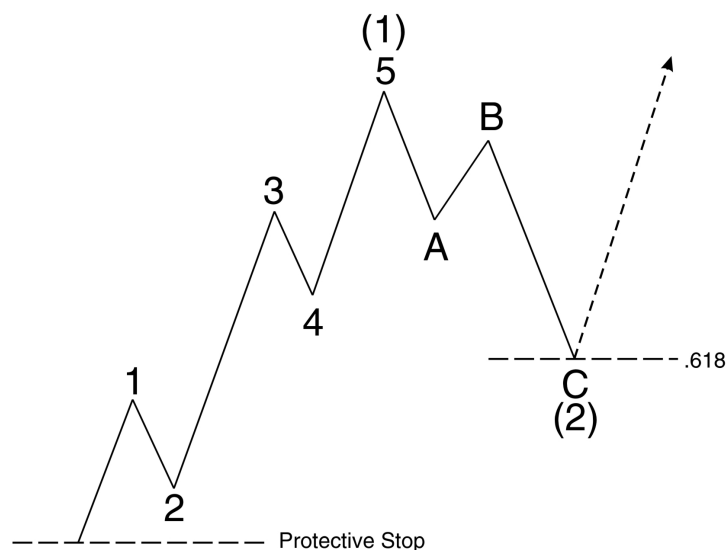


Figure 1-4

When considering a forex trade, you always want to answer this question first: Where could I be wrong? The point is to know your risk before you get started, before you think about how far the market is likely to go and before you start calculating targets. I want to know my risk.

For example, let’s assume the market has been falling for quite some time and that we’re expecting a low. All of a sudden, we can count a five-wave advance on a 60-minute chart. At that point, should we take any action? No, we should wait for a three-wave decline, which would be the correction of that advance, before entering the trade.

Based on one rule of the Wave Principle, I know where the count becomes wrong. Wave (2) cannot retrace more than 100% of wave (1). So I draw a line at the start of wave (1) (marked with a dashed line labeled “Protective Stop”) and if the decline surpasses that level, I know that my count is incorrect. Elliott Wave is one of few methodologies that give us an absolute number for our protective stop.



When projecting targets, wave (3) always offers the greatest potential, because it is the most likely wave to extend, and it often travels 1.618 times the distance traveled in wave (1). At a minimum, wave (3) must carry beyond the peak of wave (1). We can project a target where wave (3) equals wave (1), since equality is a common relationship, but the 1.618 multiple is actually the most common target. Once I believe that wave (3) is under way, I will mark my charts with the 1.618 target level.

Figure 1-5

Wave 5 is the final move within wave (3). Wave 5 typically exceeds the top of wave 3, and it does so in five waves. This point is more important than any mathematical calculation. Once five waves are complete, the move may be over.

When calculating targets for wave 5, look for the point where wave 5 equals wave 1 or the level where wave 5 equals .618 of the net distance traveled of waves 1 through 3. Many times, these calculations will come out in the same area, providing a cluster of targets. A cluster provides a more powerful argument for the potential stopping point. Once you have calculated your risk and have an idea where the market is going, you can decide if this is an opportunity that's worthwhile for you.

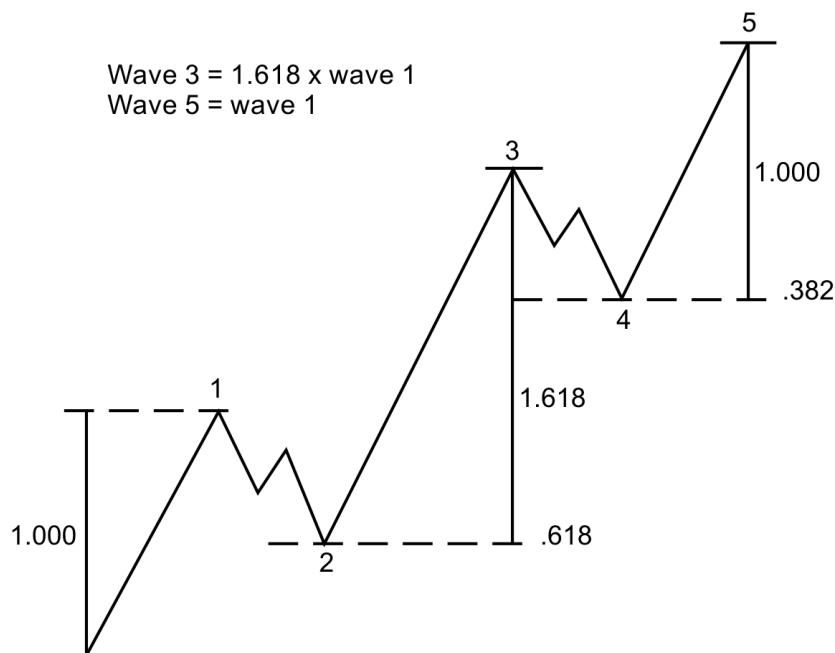
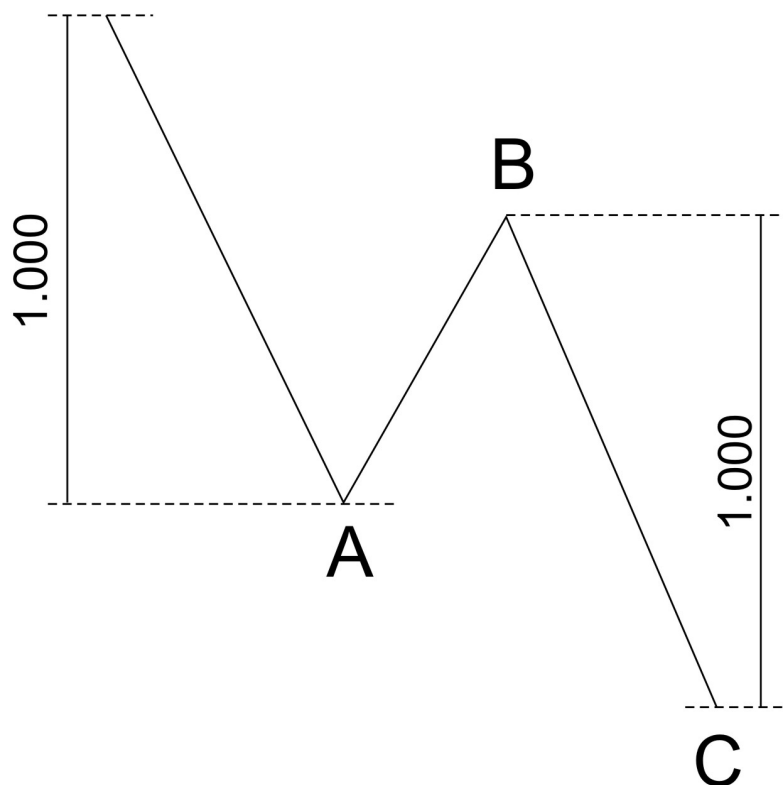


Figure 1-6

In a corrective move, wave B is a setup wave. In this case (a downward correction), the bounce provides an opportunity to get short for wave C. In terms of risk, wave B is much like wave 2 — unless you think that a flat correction is under way, wave B's peak should stay below the origin of wave A. If wave A unfolds in five waves, then we know that a flat is not unfolding, since a flat is a 3-3-5 wave structure. At a minimum, wave C will take out the bottom of wave A. Wave C will often be equal to wave A. Once you know your risk and potential target levels, you can decide if the opportunity is worth taking. Overall, then, to boost your forex trading, you want to have an understanding of the Wave Principle so that you can identify the pattern. And you want to keep it simple. That means count fives and threes, calculate the risk and the potential, and then decide if action is warranted.



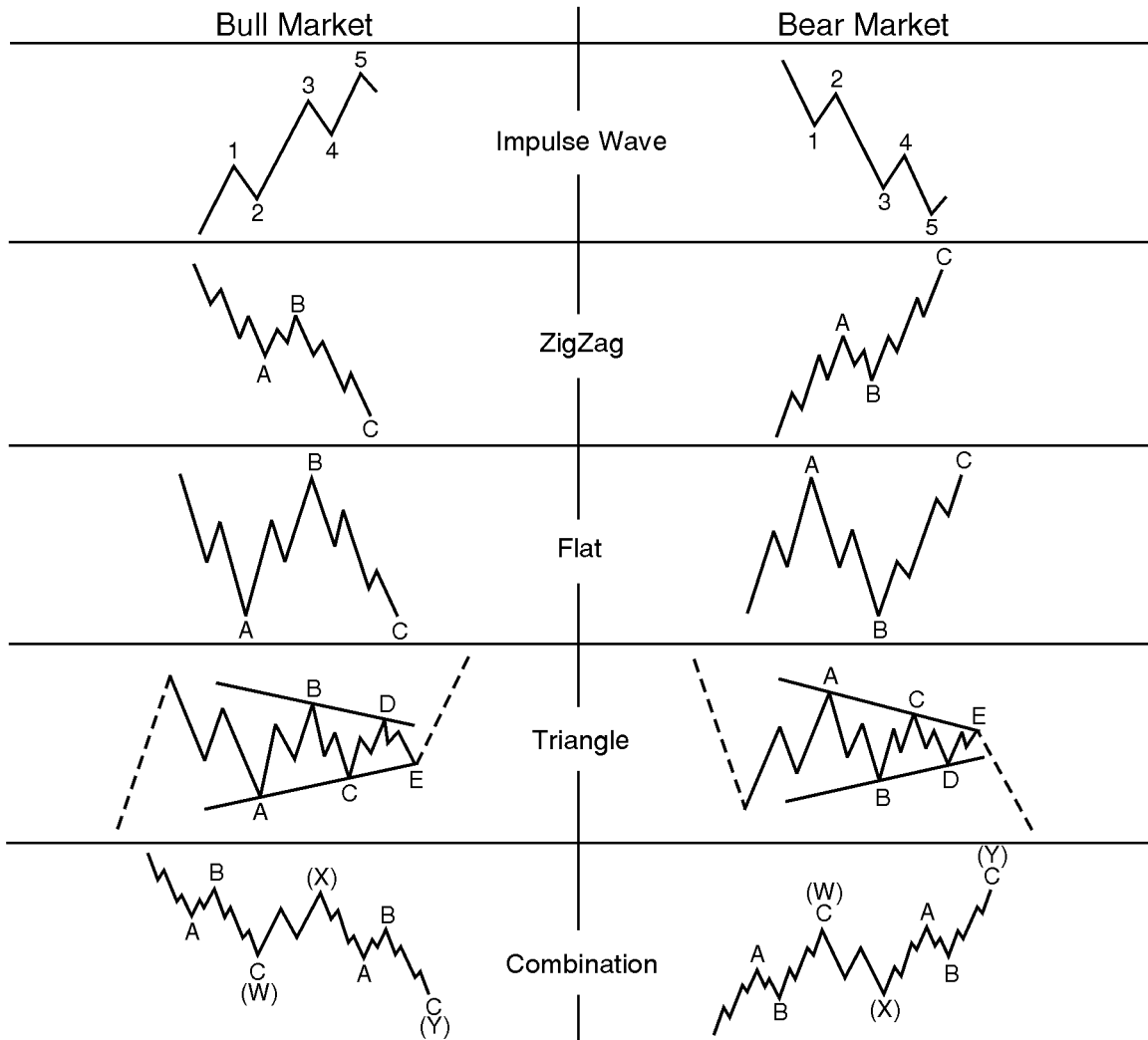


Figure 1-7

Here are the different wave patterns, which are all explained in the book, *Elliott Wave Principle*, and in The Basics of the Wave Principle brochure. Both of these resources can be ordered online at www.elliottwave.com. You can keep it simple by just counting the basic movements. Count five waves to the upside and three waves to the downside for a bull market. Flip that over if it's a bear market. However, you can be more precise if you understand the other patterns.

Evaluation	
Wave Clarity	How clear is the pattern?
	Does the wave pattern exhibit any of the Elliott wave guidelines?
Fibonacci Analysis	Are there any significant Fibonacci relationships present between waves?
	Is Fibonacci support or resistance nearby?
Structural Significance	Are prices near a previous extreme?
Technical Validity	Is divergence present?
	Are conditions overbought or oversold?
	Do technical readings agree with the wave pattern?

Figure 1-8

When we evaluate the wave structure, I believe the most important aspect is **wave clarity**. Sometimes a chart can have multiple counts, but I'm looking for the count that is the cleanest. That count is based on where the market has been and how it's been acting of late. It takes into account multiple time frames and multiple degrees of trend. You can add **Fibonacci analysis**, but I think that measured objectives and retracement levels are secondary to the wave structures themselves. You can also consider **structural significance** by identifying if prices are near a previous extreme. Or take some other technical readings to test the **technical validity** of your wave count.

But I focus on examining the basic Elliott wave structure of fives and threes. From time to time, I will discuss measured objectives and retracement levels, but usually I'm most concerned with counting five waves up and three waves down. Before entering a trade, it is critical to evaluate the situation. When using the Wave Principle, I find wave clarity and risk-reward ratios to be the most important pieces of information.

Chapter 2

Two Trading Examples

Figure 2-1

Now let's look at some examples of forex trading. I believe in starting with a long-term chart and working my way down to shorter time frames. When I am asked what the best time frame to trade is, I tell people there isn't just one, because the Wave Principle works on all degrees of trend. Any time there is a five-wave move in one direction, followed by a clear three-wave move in the other direction, there is an opportunity.

This example in Figure 2-1 was taken from mid-2007. It is a weekly chart of the dollar/yen. At the time, this market was in an uptrend. There was a correction in early 2006 (circled), and then there was a rally (marked with a diagonal line). Notice in the top right of the chart that there is a small pullback. Even though it's of a much smaller degree, it looks similar to the larger pullback in 2006. It makes me think, "Since the market is in an uptrend and there is a three-wave pullback, here is an opportunity to the upside."

Figure 2-2

So I move from a weekly chart to the daily chart, and now the circled portion offers a close-up view of that same pullback. It is clearly not a five-wave structure and, therefore, it's a correction.

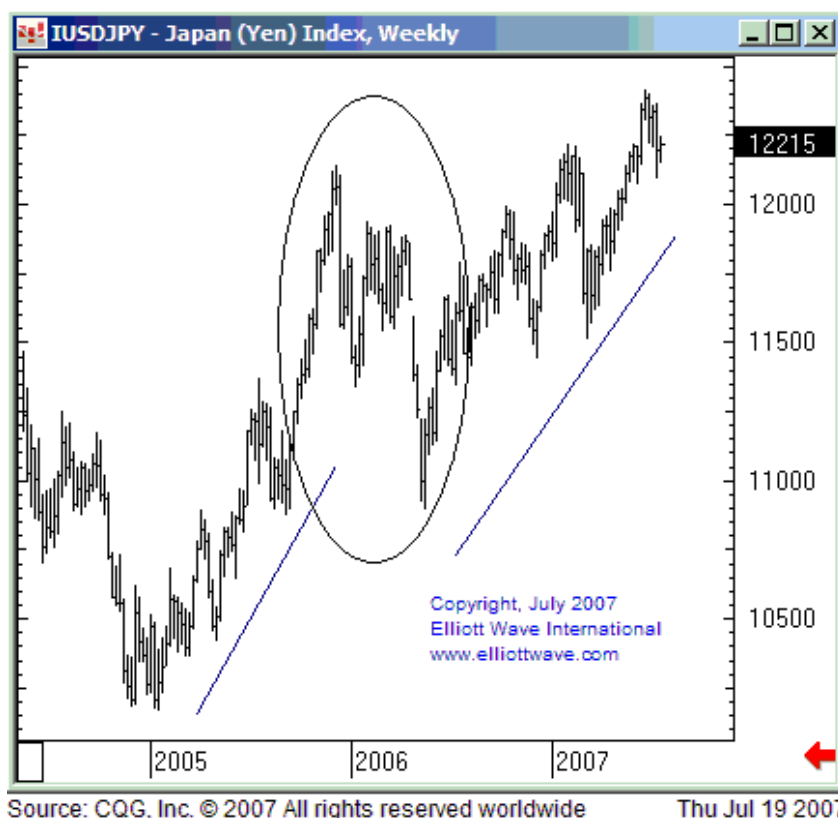


Figure 2-3

Now we step down to the intra-day chart, and we can see that the pullback is an a-b-c correction. The rise off the c wave low looks impulsive, meaning that the trend is still to the upside. The subsequent pullback provides a potential entry point, with risk limited to the low near 121.

What should I do at this point? Before the Internet, I traded off paper charts that I updated by hand. I didn't have time to watch every tick. If I saw a pattern like this, I would place my order with the broker over the phone and put in a stop at the same time (which would have been right below the low at 121). If my broker didn't call me back, I assumed I was okay. Sure, I checked the price as often as I could, but that might not be until that evening or even the next morning when I read the paper. I was prepared for the risk of loss down to my stop around 121, but if the phone didn't ring, I knew I hadn't lost that much and that I was still in the game. When I put in my order, the market was moving sideways so I would have been hoping that it would turn higher and move up above 124 once again.

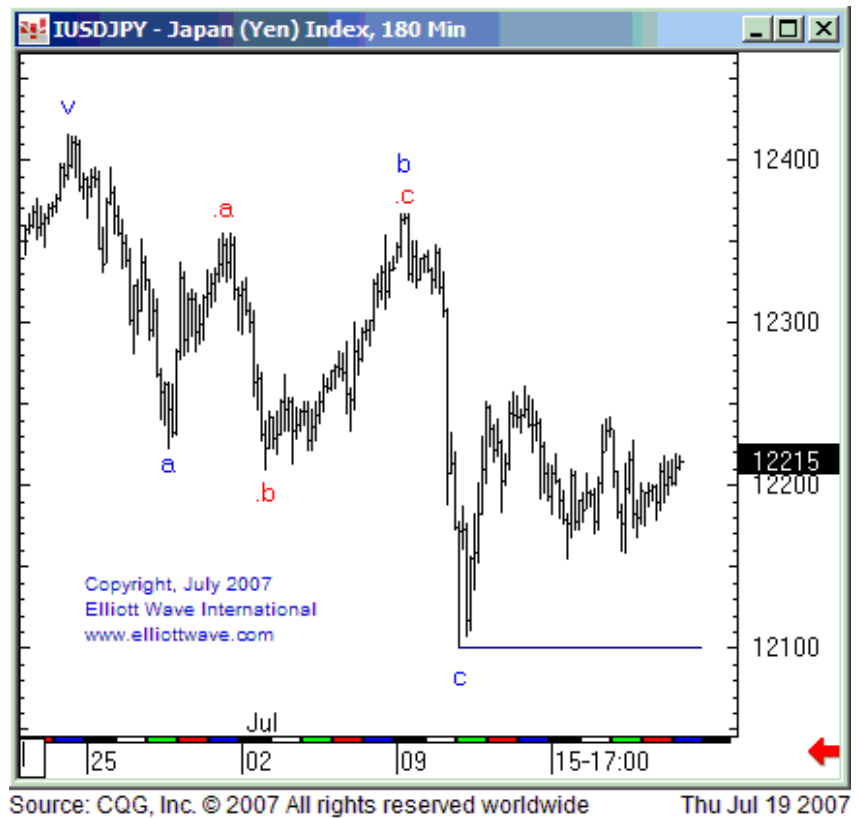


Figure 2-4

Updating the chart, you can see that I was just plain wrong.

I start with this example to prove to you the importance of risk management. Although this was an unsuccessful trade, and an unsuccessful analysis on my part, I was prepared for the risk that the opportunity brought with it.

What happened in the market next? The market went down close to 91, and it never did rally above 124. When you're proved wrong, you sometimes need to consider alternate counts that take the market in the other direction.

The questions to ask yourself are: At what point am I wrong? What other structures could be developing? What's my risk? It is important to be focused on risk management if you trade the markets. It's fine to be wrong, as long as you know your risk and size your position accordingly.

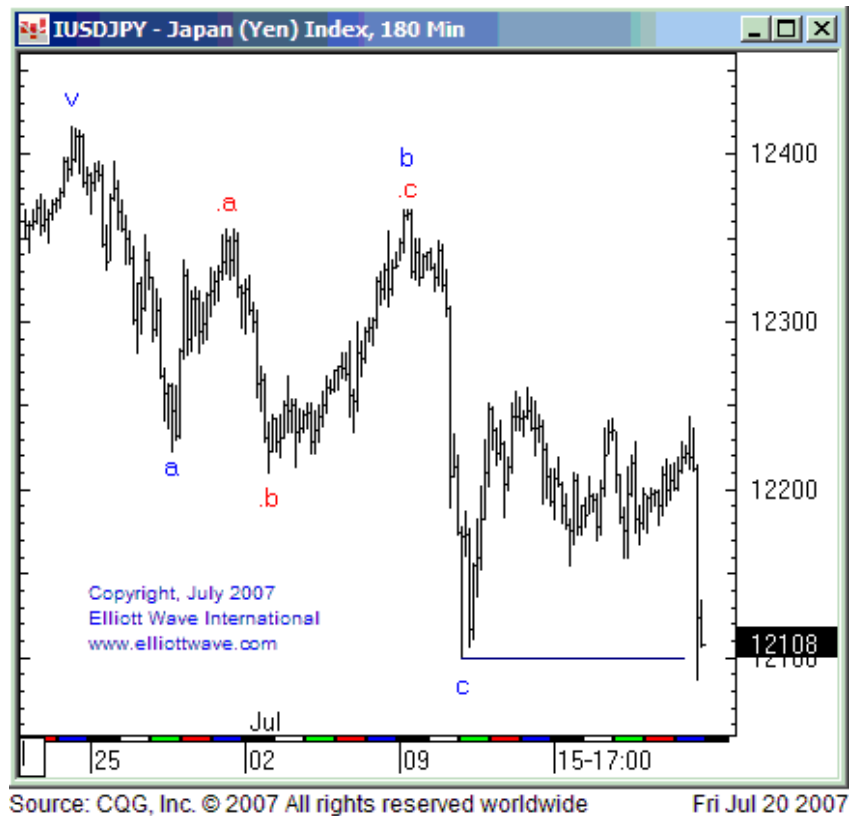


Figure 2-5

In this chart of the U.S. dollar/Canadian dollar, you can see that the market had been in a long downtrend and then it bounced in three waves. At the time of the bounce, we were not expecting a reversal in the market. We just needed the market to signal to us that the correction was over so that we could position ourselves for a continued move to the downside. Remember, I'd rather take advantage of something moving in the direction of the trend as opposed to a countertrend move. Some people like to do it the other way, and there's nothing wrong with that — I just like to trade with the trend.



Figure 2-6

On the daily chart, you can see that wave (c) was just a tad longer than wave (a), and by the end of that day's trading session, the market was back below the equality measure. I felt confident at the time that this was a completed corrective movement and that dollar/Canada was starting lower again, resuming a much larger bear trend.

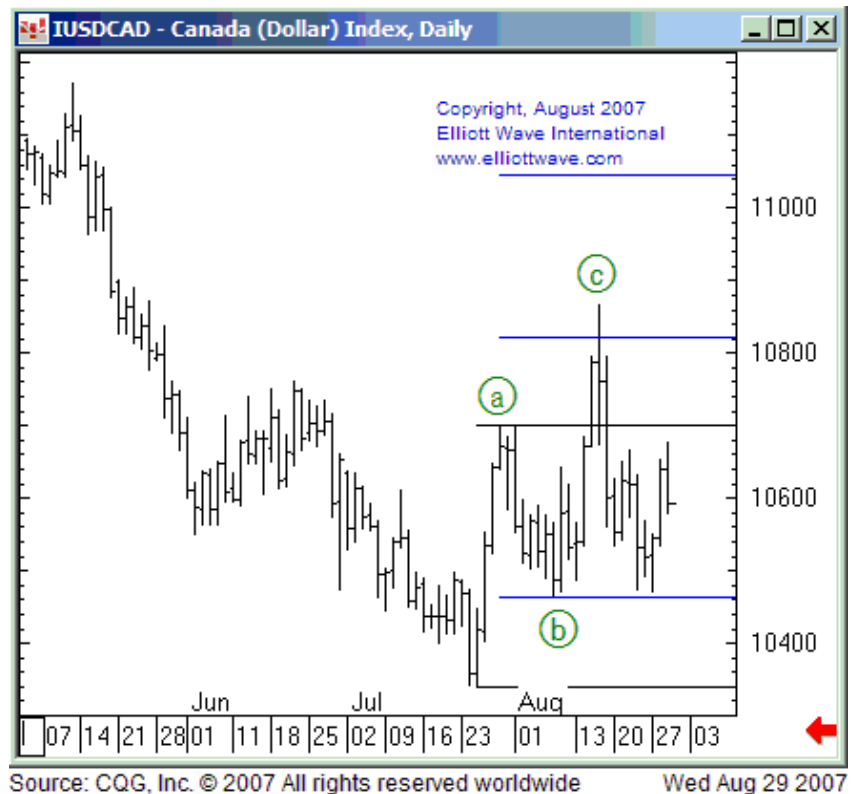
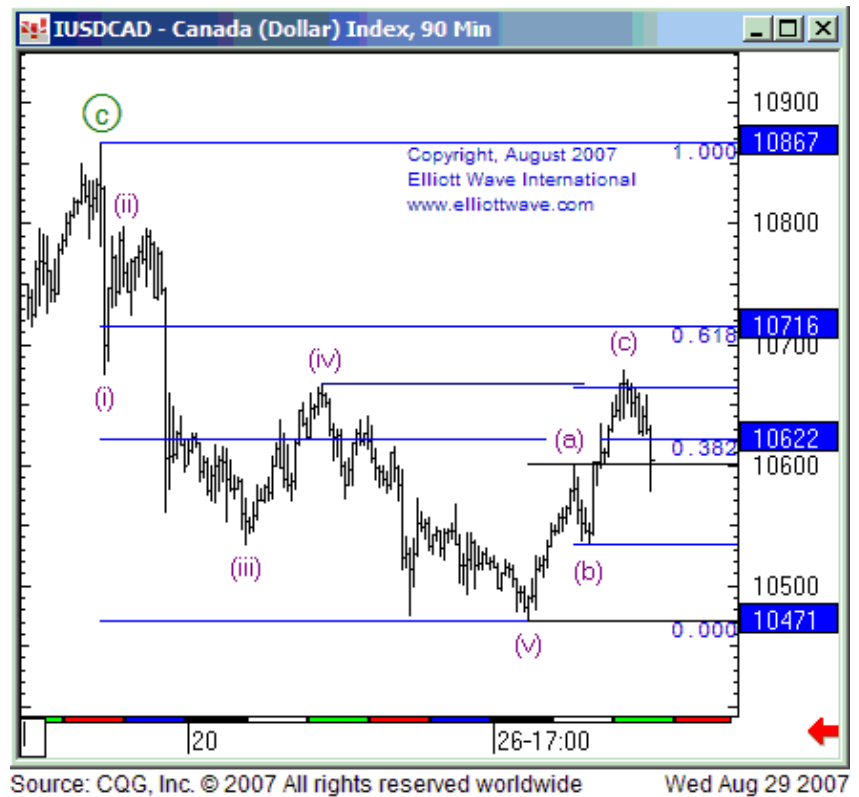


Figure 2-7

Taking it down to a 90-minute chart, you can see the top of the ③ wave in the upper left corner. If you didn't take action at that top, you could have waited until the bounce labeled wave (ii). At the time, we speculated that there was a three-wave correction in place. If the market went above the ③-wave top, our analysis would be wrong. We were looking for a move back below 1.04, fairly close to 1.03, at a minimum (see figure 2-6).

Another option for entering a trade would have been when the market started to break down near 1.07. Or, you could have waited for a full five waves down and then sold the next bounce. From the top of wave ③, we counted five waves down [waves (i) through (v)], which confirmed the downtrend. If you're conservative, the ideal time to enter the short trade is after the next three-wave bounce.



How do you know when the three-wave bounce will be complete? A corrective move after a five-wave sequence will often return to the area of the previous fourth wave of one lesser degree, in this case, wave (iv). Figure 2-7 includes the Fibonacci retracements of the five-wave decline (marked with the long horizontal blue lines). Not only did the bounce end after three waves that reached the previous fourth wave, it reached the middle of the Fibonacci target range. Is that strong enough evidence that the correction is complete?

Perhaps, but another question to ask is, Where does wave (c) equal wave (a)? The larger degree wave ③ exceeded equality with wave (a), and then backed off the same day. In this case, wave (c) exceeded the equality level just slightly before rolling back over. So, there is a cluster of targets for the end of the correction that includes the area of the previous fourth wave, the level that wave (c) equals wave (a), and the range of the Fibonacci retracement levels. Entering a trade at this point, though conservative, entails a bit more risk than a trade entered into at wave (ii). Where would our count become incorrect? If prices move back up above the previous wave ③ at 1.0867.

As you can see, there are many places at which you could enter a trade, so why do we have to limit ourselves? We could take action at wave (ii), on the breakdown near 1.0700, at the top of wave (c), or even on a break of the wave (b) low following wave (c). It's not an all-or-nothing game. You can approach trading with small steps. You don't have to take a leap.

The Wave Principle offers plenty of trading opportunities. As prices unfold according to your wave count, your confidence in the move will build, and you can use various countertrend moves along the way to take advantage of the trend by adding to your position.

Chapter 3

Applying the Wave Principle

Our subscribers often ask me to explain how to apply the Wave Principle to their trading. There are many aspects to applying the Wave Principle, including counting five- and three-wave movements, understanding the corrective patterns, and looking at the various degrees of trend.

I also look at related markets to try to arrive at a coordinated view. Since I follow the dollar, I like to see most of the major pairs agree that either the dollar is getting stronger or the dollar is weakening.

I also find news events very useful. As an example, there were many pieces of news due this morning. Before the data was released we looked at the charts to determine if the wave pattern could give us a hint on which way the market would react. It doesn't matter what report is coming out or what the news is. What is important is how the market will react to that news. Oftentimes, the news is the fuel that will propel a market move at times.

Figure 3-1

This chart portrays the corrective patterns under the Wave Principle. The simple zigzag is on the top left. The pattern on the top right is called a flat. It consists of three waves down, three waves up (sometimes to a new extreme), and then five waves down, ideally ending below the termination point of wave A.

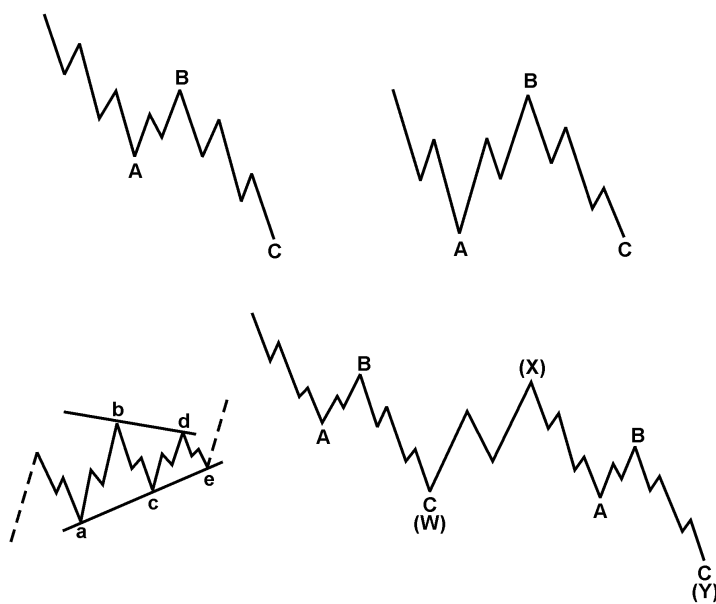
The pattern in the lower left of the chart is a triangle, which consists of five three-wave structures. The pattern in the lower right is a double zigzag. This pattern is more complex than the rest. It has an A-B-C followed by a rally in three waves, and then another A-B-C movement.

When data is released or reports are coming out, I home in on the flat (upper right) and the triangle (lower left). If I see one of these two patterns unfolding, I have an edge in figuring out which way the market will respond.

The key point with a flat or triangle pattern is that both allow the market to move in three waves to a new extreme. They are the only two patterns to do so. If a three-wave move has occurred before the report was issued and the market has already started coming down, then I can be fairly confident that any move down below the previous extreme (in the case of the flat, the A wave) will end a corrective pattern, and then the market will rally.

On the initial reaction, the market will often come down and make that new low. Within a short time, traders will reinterpret the data and then undo the trades they just did, and the market will go the other way.

If the market has been rallying and I can count a flat to the downside very near an end, then my confidence is high that the reaction to the news will be a thrust to the upside.



The triangle sends a different message. The thrust from a triangle is usually a terminal pattern. It will either be a fifth wave or a C wave. This pattern allows me to prepare for a reversal.

Figure 3-2

Let's take a look at the move down from October in this chart of the U.S. dollar. It appears to be five waves down from the wave (ii) peak. That tells us that no matter the larger trend, the dollar should enjoy some kind of recovery.

What is the minimum expectation for this recovery? In this case, the minimum expectation would be a correction to the previous fourth wave, wave iv, just above 76. Therefore, I entered the day with a bullish bias for the dollar.

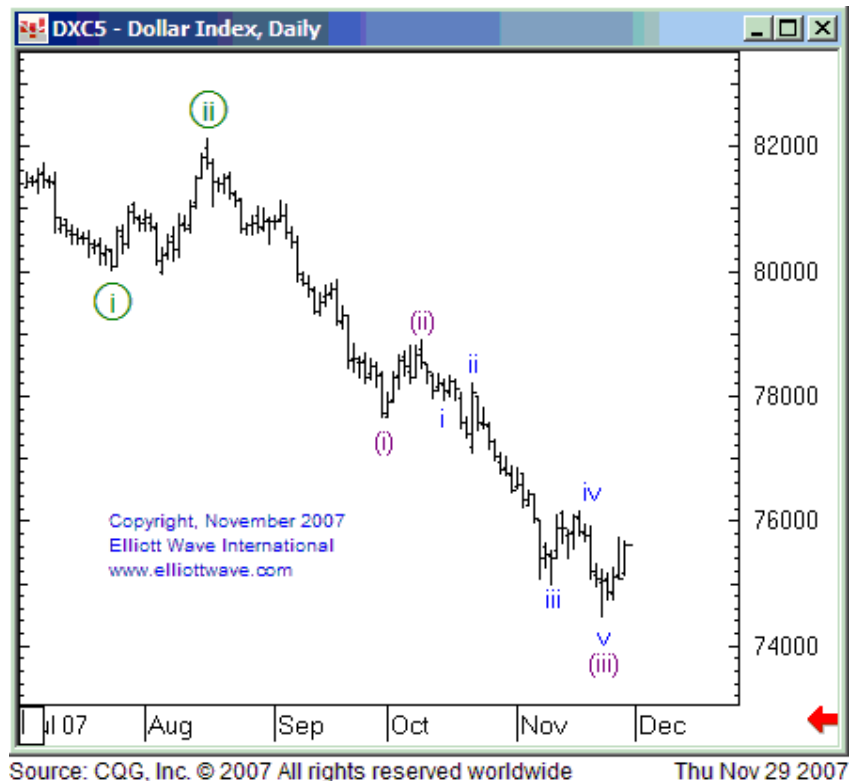


Figure 3-3

I counted an initial a-b-c and an x wave on the intraday chart, which means that this move is a double zigzag (an inverted version of the diagram in Figure 3-1). Within the second wave **b** is a three-wave move to the upside. We don't know yet whether we're seeing a flat or a triangle unfolding in wave **b**, but that small three-wave pattern in wave **b** suggests that the trend is still to the upside and that the corrective structure is still under way.

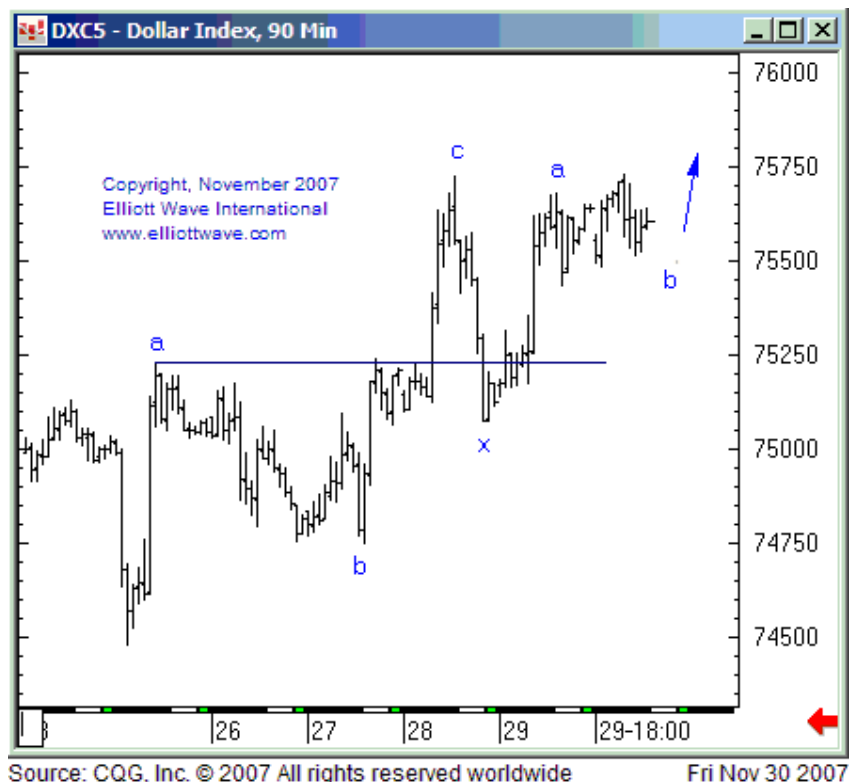


Figure 3-4

Let's look at the euro to help confirm our analysis. The euro moves inversely to the dollar index. We can count the a-b-c and an x wave in the still-developing double zigzag. We need another a-b-c to complete the pattern. The first wave **a** is impulsive. Wave **c** is impulsive, as well as the initial move down from wave **x**. This circled area is overlapping, corrective price action.

This chart supported the outlook that the dollar was going to strengthen, meaning that this chart would go lower as the euro weakened.



Figure 3-5

Let's take a look at cable (the British pound) as well. Again, there is a nice double zigzag bounce into measured objectives. The market fell sharply, and then over the last day or two it rebounded in a corrective pattern. Hence, this market should move lower, which means that the dollar should recover.

Since we've looked at the short-term chart of the dollar that suggests it is going to continue climbing, and we've looked at some charts that move inversely, which also support the outlook for the dollar, now we can look at the next chart to see what happened.

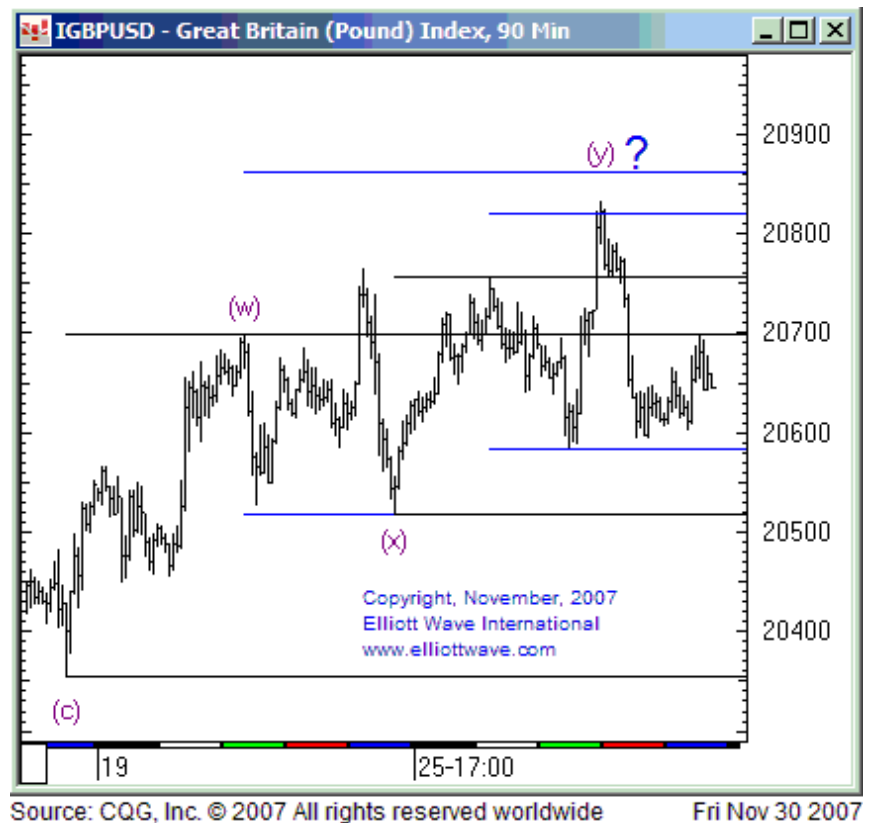
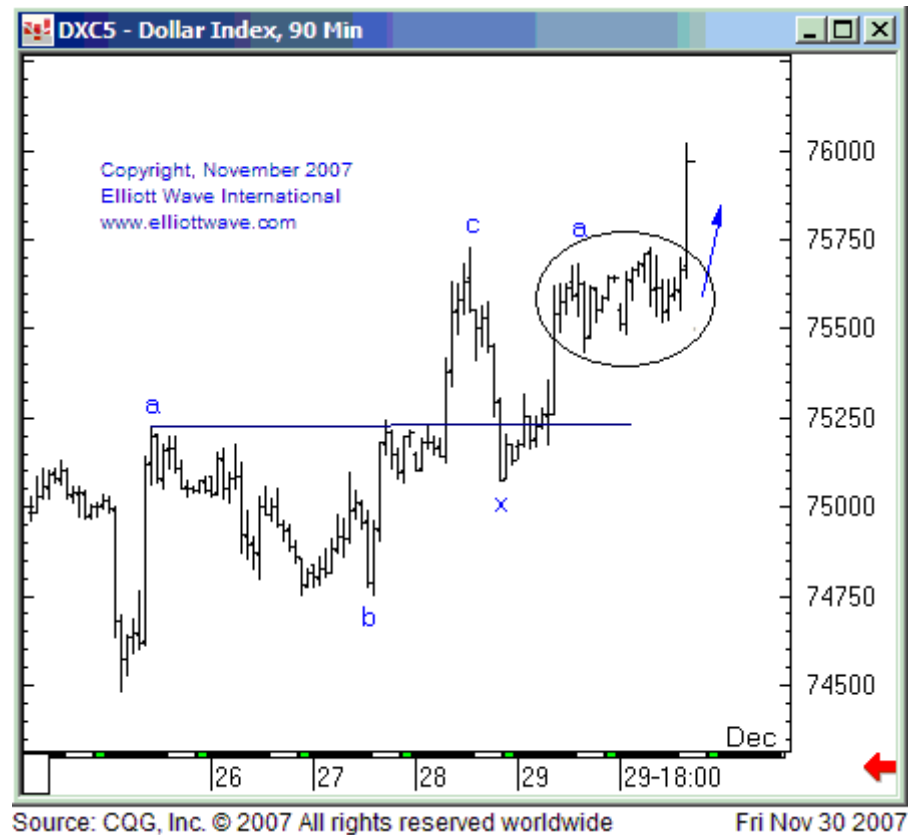


Figure 3-6

The circled area is consolidation. It turned out to be triangle a-b-c-d-e, and then there was a thrust above 76, into the area of the previous fourth wave, which we mentioned on the daily chart.

With a little perspective on the trend of the dollar market, related markets, and knowledge of corrective patterns, we can apply the Wave Principle to predict what will happen next. Sometimes corrective patterns can be confusing, especially the flats, triangles and combinations. Once you learn to read them, though, you can combine all of these pieces to take advantage of trading opportunities.



Chapter 4

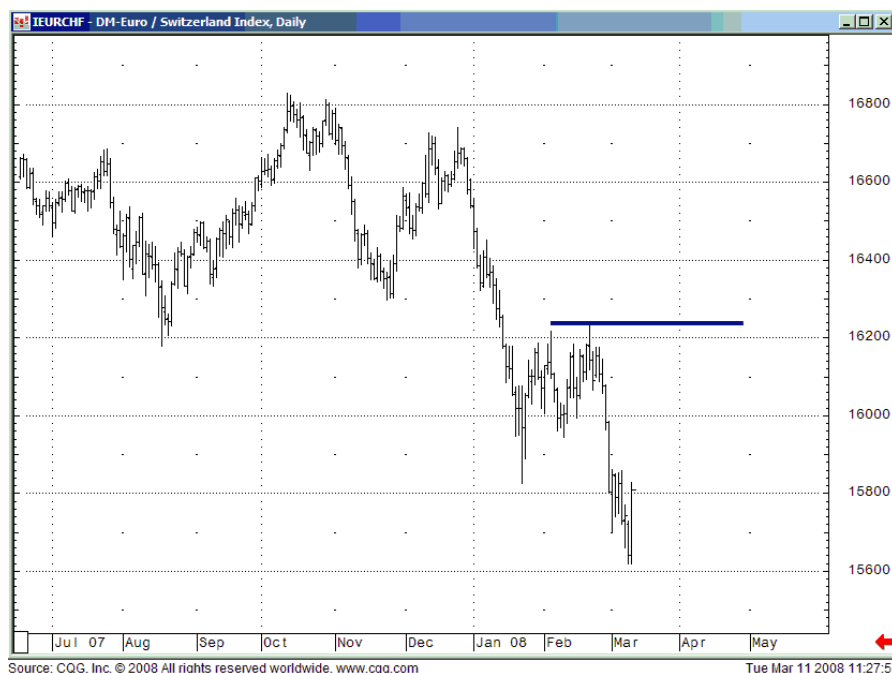
Expectations at the End of a Pattern

What can we expect at the end of a pattern?

Figure 4-1

Looking at the daily chart of euro/Swiss, you can see that the market has been in a downtrend, and the decline is in five waves. There was a decline from October to November for wave 1, a recovery to the end of December in wave 2, a fall in wave 3 into January, a corrective rebound in wave 4 into February and, finally, a decline in wave 5 that presumably ended in March.

What can we expect from here? A guideline of the Wave Principle states that a minimum expectation is a return to the area of the previous fourth wave.



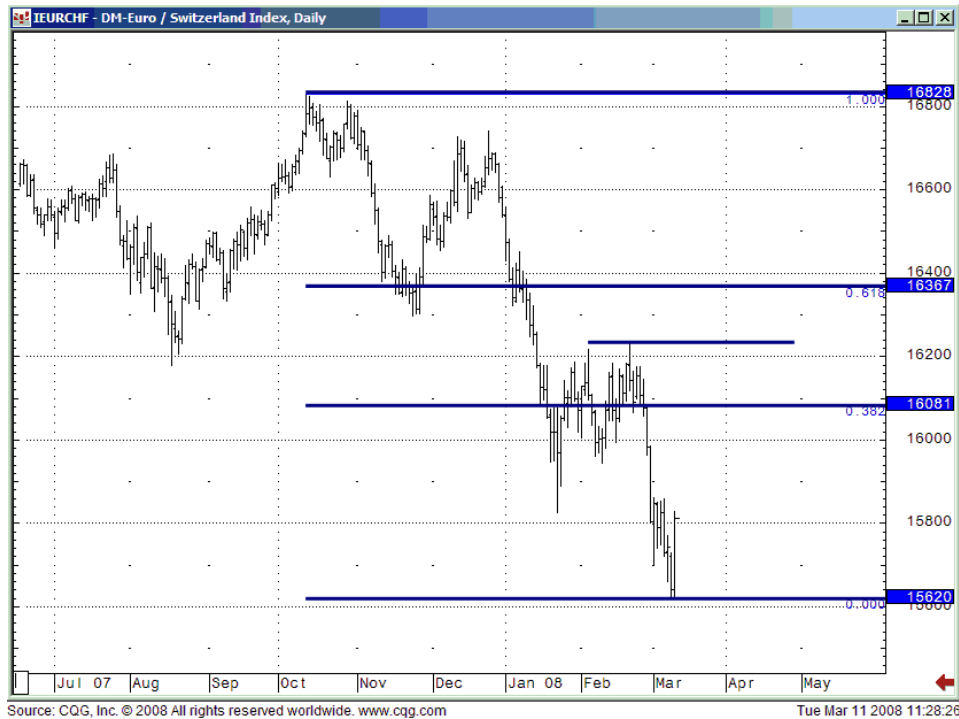
I find it helpful to place a horizontal line across the previous fourth wave. In this case, the previous fourth wave is just above 162 (the short horizontal blue line). Once we think the low is in place, we can add Fibonacci retracements to our analysis. The reversal is a good signal that a bottom is in place.

Figure 4-2

I marked the 38.2 and 61.8 percent Fibonacci retracement levels on the chart (long horizontal blue lines). You can see that the upper end of the previous fourth wave falls within this range. It ends around the mid-point, which would be the 50 percent retracement. Now we have two areas to look for — the Fibonacci range and the area of the previous fourth, particularly near its termination. We want to pay close attention to the lower half of the Fibonacci area.

We're looking for a correction in the market that will return to the lower half of the Fibonacci area and do so in a three-wave pattern. If euro/Swiss were to rally to the 162 area in three waves and then stall, that would increase the likelihood that the move is corrective.

However, if the rally unfolds in five waves into the 162 area, it could still be a correction, but just wave **a** of a larger a-b-c correction. This would indicate a wave **b** still to come and a second five-wave move for wave **c**. If this were to happen, wave **c** would rally into the upper end of the Fibonacci range. However, that would be the first warning sign that this could be the bottom to something different.



If I saw this action in real time, I would look back to the weekly chart for perspective to see if the five-wave structure to the downside were possibly wave *c* of a flat. If it is, then we could conclude that we're probably going to rally in five waves off the low as the first wave of something larger to the upside.

If, however, we conclude that the five-wave move is not part of a flat, then it is wave *a* of a larger move to the downside. Perspective is such an important piece of the puzzle.

A guideline of the Wave Principle provides us with minimum expectations when the count shows that there should be a bottom forming. We can now add the Fibonacci retracement levels to the minimum expectation to help us find a cluster of targets. After that, we need to be sure to follow the recovery to see whether it unfolds in a trend-defining five waves or a corrective three-wave pattern.

Chapter 5

Using a Momentum Indicator

I'm often asked about other tools I use besides the Wave Principle and, typically, I say, "Really, none." I'm a purist in terms of using just the Wave Principle, and I keep it very basic. I count five waves, make sure that wave three is not the shortest, and look for a five-wave structure within the fifth wave. If all of these occur, then the market should be at an extreme, and a turn is due. In a correction of a five-wave move, the guidelines of the Wave Principle tell me that the market typically returns to the area of the previous fourth wave, often towards the extreme of that fourth wave. So I just stick to simple rules and guidelines and watch the wave pattern as it develops.

However, there is one additional tool that I use, and it is a momentum indicator.

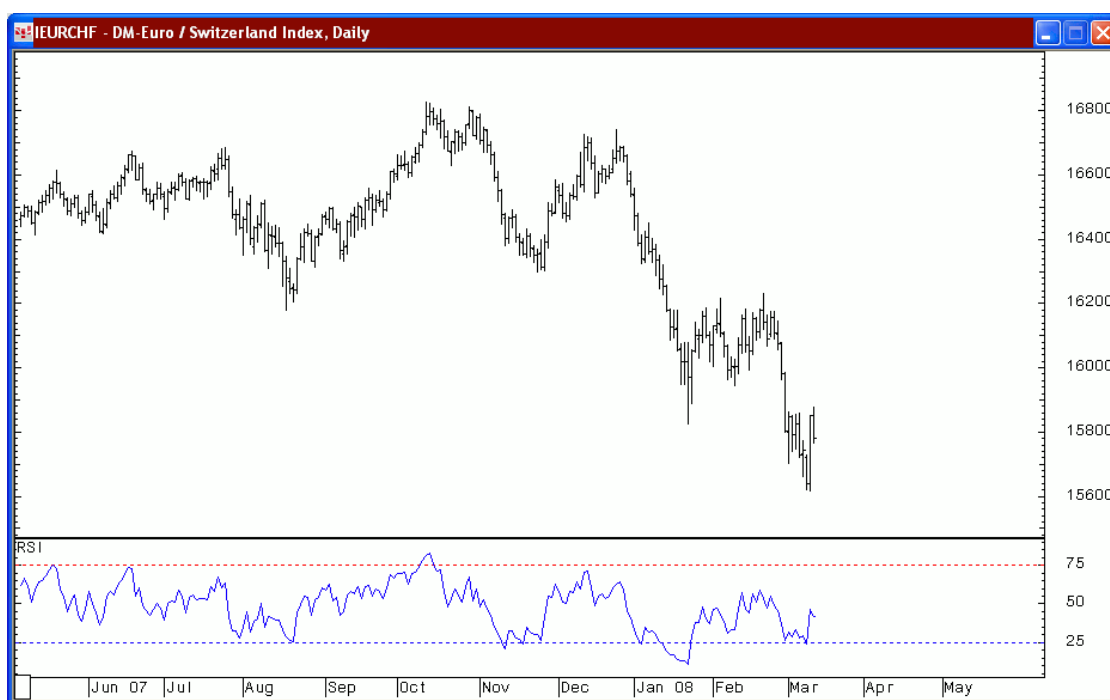


Figure 5-1

You can see on this chart that I have RSI (Relative Strength Index), but I could have chosen a Stochastic oscillator or any of the other momentum indicators. They all work.

The Wave Principle suggests that the third wave is typically the longest and strongest wave. In the daily chart of the euro/Swiss, we have five waves to the downside. The point of recognition is at some point in the middle of wave 3, when people recognize the trend. It is usually as prices break through the bottom of wave 1. On this chart, the point of recognition occurred in January 2008.

We are also looking for momentum to reach an extreme somewhere beyond that point of recognition. Many times, momentum will peak a bar or two before the end of wave 3. If wave 3 subdivides into five waves of its own, a momentum indicator may actually hit its extreme with wave 3 of 3. In this case, they bottom together (at the low in January) and then, during wave 4, momentum recovers. In the fifth wave, prices make a new low but the momentum indicator does not. There is a divergence. In this case, it would be a bullish divergence.



Figure 5-2

The momentum situation becomes more interesting in the structure of the decline within wave 5. Looking at the chart at a 120-minute level, you can see that there are five waves down. The sharp decline in the middle is the third wave. It's also the longest wave. When we look at momentum, we can see that it reached its extreme low during the third wave. The fifth wave went to a new price low, but not a momentum low.

Again, there is a bullish divergence that suggests a possible low at hand, which confirms what the wave count is telling us.

Momentum indicators can help add confidence to the wave structure, and they can be used on any time frame. However, the wave structure should always be your primary tool, with other indicators being secondary.

Chapter 6

The Importance of Market Perspective

If you subscribe to one of my currency services, you know that I like to hammer home the importance of market perspective.

Figure 6-1

If you put this hourly chart of the dollar/yen in front of me, I would conclude that there is an impulsive-looking rise off the low back on the 11th. That rise to just over 108.50 is followed by what looks like a corrective pullback. Therefore, I would suggest that dollar/yen is headed higher.

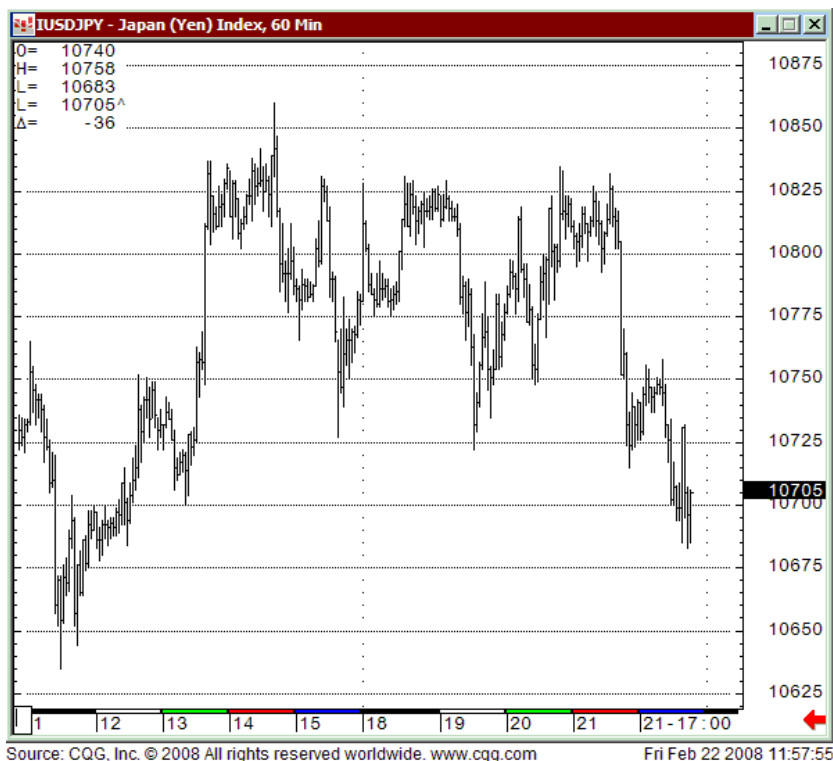


Figure 6-2

Here is a two-hour chart. The high right above 108.50 (from Figure 6-1) is the high on the right of this chart.

If you put this chart in front of me I'd say that there is corrective action, and dollar/yen is headed lower.

How can this be? I believe I'm right in both cases when I look at the charts separately. The point is that *you should never look at anything in isolation.*

Perspective tells us where the market came from before it got to where it is now. In this case, where did dollar/yen come from before it got to the low near 105.00?

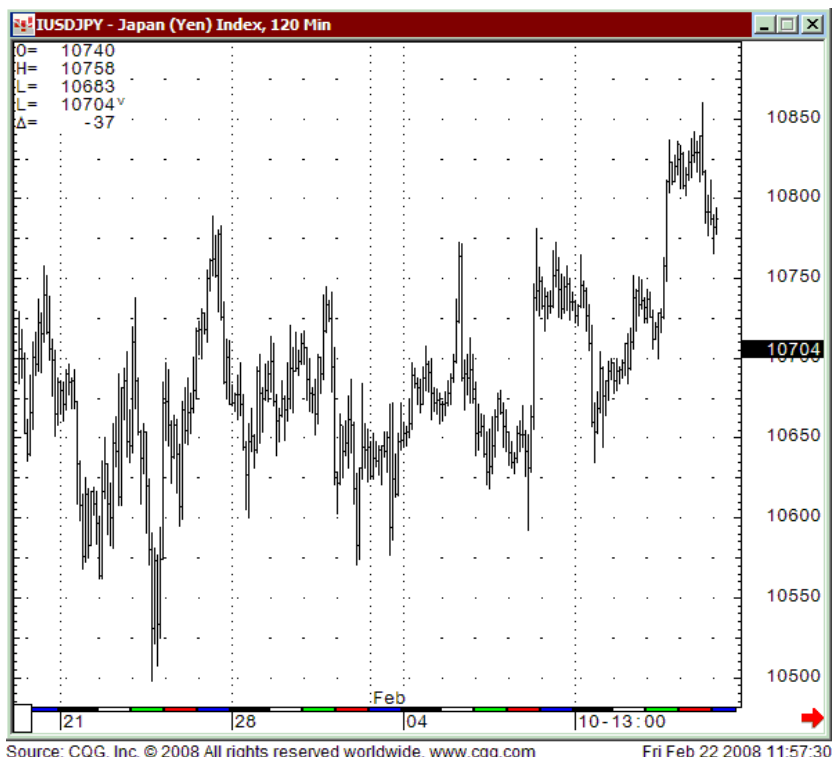


Figure 6-3

Take a look at the daily chart. We can see that dollar/yen fell from above 114.00 (marked with the top horizontal blue line) all the way down to just below 105.00, and the bounce since then retraced just about 38.2 percent.

If you showed me this chart before the others I would have had no doubt at all that dollar/yen is headed lower. The market action is sharp to the downside and corrective to the upside.

I've looked at three charts. In one, I thought dollar/yen was going up, and in the other two I thought dollar/yen was going down.

I could go with the majority and weigh in on the bearish side. When I'm working with multiple wave counts I often do just that. If they're all fairly equally weighted, and four of five wave counts are bullish, I'll lean towards the bullish case. However, the wave count of the bearish case will help me to know where my analysis is wrong.

To get market perspective, I always look at the larger time-frame charts first. From this daily chart I know the market is having an easier time falling than rising. This means that the larger trend is to the downside.

Now I can look at the intraday charts knowing what to expect. The bounce on the right side of the 120-minute chart should prove to be corrective.

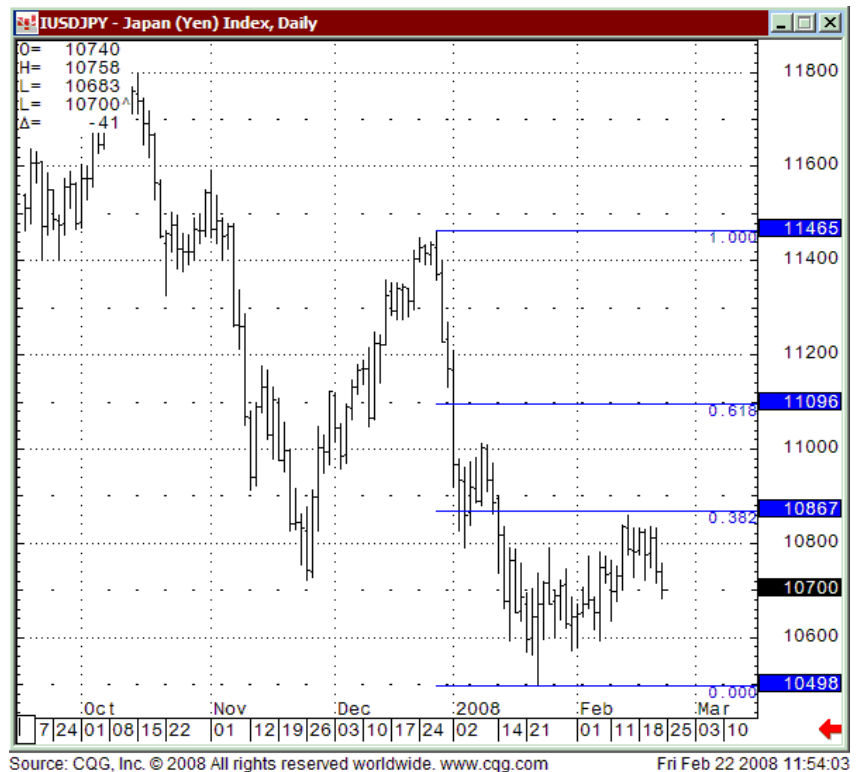


Figure 6-4

This chart shows how we counted the action in real time. There was a zig-zag up, an (x) wave, and then a second (a)-(b)-(c), which makes it a combination correction.

To add confidence to our count, we know that the high on the right side of the chart, labeled (c), was in the area of a 38.2 percent retracement of the prior decline. We also know that the two upward moves, the first (a)-(b)-(c) and the second (a)-(b)-(c), are about equal in length.

**Figure 6-5**

Knowing that the larger trend is to the downside, we can go back to the original 60-minute chart and label the price action. I went with a *i* and expanded flat *ii* because we reached new lows within the correction, *.c* ended just above *.a*, and the market was going sideways.

While the count was in doubt, perspective told me that I had to lean towards the bearish side. That's why I'm labeling with numbers to the downside and letters for the corrective moves.

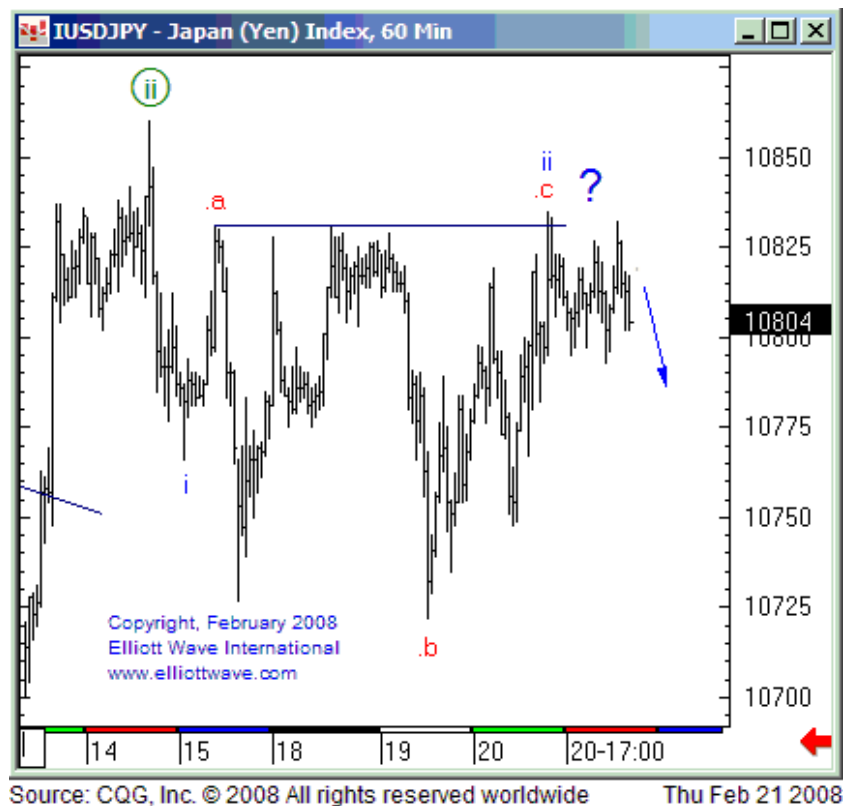
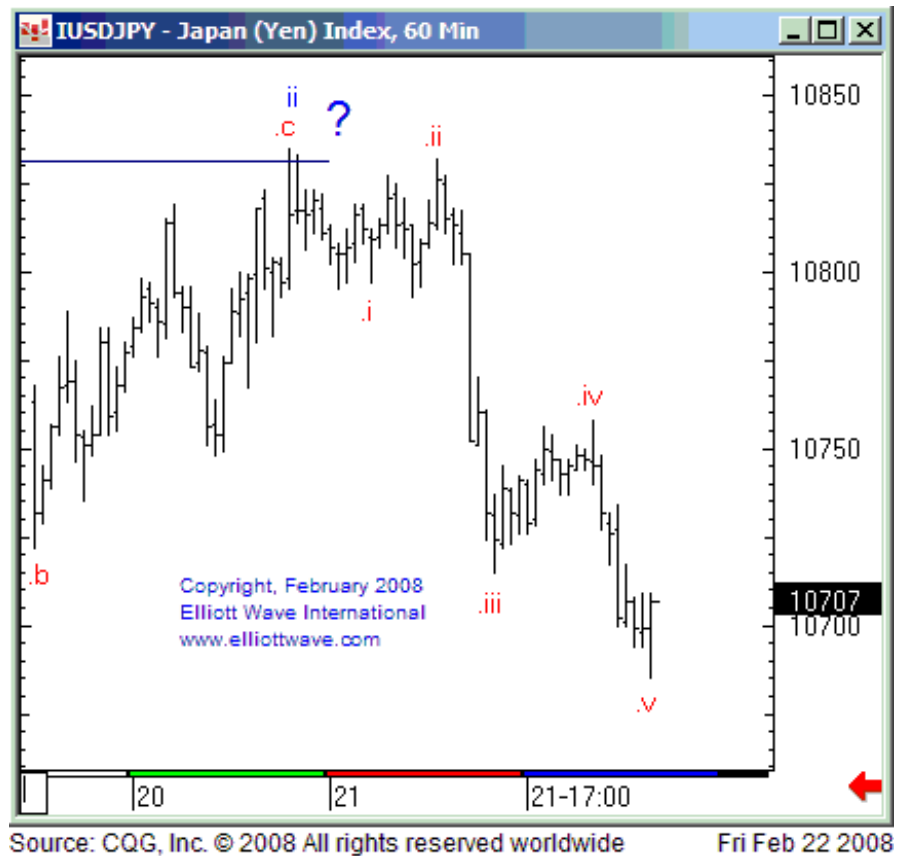


Figure 6-6

This is an updated chart. Dollar/yen did fall and did so impulsively.

It's so much easier to be bearish in a bear market or bullish in a bull market. Find out the general trend of the market, and then drop down and start following the shorter-term swings.



Chapter 7

Setting Targets for Subwaves

Within an impulsive movement, how do we derive targets for each of the subwaves within the sequence?

Figure 7-1

Since wave 2 serves to correct wave 1, we need to have a useful retracement measurement. The standard Fibonacci retracement measurements for wave 2 are .382 and .618. In this case, you can see that wave 2 exceeded the upper retracement level (0.618). That's fine. Wave 2 can retrace up to, but no more than, 100 percent of wave 1.

However, an extraordinarily deep wave 2 sends a message. It tells us that this is probably the entire correction. Once the market starts lower, it will continue lower in the third wave. If wave 2 had ended closer to the 38.2 percent retracement, there would be a possibility that the market could come down, retest the low of wave 1, and then rally again to complete a larger correction, such as a flat. However, once you have such a deep retracement, it makes a larger correction unlikely.

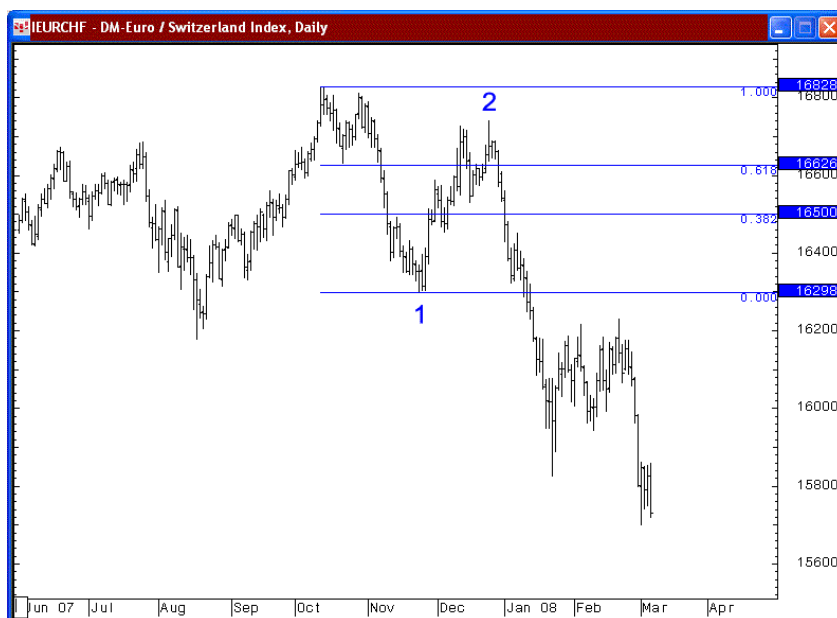


Figure 7-2

Wave 3 is a continuation of wave 1, in a sense. From an Elliott wave perspective, wave 3 is often the longest movement of the three impulsive waves (waves 1, 3, and 5). So to come up with a target, calculate where wave 3 will be 1.618 of the distance traveled in wave 1.

In this case, you can see that the market came right down to this level (the lowest blue horizontal line), exceeded it just a little bit but bounced back in the same session. However, you need to remember that these measurements are objectives only. They give us only an idea of where the market might turn — not an absolute certainty.

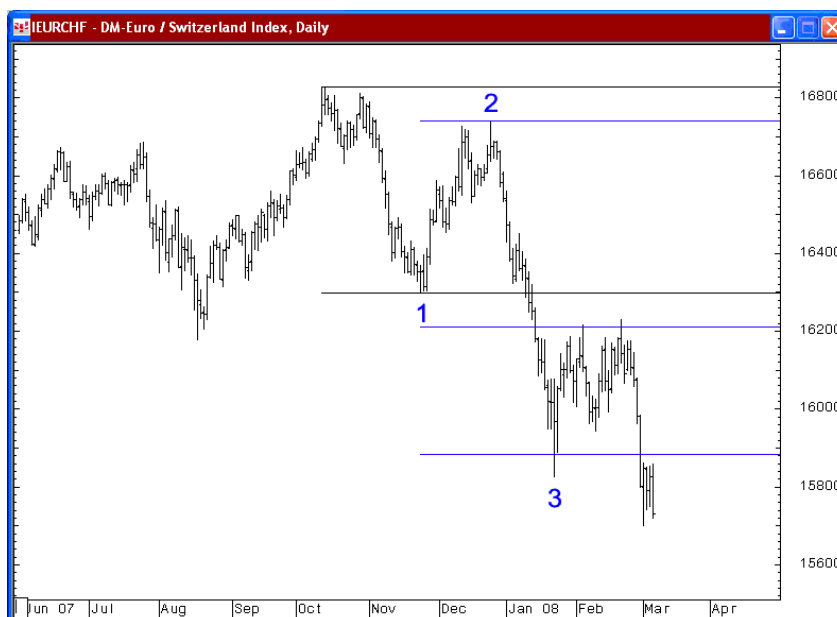


Figure 7-3

Wave 4, like wave 2, is a correction, but it corrects wave 3. Once again, we'll look at Fibonacci retracement levels — the 38.2 percent and 61.8 percent retracements. Wave 2 was extraordinarily deep, so it comes as no surprise that wave 4 was not so deep. It pushed up into the lower end of the Fibonacci area (the 0.382 level) twice before falling. That alternation between waves 2 and 4 (one being a deep retracement and the other one shallow) is quite common. In fact, so common that it is a guideline we use in wave analysis.

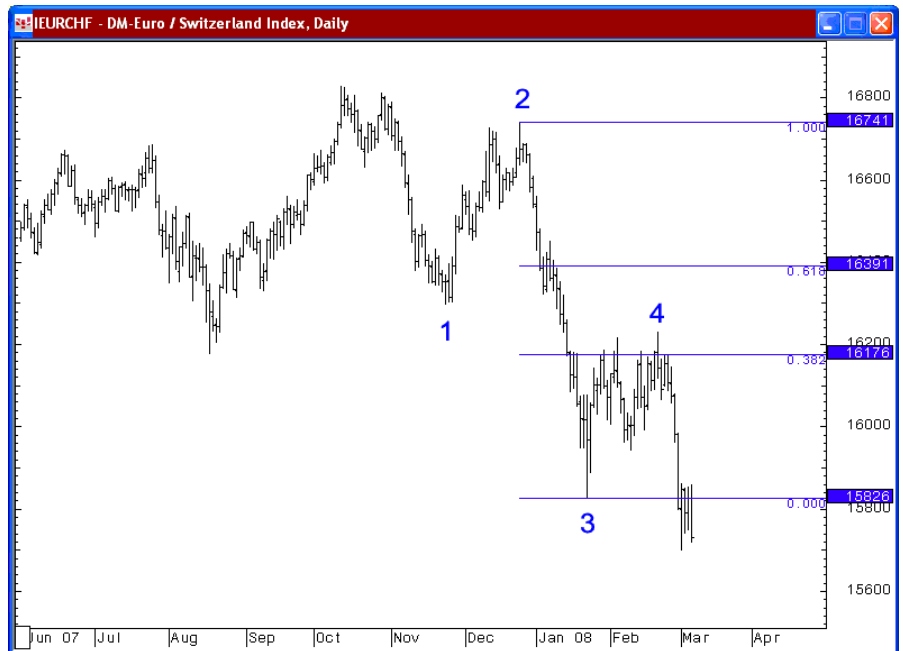


Figure 7-4

Wave 5 is once again a continuation of the previous impulsive waves. The first target level to look at is where wave 5 equals wave 1. In this case that is right about 157.00, and we can see that the market has already reached that level in what looks like a five-wave move. We definitely should be on the lookout for a bottom. Since there are five waves down in the fifth, the entire movement from October could be complete.

Wave 5 can exceed the measured objective, but the wave structure alone suggests that a low is at hand, and the fact that we're very close to the measured objective only strengthens that message.



Be sure to follow the guidelines of the Wave Principle to help determine targets for the subwaves within an impulsive structure. However, it's best to always look at wave structure first and measured targets second.

Chapter 8

Dealing with Combination Corrections

The most difficult corrective wave pattern to identify is called a combination. The combination correction confuses most people, but it doesn't need to confuse you. In this section, I will explain this corrective pattern and show you that sometimes what you think is a simple zigzag will later develop into a combination correction.

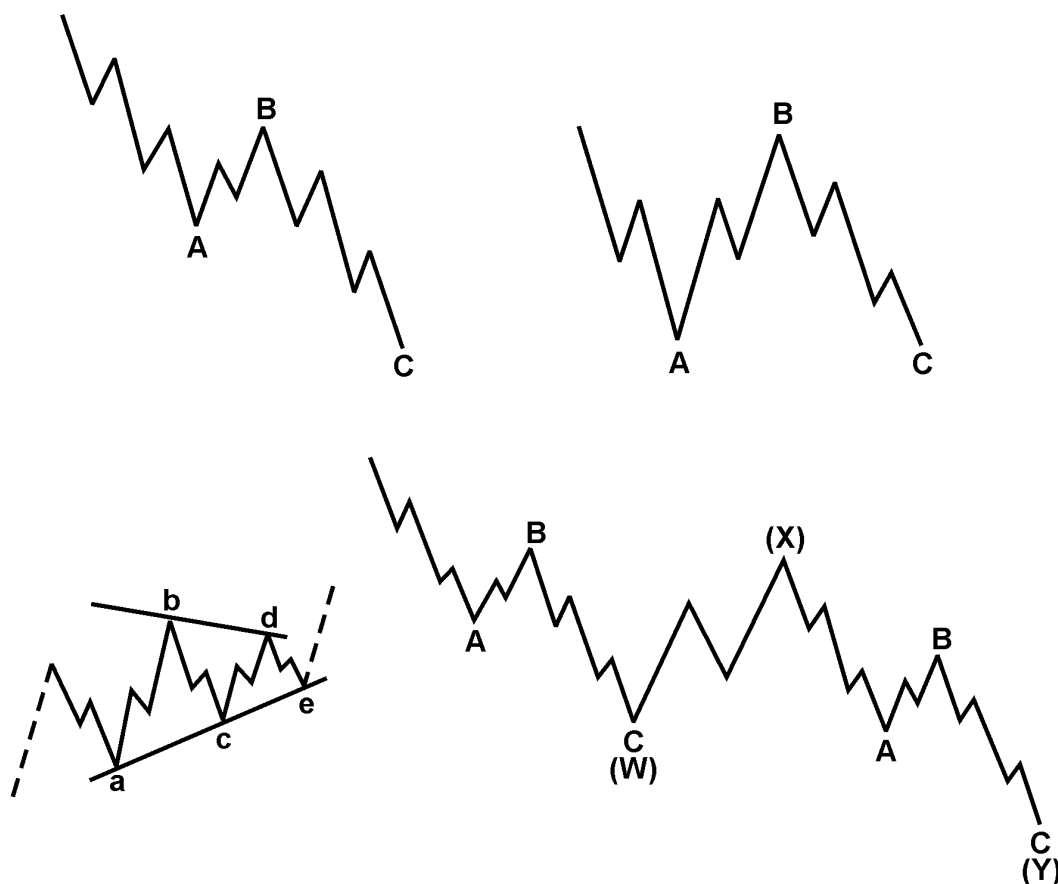


Figure 8-1

The combination is two corrective patterns connected by a third corrective pattern. A rendering of a combination correction is at the bottom right of the chart. First you can see a 5-3-5 zigzag pattern. The correction could be done there. But in this idealized example, the market recovered in only three waves and did not come close to the start of wave A. It started falling again and fell in five waves.

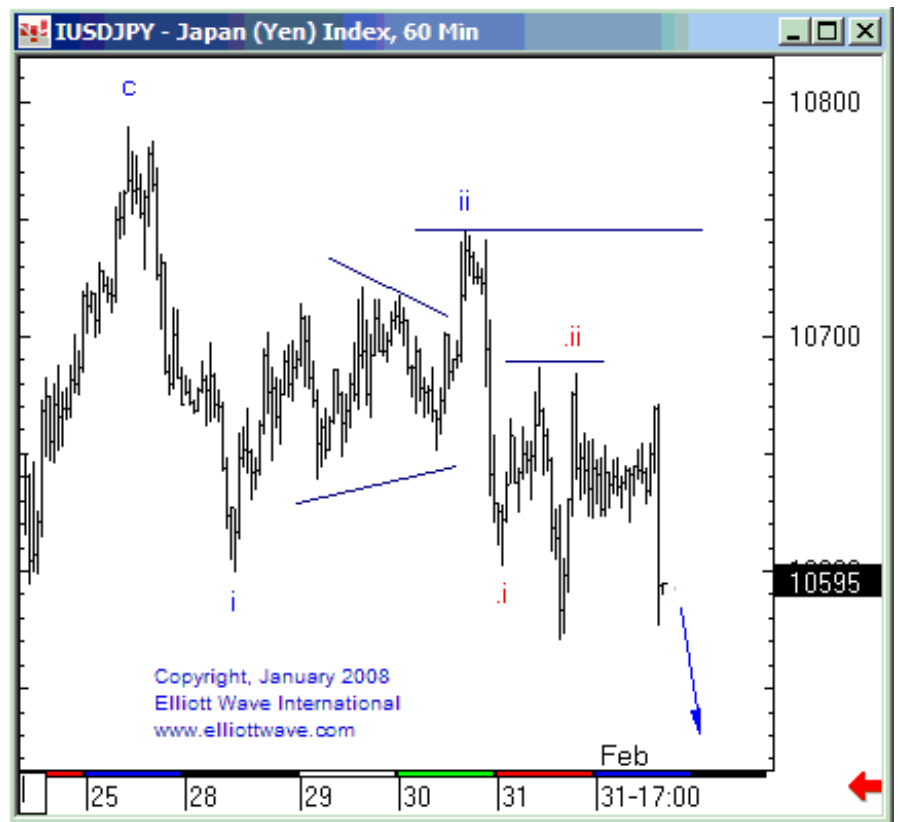
Once prices approach the prior low of wave C, we know there is more to come. So we label the top of the three-wave move as wave (X), and we look for another A-B-C corrective pattern. It can be another zigzag, a flat, or a triangle. The (X) wave can take any of these three forms as well.

So, a combination correction is a sequence of independent corrective patterns that are linked together.

Figure 8-2

To give some perspective to this example, dollar/yen had fallen from around 114.65 down to just below 105.00 when this chart was issued. There was a three-wave rally to the top of wave **c**, just shy of 108.00. Then, there was a fairly impulsive decline in wave **i**, another correction (to **ii**), followed by another sharp decline in wave **.i** (red), and maybe a flat wave **.ii**. The horizontal lines indicate where the market should not go if the larger downtrend is back in force.

I was confident that the larger trend was to the downside and was expecting rallies to be three-wave structures, declines to be fives.



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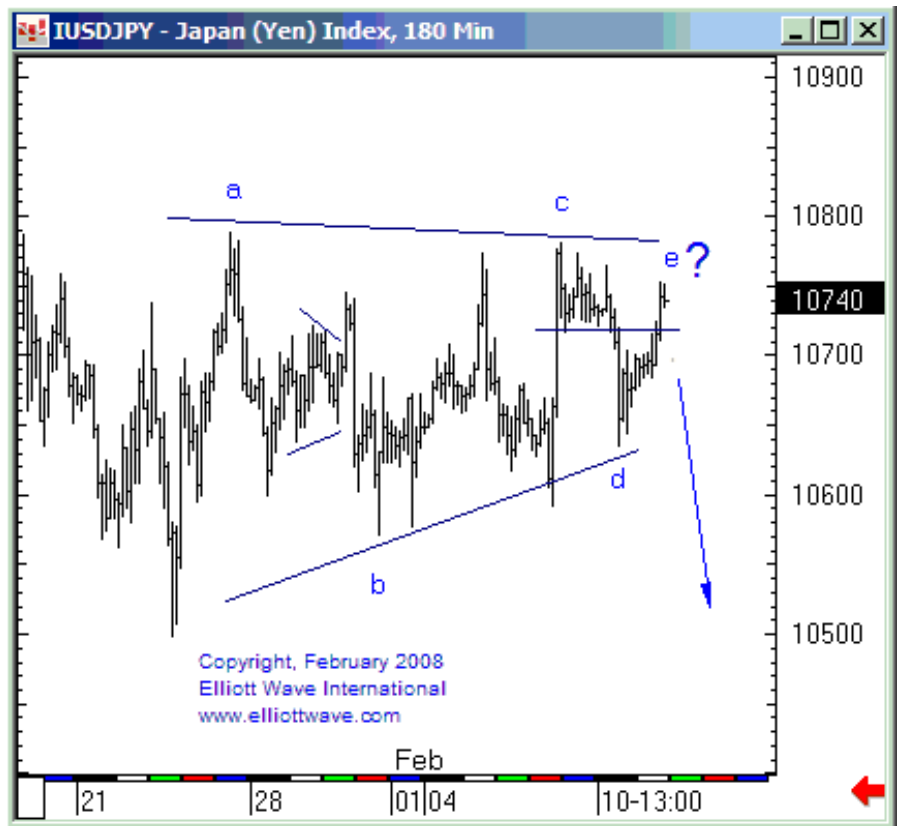
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Figure 8-3

By the 12th, the market had gone sideways. The original three-wave move from near 105.00 is labeled wave **a**. Prices could not break beneath the low of wave **b**, and clearly could not break below 105.00. The market kept consolidating.

What other pattern could this be? It could be a triangle; three waves up for **a**, a three of some sort in **b**, and three waves in each of waves **c**, **d** and **e**.

I like this pattern, because I know where my outlook is incorrect. If this is a triangle, wave **e** must hold below the highs of waves **a** and **c**. So, I know my risk and I know my reward. If the triangle label is correct, prices should be getting ready to thrust to a new low beneath 105.00, and the risk/reward is quite favorable.



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Tue Feb 12 2008

Figure 8-4

Here's the updated chart. As you can see, prices broke out above these previously labeled highs, waves (c) and (a), in a sharp move. However, the fact that the market broke out does not mean the structure is necessarily bullish.

I knew that if the market went to a new high, I would still think the whole move was a correction. If the market was doing a combination correction, we would be looking for another three-wave movement.

There are three waves up to just short of 108.00 that we labeled (a)-(b)-(c), then there is a three-wave correction, which is labeled (x). The action following wave (x) clearly wasn't impulsive, but how do you label it? I could count a five-wave movement in wave (a), then a triangle (a-b-c-d-e) for the (b) wave. There is a rally in (c). What's interesting is that the two zigzags [(a)-(b)-(c) moves] are within two pips of being equal.

The decline into the low at 105.00 began around 114.65, and the .382 retracement also lies within pips of the equality measurement. That area provides a strong cluster of targets. So far we have seen the market fall. This chart was taken on the 14th and by the 15th the market had traded as low as 107.30.

We don't know if the count is correct, but clearly with no other perspective than knowing that this market came from 114.00 down to 105.00, and then looking at the sideways, choppy mess on the chart, I would anticipate that this move will prove to be corrective. Looking at the internals and being able to count this two-zigzag combination, with equality between the zigzags and a near-perfect .382 retracement of the prior decline, there is a strong case that this is a correction.

I wanted to show this example because the combination is a pattern that often confuses people. Corrective patterns can be challenging enough, and it can seem even more difficult when we link corrective patterns together.

One of the most important things we have learned is that the wave count can change as we get more price information. As the market continues to unfold, there's nothing wrong with changing the wave count. We have to adapt to what the market is doing because, at the end of the day, all that matters is price. If you use the skills taught in this eCourse Book, I think that you will find it easier to anticipate and to understand corrections.



Chapter 9

Questions and Answers

Q: Does each degree always correspond to the same time frame? Sometimes, waves 1 through 5 will form another wave at a larger time frame. How can I recognize this phenomenon?

A: Wave degrees are not always tied to the same specific time frames. An impulse wave at one degree on a 1-minute chart may turn out to be wave one of a larger impulse wave at next higher degree seen on a 10-minute bar chart or a 15-minute bar chart. The time that it takes for waves to link together to form other waves at higher degree varies from market to market and from time period to time period.

It's not just sometimes. Every wave pattern is always part of a larger pattern at the next higher time frame. Therefore, to see how one pattern fits into the larger one, you should start by identifying the wave pattern at the larger degree and work your way down to the smaller time frames.

Q: Can subwaves of wave 3 overlap wave 1?

A: Subwaves of wave 3 can overlap wave 1 since they unfold at different degrees of observation. Elliott wave rules apply to waves of the same degree.

Q: What can we expect after a zigzag ends? We know that at the end of a fifth wave we get a correction of the five waves. Does this apply to the second five-wave structure of a zigzag?

A: After every five-wave movement, whether it's part of a correction or of a larger impulsive movement, expect a countertrend movement. In the case of a zigzag, a 5-3-5 movement, wave B is a correction and typically unfolds in a three-wave manner. Wave C follows and unfolds in five waves. At least a reaction should follow.

This is where having market perspective is critical. If you know that the setback is a correction, then you can be reasonably certain that the larger trend will resume. A reaction in five waves would strengthen this view.

(Editor's note: For more details on zigzags, see our courses on zigzags, available at www.elliottwave.com.)

Q: How do I know whether wave 4 is still in force or wave 5 has begun? Assume wave 3 to the upside is complete, a flat correction retraces less than 38% of wave 3 and then there's a five-wave move to the upside. How do I know if the last five-wave move upwards is all of wave 5, part of wave 5 or part of a zigzag for wave X within wave 4? How do I trade it?

A: The five-wave rally signals the potential end of the fourth wave. If the rally does not exceed the top of wave three, either wave one of five is complete or the rally is the first wave of wave B in a larger downward correction. It is impossible to "know" which count is correct; both are valid. This is where risk management is crucial.

Q: In an expanded flat, can wave B be a zigzag?

A: In an expanded flat, wave B will often be a zigzag.

Q: In an expanded flat, how far can wave B travel? At what point will we be forced to say that what we thought was wave B of an expanded flat is actually the resumption of the main trend?

A: In an expanded flat, there is no set limit as to how far wave B can travel, as long as Elliott's rules are not violated. Since B waves are corrective structures, a completed five-wave structure at the same degree would indicate the resumption of the main trend.

Q: If we use closing prices, can the end of wave 4 overlap wave 1?

A: In general, one should use bar charts as opposed to closing prices to determine wave counts in accordance with the Wave Principle's rules and guidelines. However, there can be certain situations that justify the use of closing prices. It depends on the situation.

For example, assume that in the FX market, every major currency against the U.S. dollar clearly displays the same type of impulse wave on a bar chart, except for the Swiss franc, where the end of wave 4 overlaps wave 1. If the Swiss franc displays a clear and simple impulse wave only using closing prices, does that invalidate the wave count in the Swiss franc? In this situation, unless there were some other special factors, we could view this as an anomaly.

Q: What time period do you use for RSI (Relative Strength Index)?

A: I use the default setting on my quote machine. It's set to 9. It's not the setting that matters, just that I see a divergence while I'm counting a fifth wave. It doesn't happen every time, but it's common enough that I look for it.

Q: Why did you use .618 to estimate wave 5?

A: A common Fibonacci relationship is that wave 5 will be equal to .618 times the net distance traveled of waves 1 through 3, if there are no extensions. That is one of several relationships that we look for in wave five. Of course, I consider structure and five waves up in the proposed fifth to be more important than a measured objective. The Fibonacci ratio of .618 also represents the Golden Ratio, which appears in mathematical relationships that involve nature, human biology, and aggregate human decision-making in financial markets. If you are interested in studying more about Fibonacci relationships in financial markets, please see our courses on "How You Can Identify Turning Points Using Fibonacci."

Q: How do I know whether I'm in a wave B of a correction or starting a new trend? If I've counted five waves for wave A and add a 5-3-5 structure for wave B, how do I know whether it's wave B or the start of a new trend with waves 1, 2, and 3?

A: One way to check is to identify where you are in the overall "context," which refers to the wave structure at next higher degree. If you've just finished wave 5 of wave three, then the next wave would be wave four, which has to unfold as a corrective structure, in three waves.

A corrective pattern cannot be solely one five-wave structure. If you've identified a five-wave structure for wave A, then the correction is not over yet. Waves B and C must follow to form a zigzag, since zigzags are 5-3-5 patterns. In a zigzag, wave B can never go beyond the start of wave A, even if wave B is also a zigzag. Therefore, as long as wave B does not go beyond the start of wave A, you can expect wave C to unfold in the same direction as wave A to complete the correction. If wave B goes beyond the start of wave A, it is not part of a correction.

Q: Where can I get currency charts starting before 1978?

A: My currency data on CQG goes back to 1971. The Foundation for the Study of Cycles may have data going back further.

Q: Tell me how you got into using Elliott wave analysis as your trading methodology.

A: I was introduced to the Wave Principle in 1985, but let me take a moment to mention some of the lessons I've learned along the way. In 1989, I joined Sabin Commodities. I was on the floor of the exchange in New York with gold traders, standing on the top step, looking at a weekly and daily chart at the time. I didn't have access to a real-time quote system. There was no Internet. Yet, I worked with traders on the floor who were making quick decisions. I was charting by hand, tick by tick, and it worked for me.

The lesson I learned at Sabin Commodities, while on the floor, really had nothing to do with the Wave Principle directly. People who didn't know me would just walk up to me and ask my opinion. It didn't take but two weeks of standing on that floor to get myself adjusted. Suddenly, traders with badges pinned on them were asking me, "Jim, what do you think about the market? What should I be doing?"

I learned that people will take a tip from anybody. In fact, most of them didn't even know my name. If I was on a streak and doing well, I would see them several times a day. As soon as I was wrong once or twice, I didn't see them again. I came to realize that they traded multiple methodologies in two or three weeks' time. They didn't stick with anything. They never learned anything thoroughly enough to make it worth their while and profitable to them — and these were professional traders. That's something that's always stayed with me. I started reading about the Wave Principle in 1985, and I'm still using the same methodology.

Soon after, I went to work for the Bank of New York, where I had nothing to do with the markets. I was a corporate credit analyst. My job was to look at financial statements of major companies that wanted loans. They sent me to a seven-month intensive course on how to read financial statements to find the outright fraud. You had to read all the footnotes. My experience at the bank convinced me that you can make numbers say anything you want them to. One company can buy another company right before they have to prepare the financial statements, so they can adjust their earnings based on the acquired company.

However, price never lies. Price is the final arbiter. That's all we care about — price. That's technical analysis.

Whenever you buy or sell, you are taking into account the news around you and what's going on in the world. That's reflected in price. I don't have to be the guy picking the tops and bottoms. I'll leave that for someone smarter than myself or luckier than myself. I want the bulk of the trend. From our perspective, I want that third wave.

I came to Elliot Wave International and just started following lots of markets, working night shifts, following everything, honing my ability. Then, I went to Nexus Capital. That was a hedge fund where I helped the traders to decide things like, Should I execute an order now? Should I wait a minute? Can I squeeze 10 pips out of this? I was working to learn, as well as doing analysis and trying to find the opportunities that we needed to take advantage of. It exposed me to the money side of things. Everything before that was theoretical, purely analytical. This was turning that analysis into real money, and it was very valuable.

Of course, I came back to Elliott Wave International. I use all of that experience to try to help you make decisions. I cannot make that decision for you. People are always asking me for more specific trading advice. I can't offer that. We have too many clients. I don't know your risk tolerances. I don't know if you like to trade with big risk or if you're more cautious like me.

In my experience, the clients who have stayed with us the longest are those who at least have a basic understanding of the Wave Principle. It seems kind of counterintuitive. You might think that if they can count waves, they wouldn't need EWI. Well, I found that those clients are the ones who stay with us. They use us as a sounding board. They have their own count. They have their own market idea. They will look at what we're saying. If we agree, they're more confident. If we disagree, they take a step back.

If you're going to use the method, you should understand the method. It goes back to my experience at Sabin Commodities. Most of the guys didn't even know my name, yet they were willing to bet their money on what I thought. Some of the guys thought my name was Elliott, because I'd say, "I use the Elliott Wave Principle." They assumed that this was just something I came up with. I'm not smart enough to come up with something like this. I simply read the book, and I took it from there. It's not very difficult if you just read it several times and practice it over and over.

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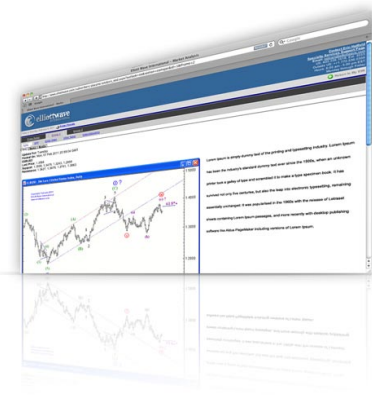
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