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# VISUAL GUIDE TO ELLIOTT WAVE TRADING

WAYNE GORMAN AND JEFFREY KENNEDY

FOREWORD BY ROBERT R. PRECHTER, JR.

Visual Guide to

# Elliott Wave Trading

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Wayne Gorman
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**Foreword by Robert R. Prechter, Jr.**

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# How to Use This Book

The *Visual Guide to . . .* series is designed to be a comprehensive and easy-to-follow guide on today's most relevant finance and investing topics. All charts are in full color and presented in a large format to make them easy to read and use. We've also included the following elements to reinforce key information and processes:

- **Definitions:** Terminology and technical concepts that arise in the discussion
- **Key Points:** Critical ideas and takeaways from the full text
- **Bloomberg Functionality Cheat Sheet:** For Bloomberg terminal users, a back-of-the-book summary of relevant functions for the topics and tools discussed

## Go Beyond Print

Every *Visual Guide* is also available as an e-book, which includes the following features:

- **Video Tutorials:** To show concepts in action
- **Test Yourself:** Multiple-choice or true/false quizzes to reinforce your newfound knowledge and skills
- **Pop-Ups:** Definitions for key terms

# Foreword

For many years, I have wanted to have my company produce a trading book based on the Elliott wave model. As with markets, sometimes you have to wait patiently for the time to be right. The time is finally right, as two highly qualified Elliott-wave traders have partnered to write a good book on the subject.

Wayne Gorman, who ran a major trading desk at Citibank and Westpac Banking Corporation, is head of Educational Resources at Elliott Wave International (EWI). Jeffrey Kennedy traded for a living and handles Elliott Wave Junctures, EWI's daily educational and trade-identifying service. Both guys teach our trading seminars. And they can write well, too.

This is not a book about how some market method sets up perfect trades on paper. Wayne and Jeff walk you step by step through their thinking process during a number of trades they took in real life. They also present hypothetical setups that you might encounter in your own market experience and show you how to handle them. They aren't easy layups but real conundrums that require thoughtful analysis and careful action. Unlike many experts, Wayne and Jeff aren't shy about relating some of their mistakes and what they learned from them. When you read their discussions, you will know they have walked the hard road of experience.

You will also realize how much work it takes to do things right. Even if this book leads you to decide that successful trading takes too much effort, it will have provided a service. Books that make trading look easy actually cost you a lot of money in the end.

Frankly, most people are not cut out for trading. No book can cure impulsiveness, timidity, laziness, or a self-destructive personality. But this book does show you, very carefully, how two traders repeatedly negotiate the minefield of the market and come out alive and happy on the other side.

If you want to trade your own money for a living, if you want to be employable as a trader, if you just want to trade the occasional ideal setup, or even if your goal is simply to stop losing money in the markets, you are in the right place.

Successful trading takes work, discipline, and smarts. With those three things, you're mostly there. The final thing you need is knowledge—that's what this book provides.

Robert R. Prechter, Jr.
Elliott Wave International

# Acknowledgments

We want to thank our colleagues for their valuable assistance in producing this volume: Sally Webb, Paula Roberson, Susan Walker, Cari Dobbins, Dave Allman, Debbie Hodgkins, Bob Prechter, Will Rettiger, Michael McNeilly, and Pam Greenwood.

# Introduction

Welcome! *Visual Guide to Elliott Wave Trading* is a must-have book on how to use the Elliott Wave Principle—how to use it to find trades, assess trades, enter trades, manage trades throughout by raising or lowering protective stops, and exit trades.

*Visual Guide to Elliott Wave Trading* assumes a basic familiarity with the Wave Principle and its application. Much like a strategy book for chess assumes a basic knowledge of how the pieces move around the board, this book assumes a basic knowledge of the various patterns of the Wave Principle and how they fit together.

If you are already an experienced Elliott wave practitioner and simply need a refresher, the Appendix reviews these basic building blocks and their structures.

If you are a complete newcomer or you want a more in-depth review, we suggest you consult the free resources and access your free copy of the Wall Street classic *Elliott Wave Principle* by Frost and Prechter at your exclusive Reader Resources site: www.elliottwave.com/wave/ReaderResources.

Both of us have traded for a living at one time or another. Each of us during those times used the Elliott Wave Principle as our primary discipline. *Visual Guide to Elliott Wave Trading* walks you through a highly personal journey of our thought processes throughout each trade: what we looked at, what we ignored, what we did right, and what we did wrong.

We do not present perfect-world examples that will leave you convinced that you can trade your way to wealth in 30 minutes while golfing the rest of the day. Rather, we have tried to produce a realistic trading book, warts and all, recognizing that while there may be no one perfect way to trade, there are various ways to trade successfully using the Wave Principle as your primary discipline.

We hope you enjoy *Visual Guide to Elliott Wave Trading*. Let's get started.

Wayne Gorman and Jeffrey Kennedy

# Disclaimer

The trading examples throughout this book are solely for the purpose of demonstrating the mechanics of applying the Wave Principle. The profit or loss outcomes are not meant in any way to represent or imply a particular rate of success or return on capital.

**Visual Guide to**

# Elliott Wave Trading

PART I

# Trade Setups

CHAPTER 1

# The Anatomy of Elliott Wave Trading

When teaching the Wave Principle, I begin each class by stating that analysis and trading represent two different skill sets. Although you may be a talented analyst, that does not mean you will be a successful trader and vice versa. I learned the hard way over many years that skilled analysis is a mastery of observation, while successful trading is a mastery of self.

When it comes to trading, there is no right way or wrong way—only your way. One trader's tolerance for risk will be starkly different from another's, just as time frame, portfolio size, and markets traded will also be different. Thus, the guidelines offered within this chapter on how to trade specific Elliott wave patterns are just that—guidelines, but ones that have served me well for many years.

My best advice to you as you look for a trading opportunity is to start your search by asking the question, "Do I see a wave pattern I recognize?" You should look for one of the five core Elliott wave patterns: impulse wave, ending diagonal, zigzag, flat, or triangle. These forms will become the basis of all your trade setups once you learn to identify them quickly and with confidence.

An even simpler question to ask is, "Do I see either a motive wave or a corrective wave?" Motive waves define the direction of the trend. There are two kinds of motive waves: impulse waves and ending diagonals. Corrective waves travel against the larger trend. The three kinds of corrective waves are zigzags, flats, and triangles. If all you do is identify a motive wave versus a corrective wave correctly, you can still identify some useful trade setups.

In this chapter, we will examine how to use key components of analysis and trading to help you

KEY POINT

**Analysis is a mastery of observation, while successful trading is a mastery of self.**

become a better Elliottician and a consistently successful trader. Specifically, we will examine how the Wave Principle improves trading, which waves are the best to trade, which guidelines to use for trading specific Elliott wave patterns, and why the psychology of trading and risk management—what I call the neglected essentials—are important.

## How the Wave Principle Improves Trading

Every trader, every analyst, and every technician has favorite techniques to use when trading. Let's go over why the Wave Principle is mine.

### How the Wave Principle Improves Upon Traditional Technical Studies

There are three categories of technical studies: trend-following indicators, oscillators, and sentiment indicators. Trend-following indicators include moving averages, Moving Average Convergence-Divergence (MACD), and Directional Movement Index (ADX). A few of the more popular oscillators many traders use today are stochastics, rate-of-change, and the Commodity Channel Index (CCI). Sentiment indicators include put-call ratios and Commitment of Traders report data.

Technical studies like these do a good job of illuminating the way for traders, yet they each fall short for one major reason: They limit the scope of a trader's understanding of current price action and how it relates to the overall picture of a market. For example, let's say the MACD reading in XYZ stock is positive, indicating the trend is up. That's useful information, but wouldn't it be more useful if it could also help to answer these questions: Is this a new trend or an old trend? If the trend is up, how far will it go?

Most technical studies simply don't reveal pertinent information such as the maturity of a trend and a definable price target—but the Wave Principle does.

### Five Ways the Wave Principle Improves Trading

Here are five ways the Wave Principle can benefit you and improve your trading:

1. The Wave Principle identifies the trend.
2. It identifies countertrend price moves within the larger trend.
3. It determines the maturity of the trend.
4. It provides high-confidence price targets.
5. It provides specific points of invalidation.

#### 1. Identifying the Trend

> ". . . action in the same direction as the one larger trend develops in five waves. . . ."
>
> —*Elliott Wave Principle* by Frost and Prechter

The Wave Principle identifies the direction of the dominant trend. A five-wave advance identifies the overall trend as up. Conversely, a five-wave decline determines that the larger trend is down. Why is this information important? Because it is easier to trade in the direction of the dominant trend, since it is the path of least resistance and undoubtedly explains the saying, "The trend is your friend." I find trading in the direction of the trend much easier than attempting to pick tops and bottoms within a trend, which is a difficult endeavor and one that is virtually impossible to do consistently.

### 2. Identifying the Countertrend

> "... reaction against the one larger trend develops in three waves...."
>
> —*Elliott Wave Principle* by Frost and Prechter

The Wave Principle also identifies countertrend moves. The three-wave pattern is a corrective response to the preceding impulse wave. Knowing that a recent move in price is merely a correction within a larger trending market is especially important for traders because corrections give traders opportunities to position themselves in the direction of the larger trend of a market.

Being aware of the three basic Elliott wave corrective patterns—zigzags, flats, and triangles—enables you to buy pullbacks in an uptrend and to sell bounces in a downtrend, which is a proven and consistently successful trading strategy. Know what countertrend price moves look like, and you can find opportunities to rejoin the trend.

### 3. Determining the Maturity of a Trend

As R. N. Elliott observed, wave patterns form larger and smaller versions of themselves. This repetition in form means that price activity is a fractal, as illustrated in Figure 1.1. Wave (1) subdivides into five small waves yet is part of a larger five-wave pattern. How is this information useful? It helps traders recognize the maturity of a trend. If, for example, prices are advancing in wave 5 of a five-wave advance and wave 5 has already completed three or four smaller waves, a trader knows that this may not be the best time to add long positions. Instead, it may be time to take profits or at least to raise protective stops.

Since the Wave Principle identifies trend, countertrend, and the maturity of a trend, it's no surprise that the Wave Principle also signals the return of the dominant trend. Once a countertrend move unfolds

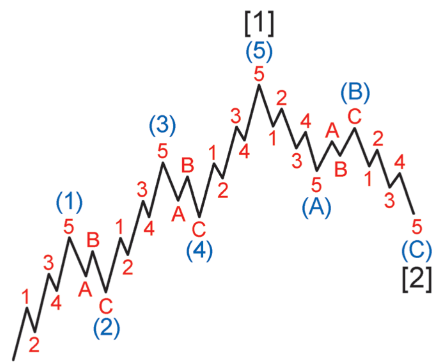


**Figure 1.1**
*Source: Elliott Wave Principle.*

in three waves (A-B-C), this structure can signal the point where the dominant trend has resumed, namely, once price action exceeds the extreme of wave B. Knowing precisely when a trend has resumed brings an added benefit: It increases the likelihood of a successful trade, which is further enhanced when accompanied by traditional technical studies.

#### 4. Providing Price Targets

What traditional technical studies simply don't offer—high-confidence price targets—the Wave Principle again provides. When R. N. Elliott wrote about the Wave Principle in *Nature's Law*, he stated that the Fibonacci sequence was the mathematical basis for the Wave Principle. Elliott waves, both impulsive and corrective, adhere to specific Fibonacci proportions. For example, all three motive waves tend to be related by Fibonacci mathematics, whether by equality, 1.618, or 2.618 (whose inverses are .618 and .382). See Figures 1.2, 1.3, and 1.4.

Also, corrections often retrace a Fibonacci percentage of the preceding wave. These Fibonacci-derived regions allow traders to set profit-taking objectives and identify areas where the next turn in prices will likely occur (see Figures 1.5 and 1.6).

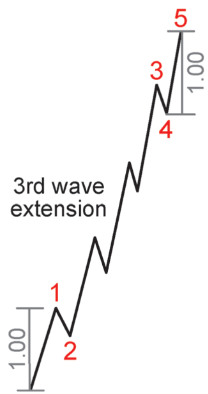


**Figure 1.2**
*Source: Elliott Wave Principle.*

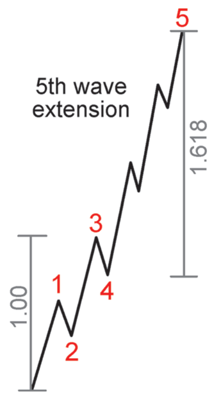


**Figure 1.3**
*Source: Elliott Wave Principle.*

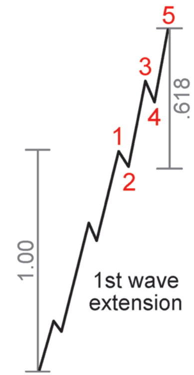


**Figure 1.4**
*Source: Elliott Wave Principle.*

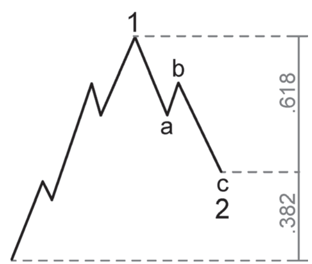


**Figure 1.5**
*Source: Elliott Wave Principle.*

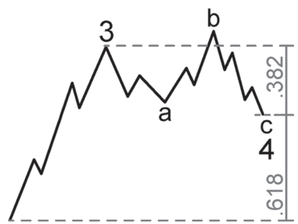


**Figure 1.6**
*Source: Elliott Wave Principle.*

### 5. Providing Specific Points of Invalidation

Wave analysis provides a specific point of invalidation, which is the level at which an interpretation is no longer viable. Knowing when you are wrong is perhaps a trader's most important piece of information.

At what point does a trade fail? Many traders use money management rules to determine the answer to this question, because technical studies simply don't offer the answer. Yet the Wave Principle does—in the form of these three Elliott wave rules for impulse waves:

*Rule 1:* Wave 2 can never retrace more than 100 percent of wave 1.
*Rule 2:* Wave 4 may never end in the price territory of wave 1.
*Rule 3:* Out of the three impulse waves (waves 1, 3, and 5), wave 3 can never be the shortest.

A violation of any of these rules implies that the operative wave count is incorrect. How can traders use this information? If a technical study warns of an upturn in prices, and the wave pattern is a second-wave pullback, the trader knows specifically at what point the trade will fail: a move beyond the origin of wave 1. That kind of guidance is difficult to come by without a framework such as the Wave Principle.

## The Four Best Waves to Trade

Here's where the rubber meets the road. Waves 3, 5, A, and C are the most advantageous to trade, because they are oriented in the direction of the one larger trend. Odds favor traders who are long in bull markets (and short in bear markets) versus short sellers in bull markets (and buyers in bear markets). Overall, trading in the direction of the trend is the path of least resistance.

The Wave Principle helps to identify these high-confidence trades in place of lesser-confidence setups that traders should ignore. Remember, five-wave moves determine the direction of the larger trend, while three-wave moves offer traders an opportunity to join the trend. So in Figure 1.7, waves (2), (4), (5), and (B) are actually setups for high-confidence trades exploiting waves (3), (5), (A), and (C).

For example, a wave (2) pullback provides traders an opportunity to position themselves in the direction of wave (3), just as a wave (5) rally offers them a shorting opportunity for wave (A). By combining the Wave Principle with traditional technical analysis, traders can improve their trading by increasing the likelihood of a successful trade.

Technical studies can pick out many trading opportunities, but the Wave Principle helps traders discern which ones are more likely to be successful.

**KEY POINT**

**Knowing when you're wrong on a trade is as important as knowing when you're right.**

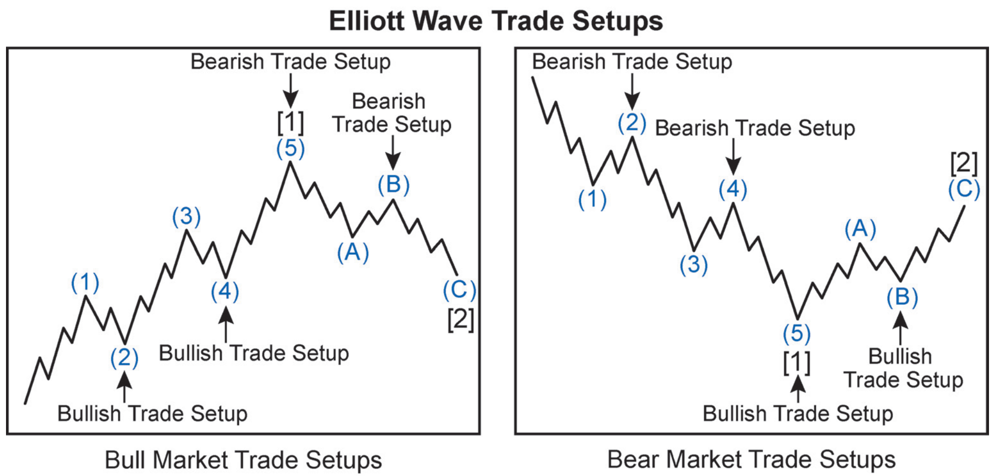


Figure 1.7

This is because the Wave Principle is the framework that provides history and context, current information, and a peek at the future.

## Elliott Wave Trade Setups

This next chart (see Figure 1.7) shows bullish and bearish versions of trade setups. In each, waves (2), (4), (5), and (B) are trade setups that introduce the four primary Elliott-based trading opportunities. These corrective waves offer the trader an opportunity to rejoin the larger trend. In such trend trading, a trader buys pullbacks in uptrends and sells bounces in downtrends.

## When to Trade Corrections

Corrective waves offer less desirable trading opportunities because of their potential complexity. Impulse waves are trend-defining price moves in which prices typically travel far. Conversely, corrective wave patterns fluctuate more and can unfold slowly while taking a variety of shapes, such as a zigzag, flat, expanded flat, triangle, double zigzag, or combination. Corrections generally move sideways and are often erratic, time-consuming, and deceptive. Thus, it is emotionally exhausting to trade corrections, and the odds of executing a successful trade during this type of price action are low.

Even though I view corrective waves and patterns as providing low-confidence trade setups, there are times when I would consider trading them—but it depends on the potential duration of the correction. If I count five waves up, for example, on a 15-minute price chart of Crude Oil, I do not consider waves 2 or 4 to be viable trading opportunities. I prefer, instead, to wait for waves 2 and 4 to terminate before entering a position. Let's say, though, that we have a market that has also formed an impulse wave, but it has taken weeks or months to do so. In this instance, waves 2 and 4 would form over many weeks and might offer traders many short-term trading opportunities.

## Guidelines for Trading Specific Elliott Wave Patterns

Before we review guidelines for trading specific Elliott wave patterns, here is my most important analytical and trading rule: **Let the market commit to you before you commit to the market.** In other words, look for *confirming price action*. Just as it is unwise to pull out in front of an oncoming car on the basis of its turn signal alone, it is equally unwise to take a trade without confirmation of a trend change.

The following guidelines incorporate this idea and benefit the trader in two ways. First, waiting for confirming price action tends to decrease the number of trades executed. One of the biggest mistakes traders make is overtrading. Second, it focuses attention on higher-confidence trade setups. If a trader believes that a particular market is topping—and appropriate price action does indeed corroborate this belief—then the trader is more likely to execute a successful trade.

### Impulse Waves

Whenever an impulse wave is complete, the Elliott wave guideline regarding the depth of corrective waves applies:

> "[C]orrections, especially when they themselves are fourth waves, tend to register their maximum retracement within the span of travel of the previous fourth wave of one lesser degree, most commonly near the level of its terminus."
>
> —*Elliott Wave Principle* by Frost and Prechter

Although that guideline may sound complicated, it's easy to follow in real trading. The trading technique is to enter on a break below the extreme of wave (iv) of 5 (see Figure 1.8). Doing so prevents top picking and requires the market to take out a prior swing low to act as initial evidence that the impulse wave is indeed finished. Set the initial protective stop at the extreme of the price move.

### Ending Diagonal

The guidelines for entry and initial protective stops for ending diagonals are similar to those for impulse waves: Wait for a break of the extreme of wave 4 before taking a position, and place the initial protective stop at the extreme of the price move (see Figure 1.9).

Remember, these entry techniques demonstrate a conservative approach that I think of as "ready, aim,

**Smart Investor Tip**

**Let the market commit to you before you commit to the market.**

**Smart Investor Tip**

**Waiting for confirming price action allows traders to use an evidence-based approach and to focus their attention on higher-confidence trade setups.**