## What Is the Elliott Wave Theory?

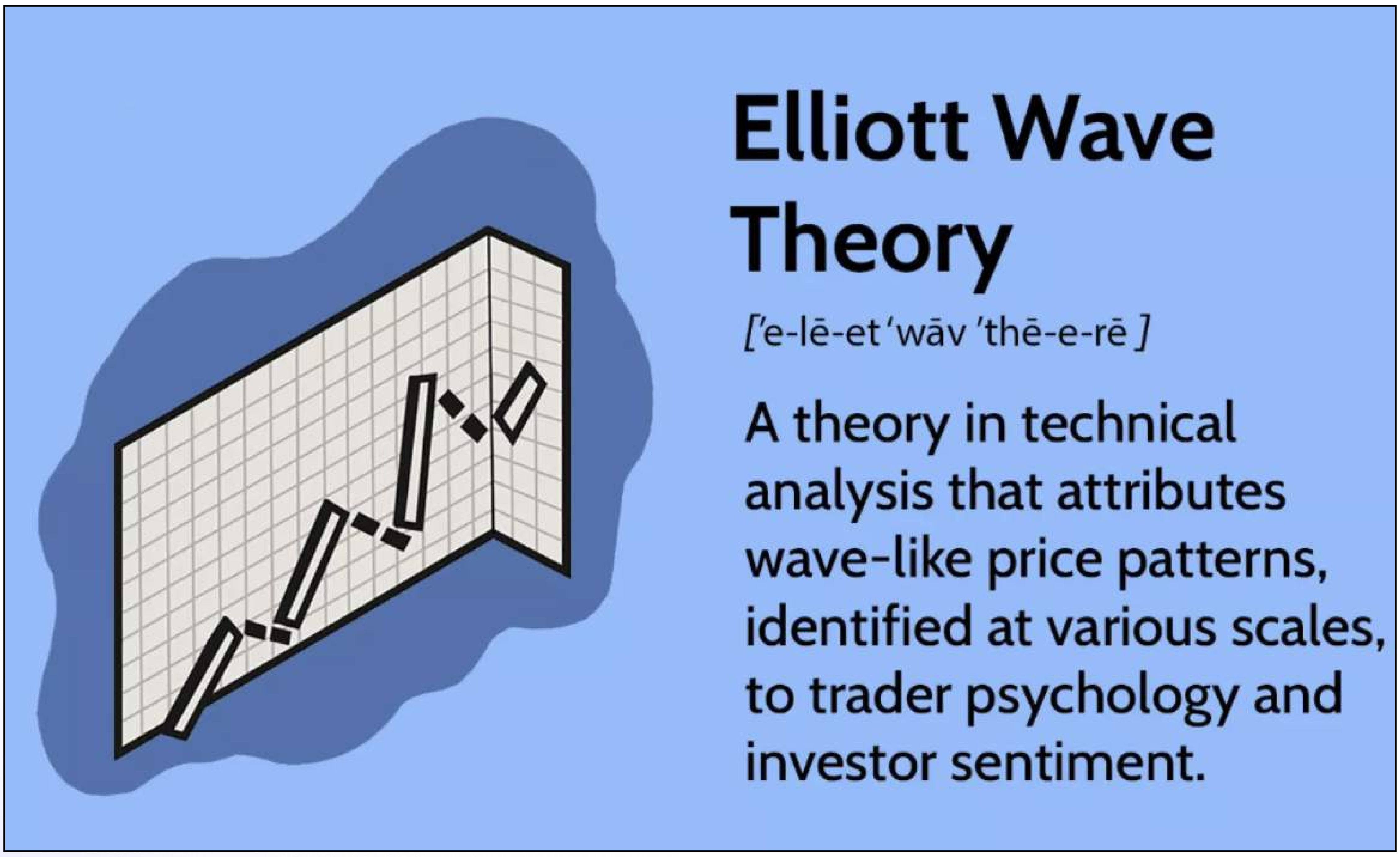
The Elliott Wave Theory in technical analysis describes price movements in the financial market. Developed by Ralph Nelson Elliott, it observes recurring fractal wave patterns identified in stock price movements and consumer behavior. Investors who profit from a market trend are described as riding a wave.

## 1. Understanding the Elliott Wave Theory

The Elliott Wave theory was developed by Ralph Nelson Elliott in the 1930s. He studied 75 years' worth of yearly, monthly, weekly, daily, and self-made hourly and 30-minute charts across various indexes. His theory gained notoriety in 1935 when Elliott made an uncanny prediction of a stock market bottom and has become a staple for thousands of portfolio managers, traders, and private investors.

Elliott defined rules to identify, predict, and capitalize on wave patterns in books, articles, and letters summarized in R.N. Elliott's Masterworks, published in 1994. Elliott Wave International is the largest independent financial analysis and market forecasting firm whose market analysis and forecasting are based on Elliott’s model.

His patterns do not provide any certainty about future price movement but help to order the probabilities for future market action. They can be used with other forms of technical analysis, including technical indicators.



## 2. How Elliott Waves Work

The Elliott Wave Theory in technical analysis describes price movements in the financial market. Developed by Ralph Nelson Elliott, it observes recurring fractal wave patterns identified in stock price movements and consumer behavior. Investors who profit from a market trend are described as riding a wave.

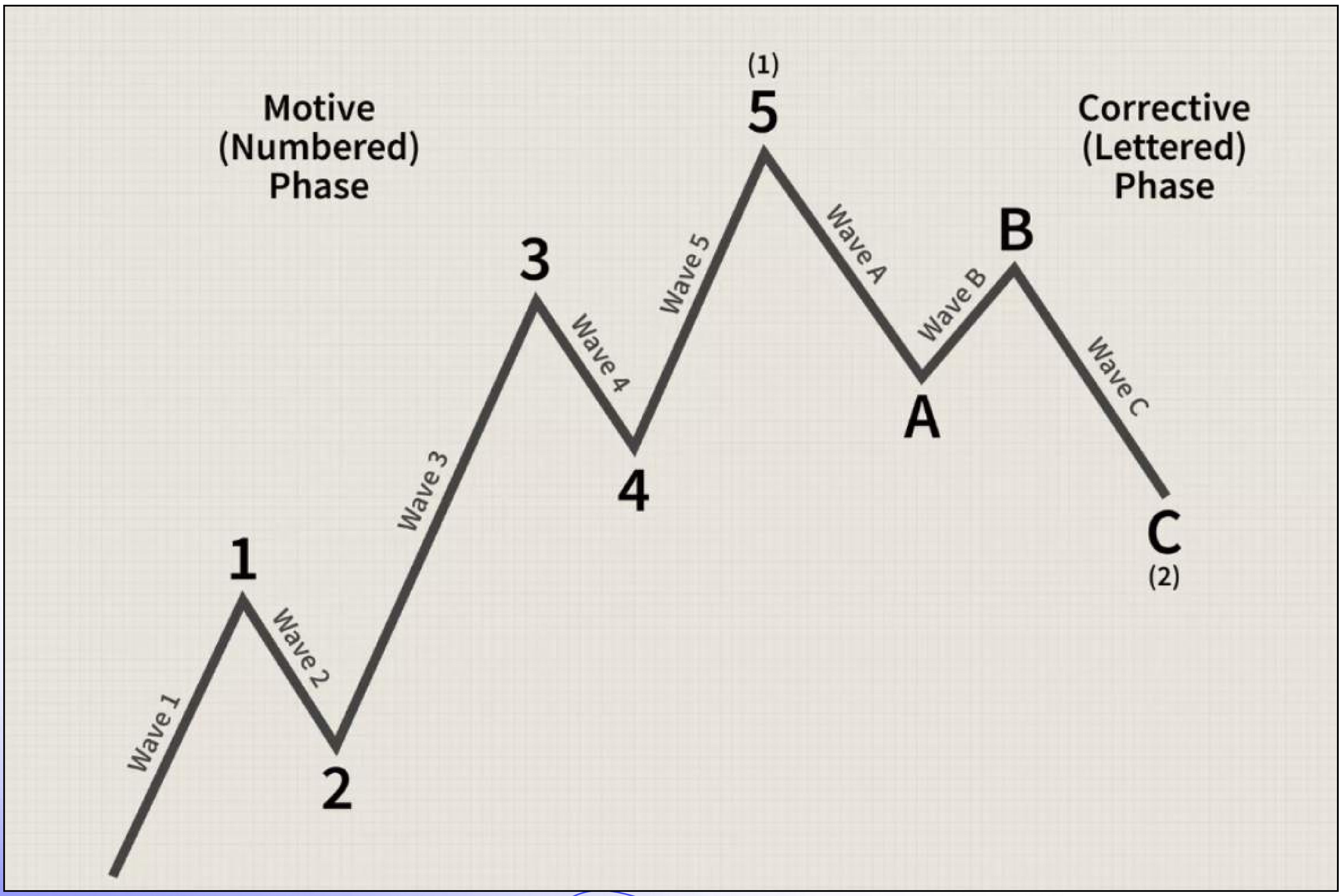
## 1. Understanding the Elliott Wave Theory

Some technical analysts profit from wave patterns in the stock market using the Elliott Wave Theory. The theory assumes that stock price movements can be predicted because they move in repeating up-and-down patterns called waves created by investor psychology or sentiment.

The theory is subjective and identifies two different types of waves: motive or impulse waves, and corrective waves. Wave analysis does not equate to a template to follow instructions. Wave analysis offers insights into trend dynamics and helps investors understand price movements.

Impulse and corrective waves are nested in a self-similar fractal to create larger patterns. For example, a one-year chart may be in the midst of a corrective wave, but a 30-day chart may show a developing impulse wave. A trader with this Elliott wave interpretation may have a long-term bearish outlook with a short-term bullish outlook.

Impulse waves consist of five sub-waves that make net movement in the same direction as the trend of the next-largest degree. This pattern is the most common motive wave and the easiest to spot in a market. It consists of five sub-waves, three of which are motive waves. Two are corrective waves.



• Wave 2 can't retrace more than the beginning of Wave 1

• Wave 3 can not be the shortest wave of the three impulse waves, 1, 3, and 5

• Wave 4 does not overlap with the price territory of Wave 1

• Wave 5 needs to end with momentum divergence

## 3. Corrective Waves

Corrective waves, called diagonal waves, consist of three, or a combination of three sub-waves that make net movement in the direction opposite to the trend of the next-largest degree. Its goal is to move the market in the direction of the trend.

• The corrective wave consists of 5 sub-waves.

• The diagonal looks like either an expanding or contracting wedge.

• The sub-waves of the diagonal may not have a count of five, depending on what type of diagonal is being observed.

• Each sub-wave of the diagonal never fully retraces the previous sub-wave, and sub-wave 3 of the diagonal may not be the shortest wave.

## 4. What Is the Elliott Wave Theory?

In technical analysis, the Elliott Wave theory looks at long-term trends in price patterns and how they correspond with investor psychology. These price patterns or 'waves' depend on rules developed by Ralph Nelson Elliott in the 1930s. They identify and predict wave patterns within stock markets and help predict future movement.

## 5. How Do Elliott Waves Work?

Based on Elliott's Wave Theory, market prices will alternate between an impulsive phase and a corrective phase. Impulses are always subdivided into a set of 5 lower-degree waves, alternating again between motive and corrective character, so that waves 1, 3, and 5 are impulses, and waves 2 and 4 are smaller retraces of waves 1 and 3.

## 6. How Do You Trade Using Elliott Wave Theory?

If a trader sees a stock moving upward on an impulse wave, they may go long until it completes its fifth wave. Anticipating a reversal, the trader may then go short on the stock. Underlying this trading theory is the idea that fractal patterns recur in financial markets. In mathematics, fractal patterns repeat themselves on an infinite scale.

## 7. The Bottom Line

The Elliott Wave Theory was developed by Ralph Nelson Elliott. It provides a technical analysis of price patterns related to investor sentiment and psychology. The theory identifies impulse waves that establish a pattern and corrective waves that oppose the larger trend. It assumes that stock price movements can be predicted because they move in repeating up-and-down patterns.