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FINANCIAL MARKETS FORECAST & ANALYSIS
A Publication of Main Line Investors, Inc.

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Elliott Wave Analysis Theory
The History, Philosophy, and Basics

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April 6th, 2007

One of the technical tools we use at ***www.technicalindicatorindex.com*** is ***Elliott Wave analysis***. Its founder, ***Ralph N. Elliott***, was an accountant by trade, who in the 1930's noted that stock market prices form repetitive patterns he called waves. He became quite ill and took that bedridden opportunity to study the Dow Jones averages since 1896, the results of which he originated as the Elliott Wave Principles. His body of work was expanded upon through the years by such noted technical analysts as A. Hamilton Bolton of the Bank Credit Analyst, A.J. Frost, Richard Russell, Robert Prechter, Glenn Neely, and Zoran Gayer.

Elliott Wave is a measure of mass human activity as applied most commonly to the financial markets — although evidence is being gathered by Robert R. Prechter, Jr. that the principle applies to socio patterns as well (see his book *The Wave Principle of Human Social Behavior and the New Science of Socionomics*, New Classics Library, 1999). Elliott Wave confirms what God said through the writer of Ecclesiastes, ***"That which has been is that which will be, and that which has been done is that which will be done."*** The issue here is one of cycles, that all of nature repeats itself, which is especially true of the markets. ***These repetitive patterns can be recognized, and to some degree of success, anticipated.***

In a gross oversimplification, in a nutshell Elliott Wave analysis goes like this: ***Markets reflect all information, and all knowledge available to man. They have a language of their own, and communicate where they are going next.*** Elliott Wave is one of many languages the markets use to tell us where they are headed next. Market moves are not reactive to news announcements, but rather independent of news. ***News comes as a result of the position of the Elliott Waves — the psychological state of man at that particular time***. How news is interpreted depends upon the wave. If the wave formation indicates a Bullish move in progress, then bad news will be ignored or reacted to in a positive way, i.e.., markets will go up anyway. And, if the wave pattern is Bearish, then good news will be ignored or reacted to negatively — markets will sell off. Thus, ***it is helpful to investors if they are aware of the Elliott Wave position markets find themselves in, and which wave pattern is next expected to arrive.***

Again, oversimplifying, and using the stock market as an example, in Elliott Wave analysis equity prices move up or down with the primary trend impulsively. These impulsive (dramatic) moves come in stair-step fashion, five waves at a time. Waves 1, 3, and 5 progress and waves 2 and 4 regress (or correct). The total move in the direction of the primary trend progresses because the sum of waves 1, 3, and 5 exceeds the sum of waves 2 and 4. ***Waves 1, 3, and 5 move in the direction of the primary trend, while waves 2 and 4 can either move in the opposite direction or sideways***.

There are five-wave counts at a smaller degree inside each of waves 1, 3, and 5. There are three-wave counts at smaller degree inside each wave 2 and 4. The five-wave counts are marked by numbers, 1 through 5. The three-wave counts are marked by letters, A-B-C. Inside the sub-waves A and C are five-wave waves of even smaller degree. Inside the B wave is a sub-wave set of three waves. To recap, ***waves 1, 3, 5, A, and C are themselves made up of five-wave lower degree waves. Waves 2, 4, and B are built from smaller degree three-wave patterns. Waves 1, 3, 5, A, and C, push the direction of prices forward and waves 2, 4, and B correct or reverse the progress of the other waves***. An exception is that if a wave 5 is occurring inside a Triangle, then it will have a three-wave subset. Also, sometimes wave A will have a three-wave subset, not five, for example when part of a 3-3-5 Flat pattern. Triangles will have five sets of waves, each wave being made up of a subset of three waves.

Degrees of waves are distinguished based upon the time period they cover. Very long-term degrees of waves could cover hundreds of years, such as the Grand Supercycle degree. Very short-term degrees of waves might only cover a few weeks, or days. Elliott Waves can even be broken down and identified intraday by hour or minute.

There are certain rules that must not be violated for an accurate Elliott Wave count. There are three cardinal rules: 1) Wave 2, when it corrects wave 1, may never move prices beyond the starting point of wave 1. 2) Wave 3 may never be the shortest wave. 3) Wave 4 must never enter the price territory of the same degree wave 1. If any of these rules are violated, then the Elliott Wave count is wrong.

In addition to rules, what is extremely helpful is knowing the different personalities of each wave. ***Knowing personalities typical to each wave can sometimes clue us as to where we are in the count when it otherwise is unclear***. I'll cover just a few that I've noticed. 1) ***Wave 3's are usually (not always) the most dramatic, most powerful, and extend the furthest.*** Usually. They usually show panic buying or selling where you see prices move almost vertical. Or, if prices move over long periods of time without corrections, oftentimes it means we are in a wave three of some degree. It might be a wave three inside a higher degree wave 1, 3, 5, A, or C. 2) ***Ending Diagonal patterns*** (Rising Bearish or Declining Bullish Wedges are often seen in wave 5's. These have a subset of five waves, each with its own subset of three waves. 3) Wave twos often reverse so sharply, and so much of the previous wave 1's move, that it confuses the Elliottician as to whether in fact the trend has really changed or not. ***Retracements of as much as 61.8 percent or 78.6 percent are not uncommon in wave twos.*** 4) ***Wave fours are often lackluster, more sideways or choppy than twos (not always).*** Often wave fours will form triangle patterns. Wave B's are often similar to fours. 5) When wave three's extend, oftentimes waves one and five will tend to equality or some Fibonacci ratio of each other that lends a sense of proportionality to the wave pattern such that waves one and five look somewhat similar. 6) ***If wave 2 retraced (zigzagged) a measurable percentage of wave 1 — was not sideways — then wave four will likely be more of a flat or sideways move and vice versa (the principle of alteration).*** 7) After a sharp extended rally, which probably was a wave three, it is not uncommon for a sharp reversal to be the first of a five-wave sideways triangle that fakes out Elliotticians, giving the false illusion of a wave one reversal, but in fact is the "a" wave in the opposite direction of an a-b-c-d-e triangle, a corrective wave four sideways pattern, with another impulse wave five to follow in the same direction as the preceding larger degree extended wave.

Once we've seen a 1-2-3-4-5 sequence that looks complete, next we can expect a reversal of that five-wave impulse wave's progress in the form of an A-B-C correction or partial reversal. Once both of these sequences have completed together, for example, once a 1-up, 2-down, 3-up, 4-down, 5-up, A-down, B-up, C-down sequence has completed, then we can expect this to repeat itself.

For a terrific book to study the elements of Elliott Wave, I suggest *Elliott Wave Principle* by Robert R. Prechter, Jr. and A. J. Frost, New Classics Library, 1978-2001. For a more advanced book on Elliott Wave, I suggest *Mastering Elliott Wave*, by Glenn Neely with Eric Hall, Windsor Books, 1990.

The charts on pages 7 and 8 show the Big Picture, the long-term Elliott Wave counts of largest degrees for the Dow Jones Industrial Average. Page 7 covers ***from 1900 to now***, and page 8 zones in on the period ***from 1960 to now***. EW is a bit like owning a compass. It is a terrific navigational tool to help us get our bearings of where the markets have been and where they are in all probability headed. While we like Elliott Wave analysis, we do not rely upon it solely when trading. We prefer to lean our proprietary ***Purchasing Power Indicator*** and ***14 Day and 30 Day Stochastic Indicators*** for trading. The chart on page 5 (courtesy of www.stockcharts.com) shows the five largest degrees of trend. Robert Prechter's bestseller, *Conquer the Crash*, John Wiley & Sons, Ltd., 2002 does a great job taking us back to the long ago, faraway galaxy origins of the largest degree Elliott Waves (www.elliotttwave.com).

In issue no. 553, page 7, we present a chart that shows ***the largest degree wave identified is the Grand Supercycle***. For this degree we use Brownish-red large Roman Numerals with brackets. Wave **{1}** peaked in 1718. Wave **{II}** down completed in 1784. Wave **{III}** up is the major top what we expect has just completed in February 2007, or alternately, will complete soon. ***The next largest degree of trend wave is the Supercycle wave***, denoted by large purple Roman Numerals with parentheses around them.

The Supercycle wave began in 1784 (the start of Grand Supercycle **{III}.** Supercycle wave **(I)** up completed in 1830, Supercycle wave **(II)** down completed in 1860, ***Supercycle wave* (III) *up completed with the stock market crash of 1929,*** Supercycle **(IV)** down included the 1929 crash and lasted through 1932. ***The last leg of the Supercycle wave, (V),*** may have ended in February 2007, or likely will sometime this year. ***The next largest wave degree, a.k.a. the Cycle degree wave***, began in 1932. Its first leg up finished in 1937. A corrective Cycle degree wave **II** down (denoted by large Roman numerals in red) completed in 1942. Cycle **III** up finished in 1966. Cycle degree **IV** down was a somewhat sideways affair, choppy, and ended in 1974. ***The greatest Bull market of all time, Cycle degree wave V up, may have completed in February 2007, or should conclude soon.*** The next largest degree Elliott Wave in U.S. history is the ***Primary degree wave***. This showed up as a 1-2-3-4-5 sequence inside every larger degree mentioned to this point, and repeated each time there was an odd number wave of Cycle degree. Primary degree **(1)** up of **V** up (denoted in dark blue) began in 1974 and completed in 1976. Primary degree **(2)** finished in 1982. Here's where confusion reigned recently, and opinions differed (and still differ) among Elliotticians. Primary degree **(3)** was thought by many to have ended in 1987, with primary degree **(4)** being the 1987 crash, and primary **(5)** ending in 2000. We felt differently and stated so back in issue no. 111, over two years ago.

"And when they came to the place called The Skull, there they crucified Him and the criminals, one on the right and the other on the left. But Jesus was saying, "Father, forgive them; for they do not know what they are doing."

Luke 23: 33, 34

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