

 Wiley Trading

Harmonic Elliott Wave

The Case for Modification of
R.N. Elliott's Impulsive Wave Structure

Ian Copsey

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Introduction

It has been 20 years since I began to learn and apply the Elliott Wave Principle to the markets. I bought two books on the topic, read them thoroughly, and thought I could begin to predict price movements more effectively. Of course, as anyone will tell you, it's not as simple as that.

I studiously attempted to apply the principle to daily forex movements, but finding no success I gave it up . . . several times. What drove me forward was that of all analysts, it was those who utilized this principle that produced the most accurate forecasts. Other analysts simply had no clue, and this prompted me to continue the quest to conquer the challenge.

It took me a full 18 months before I felt that I had mastered the technique to an extent where I could generally provide more accuracy to my forecasts, but I was not yet at the stage where there was a high level of consistency. This led me to believe that it was a technique that demanded a great deal of dedication and practical experience to achieve success. Strangely enough, even then others still seemed to appreciate my attempts.

Around 16 years ago, I left trading to join the second largest real-time data vendor, Dow Jones Telerate, to provide specialist analytical support for their clients. I began to hold seminars for traders in Tokyo, which of course included Elliott Wave. It was a marvelous experience that deepened my knowledge of technical analysis in general, but it also took me away from the front line of having to analyze and forecast every day.

It wasn't until around 2004 that I returned to full-time analysis, writing a daily report which has now developed into *The Daily Forecaster*, subscribers coming from retail traders, corporate treasurers handling forex exposures, bank traders, and hedge funds. Being independent, the need for accuracy was pressing. Subscribers paid up their bucks and wanted profits. The days of having the backing of a large bank's name, a good salary, and less risk had passed.

Utilizing R. N. Elliott's wave structure, I became aware that things were not quite right. The same anomalies in the wave structure repeated themselves over and over again. The normal Fibonacci projections that are widely quoted didn't work all that often. Impulsive waves all too often stalled early and missed out a wave. So I began to adapt the way in which impulsive wave structures develop and to research the common ratios in projections. After a few months, it was clear that my adaptations produced far more accurate results in both the projection ratios and the manner in which impulsive wave structures develop.

It was at this point that the number of subscribers who kindly wrote to compliment the accuracy of both my forecasts and the daily support and resistance rose considerably. Another quite common comment was how other market analysts seemed to have no idea of what will happen next. As one subscriber wrote:

I am also extremely happy that I stuck with you. At the time, you twisted my rubber arm to continue with the original subscription I had been suffering from a string of advisors, many of whom were well-intentioned but could not unfortunately, for me, chew gum and walk straight at the same time—I mean from an analysis point of view. It was a bit like dining “al fresco” in the middle of a hurricane . . .

By no means am I perfect and I still have varying degrees of success in forecasting, but the consistency is higher with my approach, and one factor I have noted is that the “derivatives” of both Fibonacci and harmonic ratios I employ do often provide

powerful reversal signals if my forecasts prove incorrect. The mere fact that support and resistance levels are more accurate provides more focused points in price action that identify both trade entry and stop loss/reversal levels that can assist in reducing the size of losses and thus provide more effective maintenance of capital.

In writing this book to describe my findings I do not wish to imply that R. N. Elliott failed. In my opinion he was brilliant to make such observations in the first place. I do not for one moment believe I could have identified and quantified the Wave Principle if I had no prior foundation on which to work. The ability for me to identify this different structure of impulsive waves could really only have been managed with the benefit of modern calculators and charting software. With a few touches of the keyboard I am able to generate a full range of retracement levels and projections in my spreadsheet. While Elliott did have access to hourly charts, his ability to scrutinize wave relationships was limited due to the fact that he would have had to calculate a range of ratios long hand. Spreadsheets allow these to be available almost instantaneously. All that is needed is to tap in a few highs and lows. Therefore I prefer to label my findings as a modification only. R. N. Elliott's work still remains a remarkable feat of observation and diligence.

Having mentioned to other market professionals that I feel Elliott's structure is incorrect I have encountered a significant degree of resistance. It's like I have touched a raw nerve, almost challenging a religious dogma! Therefore, in suggesting this re-appraisal of the impulsive wave structure I realize that I need to offer suitable substantiated evidence to support my claim, and this I do through the use of wave relationships. The key to this evidence comes from the fact that the Fibonacci or harmonic ratios must be present not only within each wave but also within the entire fractal sequence of waves, so that the waves of lower degrees must generate projection targets that fit harmoniously into the larger degrees. Each in turn contributes to the next larger degree.

I have provided a great number of actual examples of analysis and of the different methods of wave development, and substantiated

them all through wave relationships so there can be no doubt that the modification to the harmonic structure is valid.

Clearly with a new modified harmonic structure some of the rules that have been used with Elliott's structure have changed and the methodology of recognizing a correct structure needs a shift in perception and application to forecasting. I have therefore included a chapter dedicated to providing practical guidance in using the harmonic structure, how to recognize certain common wave developments, and hints and tips on how to approach the task of deciphering wave recognition.

I have also included a section on confirming the retracement and projection levels when reached. While Elliott's observations on alternation and degree are still mainly valid, very clearly there are multiple potential retracement ratios or projection targets. Often they can be identified by matching projections from the wave structure of lower degree, but there can often be situations where two areas can be potential targets, both garnered from different wave degrees. Use of momentum can clarify these in the majority of instances.

It is still not the "Holy Grail." I even doubt that there is such a thing. There are still enough occasions where it is very difficult to identify the individual waves either due to exceptionally erratic price development or a rapid move in one direction that makes the identification of waves nigh on impossible. Extended trending moves are still a big challenge so there is still more work to do.

In Chapter 5, I have attempted to provide a practical approach to working with Harmonic Elliott Wave, highlighting some of the problems that arise and how to cope with or understand methods of recognizing when the analysis is going astray. This is extended in Chapter 6, which covers what I feel were a sequence of unfortunate calls in EURUSD. It may sound unusual to point out one's own pitfalls but analysis and forecasting is not a straightforward or simple matter. During much of the development in price I held the correct direction, but I made reversal calls at the wrong moments. One can try to ignore such events, but the manner in which these occurrences are handled is important in order to quickly get back

onto the right track. Chapter 6 is an attempt to provide some guidelines on how this may be done.

In this book I therefore offer my own observations; others more capable than I can add to the evidence I will present. I am convinced that changes need to be made and that they provide a much more reliable structural framework in which to forecast future price movements. Having worked with this approach for several years and slowly realized what adjustments need to be made in both price structure and wave relationships, I have found the changes invaluable in providing forecasts.

One final point I should make is that since I am a foreign exchange analyst, necessarily the working examples are from the foreign exchange market. However, I have been asked by subscribers to comment on other markets on occasion. On the first occasion I was uncertain whether my changes would actually apply in other markets. However, I have been pleasantly surprised with the results, and have dedicated a chapter to providing evidence from a range of markets that substantiates my methodology. The first non—foreign exchange markets to which I applied Harmonic Elliott Wave were the Dow Jones Industrial Index and gold. The initial wave counts were generated at the commencement of writing the book. By the time I came to completion these markets had progressed a long way and followed the anticipated structural progress implied by the original analysis. I have therefore extended the original analysis to demonstrate the accuracy of the adaptations made to Elliott's original principle.

Ian Copsey

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CHAPTER 1

R. N. Elliott's Findings: Impulsive Waves

RALPH NELSON ELLIOTT

Ralph Nelson Elliott was a distinguished businessman, an accountant whose career began at the age of 25 in 1896. He was a renowned organizer, fastidious in his approach, and over the following 25 years he rescued a number of distressed companies and brought them back into profitability. In 1924 he was appointed by the U.S. State Department as chief accountant for Nicaragua—then under the control of the United States—to reorganize the finances of the entire country.

However, in 1929 he became seriously ill with pernicious anemia, which kept him confined to his bed. It was at this time, while recuperating, that he studied stock market charts, examining price behavior across all time frames. It took over five years for him to draw his conclusions. In March 1935, as the Dow Jones Average closed almost at its lows, he published his findings by declaring that the index was making its final bottom. The accuracy of his findings was impressive, and they were published in his first book *The Wave Principle*. He followed up in the early 1940s with an addendum on

the application of the Fibonacci sequence of ratios to his findings on the structure of wave development.

This became known as the Elliott Wave Principle, and it is applied by what may be millions of traders around the world in today's markets. Before offering my modifications to this principle, I will present Elliott's findings and observations, which still remain the basis of what I consider the most accurate tool in forecasting markets.

The Wave Principle can be loosely separated into two basic market characteristic types: trends and consolidation (or correction). Elliott named the trending phase *impulsive* while the rest were classed as *corrective*. I shall reproduce these in full in order that the original theory is provided, as it still forms the basis of what is a brilliant example of observation and collation into a methodical tool that can be applied even to modern markets.

Those readers who are familiar with the principle may wish to move on to Chapter 3.

THE IMPULSIVE WAVE STRUCTURE

Elliott proposed that when price movements demonstrate an underlying trend, they will always develop in five distinct waves: three in the direction of the trend and two as corrections to the underlying trend (as shown in Figure 1.1). The three directional waves are labeled Waves 1, 3, and 5, and the corrective waves as Waves 2 and 4.

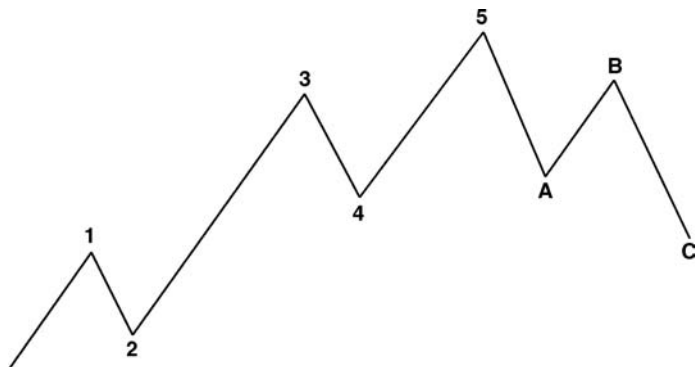


FIGURE 1.1 The Simple Wave Structure

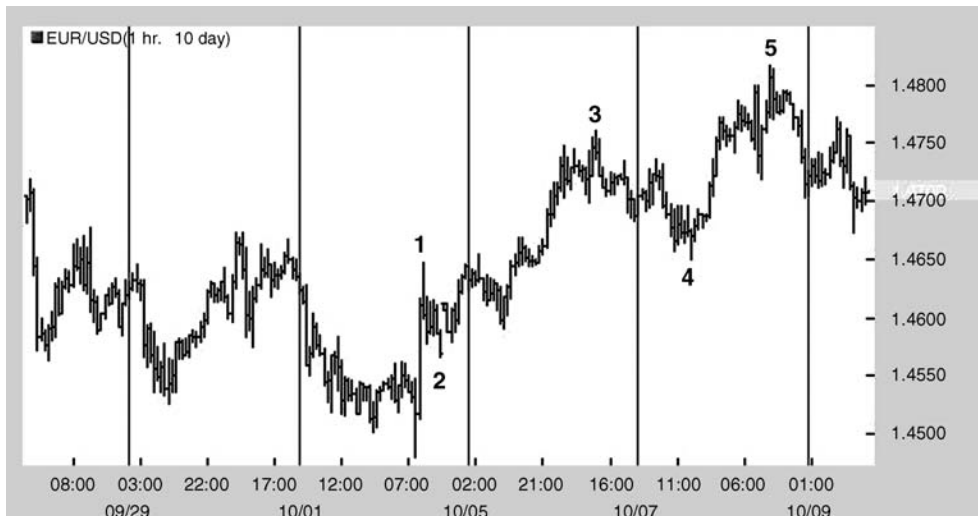


FIGURE 1.2 An Impulsive Wave in EURUSD

Source: FXtrek IntelliChart™ in collaboration with FX-Strategy.com Pro Charts™

The directional waves in a trend are normally referred to as *impulsive waves*. Once this five-wave sequence has been completed, a correction will be formed. While a fuller description of corrective waves will follow, for now I shall simply say that they develop in three waves and refer to these as Waves A, B, and C.

Figure 1.2 shows how a five-wave move would appear on a chart, the example being the hourly EURUSD chart.

Elliott's findings, which were observed over multiple time frames (daily, weekly, and monthly), were that waves are fractal. This meant that the basis of all movements, whether in five-minute charts or monthly, are intrinsically related as the shorter time frames form the building blocks for the larger time frames. This can be observed in the complex wave structure shown in Figure 1.3.

Thus, a simple five-wave move at the beginning of a new sequence will form a Wave (1) and the three-wave correction will then become Wave (2), followed by Wave (3), Wave (4), and Wave (5). Indeed, this larger five-wave move will form Wave [1] of the next higher degree, followed by a Wave [2].

Note: In a simple corrective move, Wave A and Wave C will consist of five waves due to the fact they are *counter-trending*

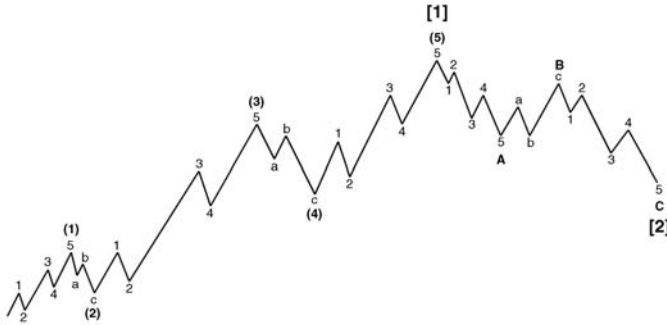


FIGURE 1.3 The Complex Wave Structure

moves. Wave B will always consist of three waves, or—as we will find later—a combination of three-wave moves.

Already it becomes apparent that where you see a five-wave directional move—with the exception of Wave 5—it will always be followed by another five waves.

Figure 1.4 shows how a complex five-wave decline would appear on a chart, the example being the daily GBPUSD chart.

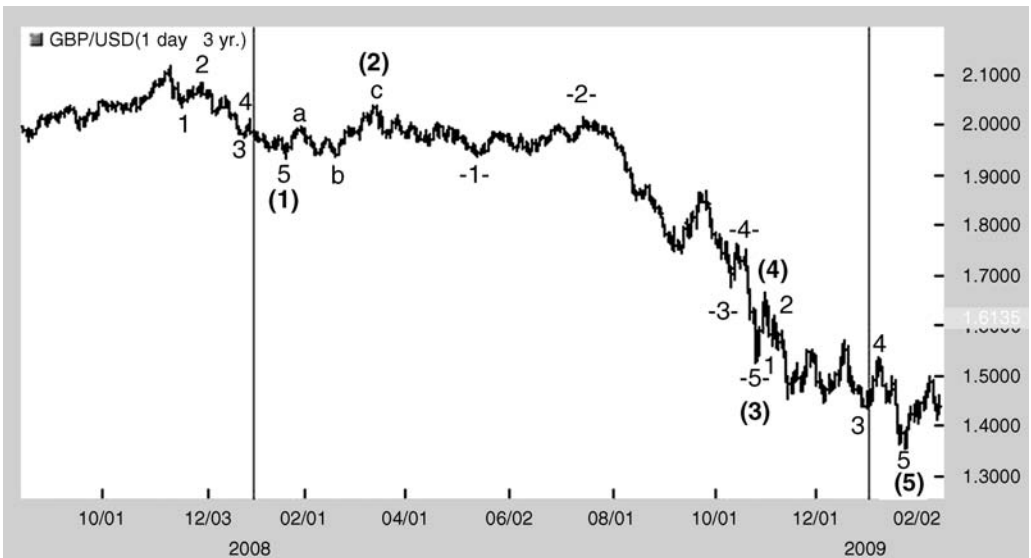


FIGURE 1.4 A Complex Impulsive Wave in GBPUSD

Source: FXtrek IntelliChart™ in collaboration with FX-Strategy.com Pro Charts™

Extended Impulsive Waves

Elliott also noted that impulsive waves had an occasional tendency to extend; he observed that there was more than a single set of impulsive waves in a trend (see Figure 1.5).

This is a simple concept, noting that the five waves constructing Wave (3) are made up of five waves of the same degree. This can perhaps be best described as saying that if this is a daily chart, then the five waves in Wave (3) are also visible and measurable in the daily chart rather than, say, the hourly chart. Of course, the impulsive waves 1, 3, and 5 will be composed of five waves themselves.

In addition to this, Elliott found that there were cases of multiple extensions (as shown in Figure 1.6).

Extended waves may occur in any of the three impulsive waves, but most commonly in a third-wave position which Elliott observed was generally the wave with the strongest risk of a powerful trending extension. Considering the often seen reversal which tends to begin with the market believing that another correction is developing—thus adding to positions in favor of the prior trend—it makes sense that the third wave is more often than not the stronger move as it begins with positions being unwound and fresh positions in the opposite direction being established.

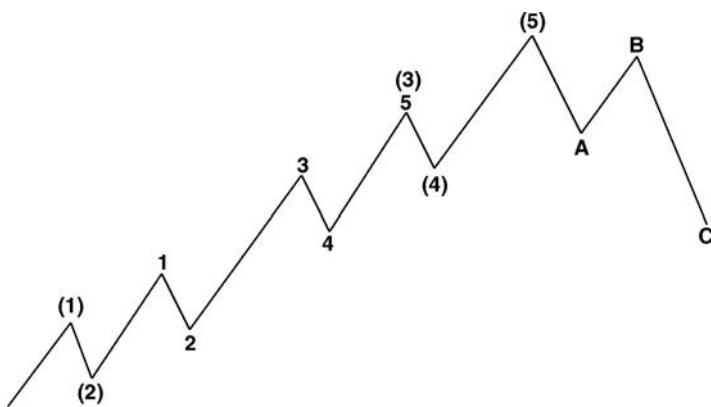


FIGURE 1.5 A Single Extended Impulsive Wave

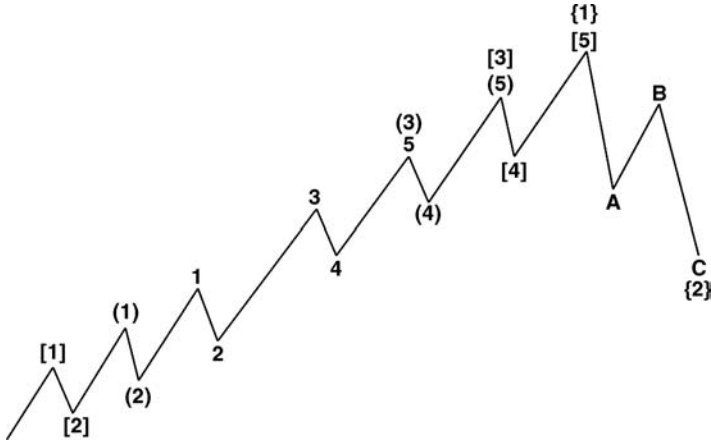


FIGURE 1.6 A Double Extended Impulsive Wave

Figure 1.7 displays an extended wave in the Wave (3) position.

There is always the question of when should we know when an extended wave is likely to occur. Sometimes it springs upon us quite suddenly and we are left scrambling to understand what is happening. I have always suggested that if there is any time where we may

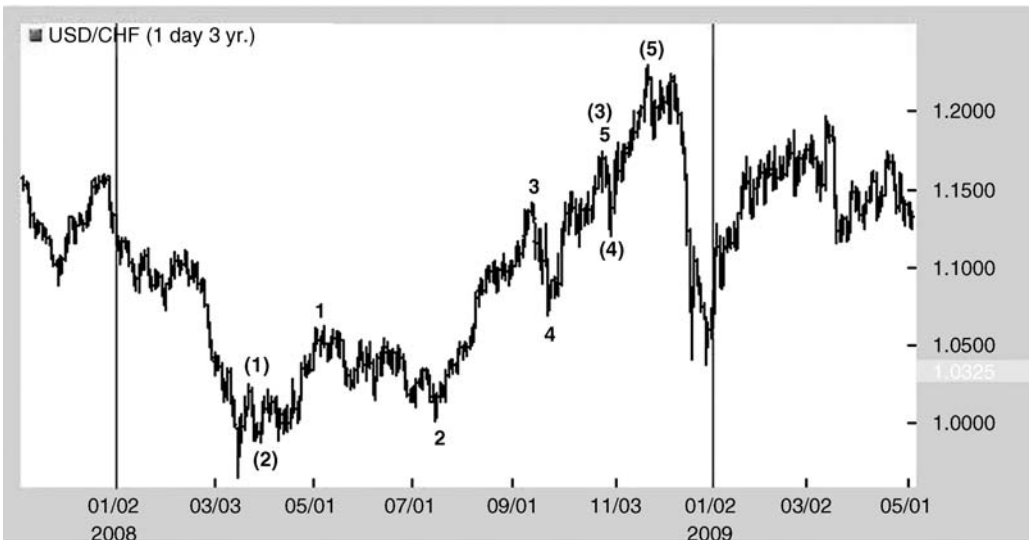


FIGURE 1.7 An Extended Wave in Daily USDCHF

Source: FXtrek IntelliChart™ in collaboration with FX-Strategy.com Pro Charts™

anticipate such a move then it must be that perhaps the final stalling area is one that can be determined from an extension of the prior wave structure. Perhaps we are looking at a five-wave move in Wave (C), and this has projections in a wave equality move around the end of Wave (5).

Later on I shall highlight why I now feel this is unlikely.

Wave 5 Position

Elliott noted a variety of ways a Wave 5 could develop. This of course included an extended Wave 5 that would look similar to Figure 1.8.

Again, the argument tends to be that our target is much higher, and since the normal extension ratios would not reach that target, we should be aware of the potential for an extended Wave (5).

Figure 1.9 displays a long rally in the weekly AUDJPY chart. Note that in this original Elliott method of counting, Wave (3) was extended and was followed by an extended Wave [5] of Wave (5). Clearly I disagree with this counting method, and will highlight this in Chapters 3 and 4.

Another potential Wave 5 is a Diagonal Triangle. Elliott noted that this has a different structure from a normal impulsive move,

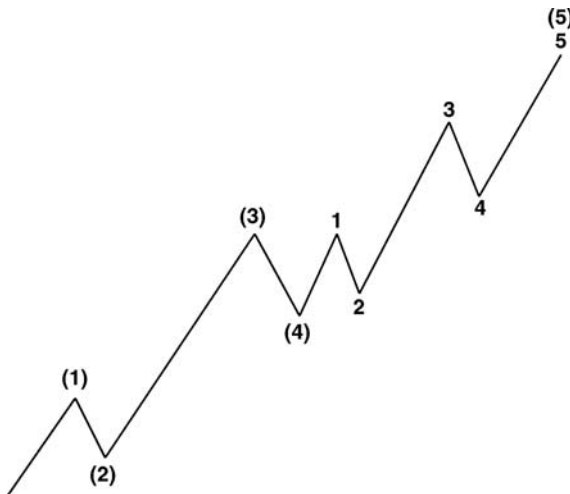


FIGURE 1.8 Extended Wave 5

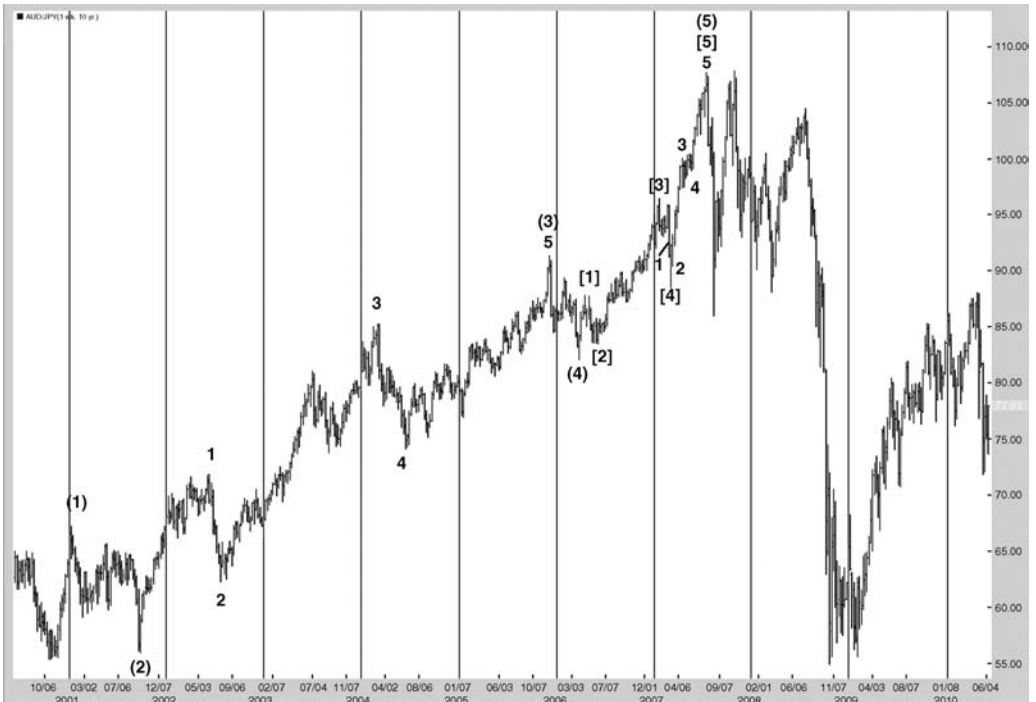


FIGURE 1.9 An Extended Wave in Weekly AUDJPY

Source: FXtrek IntelliChart™ in collaboration with FX-Strategy.com Pro Charts™

being constructed of five waves of three and commonly holding within a channel or within converging lines (as shown in Figure 1.10).

In traditional pattern analysis this is obviously nothing more than a wedge, but Elliott refined the expectations by detailing that there needs to be five waves, three in the direction of the underlying trend with two intervening corrective waves. In general, those that practice Elliott Wave tend to change the labeling to (i), (ii), (iii), and so on, to differentiate impulsive waves 1, 3, and 5 constructed of five waves with those constructed of three waves.

Figure 1.11 shows how a Diagonal Triangle Wave 5 wave rally would appear on a chart, the example being the five-minute EURUSD chart.

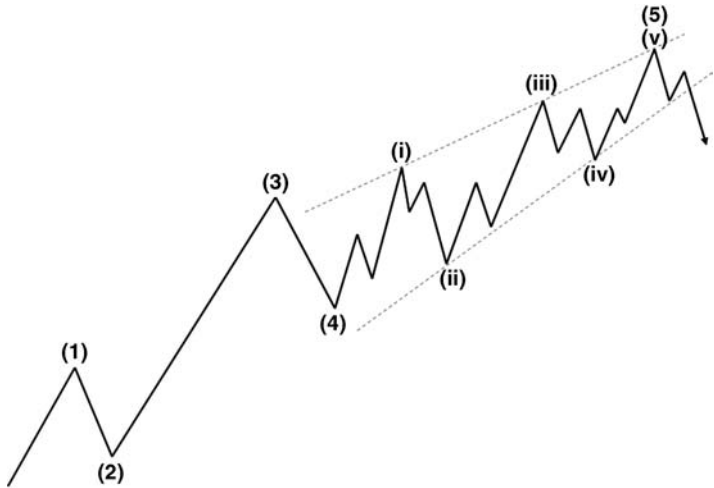


FIGURE 1.10 Diagonal Triangle Wave (5)

Elliott proposed that extended waves could appear in any of the three impulsive waves—that is, Waves 1, 3, or 5—but only one impulsive wave could be extended in any one sequence of five waves.

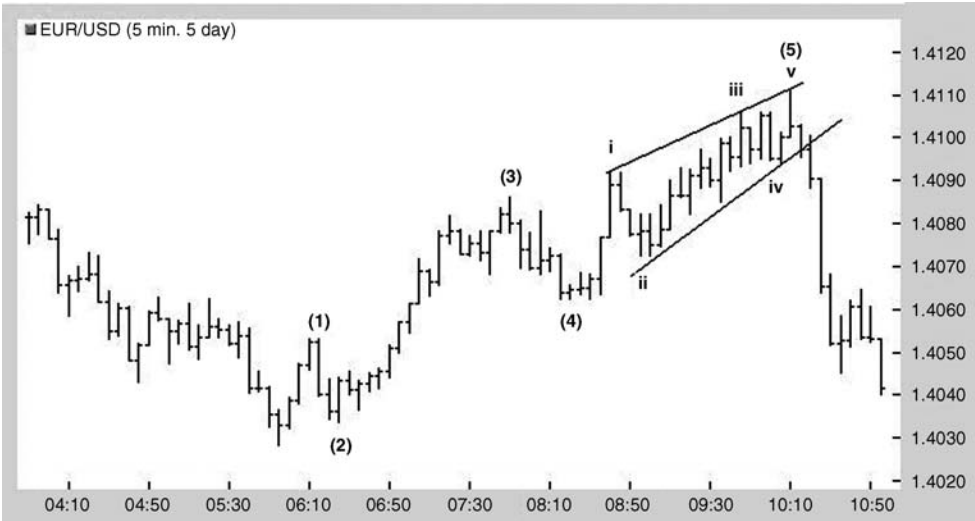


FIGURE 1.11 A Diagonal Wave (5) in the Five-Minute EURUSD Chart
Source: FXtrek IntelliChart™ in collaboration with FX-Strategy.com Pro Charts™

In my own findings I feel this is really a reflection of an alternative structure and was misunderstood. Later, through the use of detailed measurements of waves, I shall describe why I have come to this conclusion.

Failed Fifth Waves

Elliott noticed that on occasion Wave 5 fails to extend beyond the extreme of Wave 3 and generates a reversal directly (as shown in Figure 1.12).

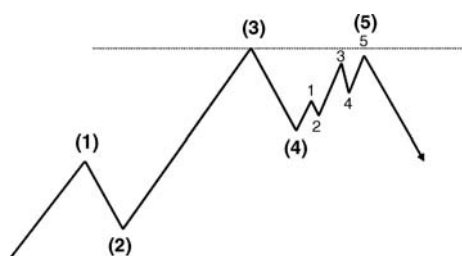


FIGURE 1.12 A Failed Fifth Wave

This has been in mainstream Elliott Wave counting, but from my own perception it is a convenient way to account for the loss of an extra anticipated move higher. I feel this actually indicates that the structure is incorrect. However, I shall discuss this later when explaining my findings.

Figure 1.13 displays two five-wave rallies, the first in Wave (A) with a distinct extended wave in Wave (3), while the second in Wave (C) has an extended Wave 5 of Wave (5). In Wave (5) the final Wave v of 5 appears to have developed as a failed fifth wave.

Again, I shall describe later in Chapter 4 why I feel this count is incorrect.

UNBREAKABLE RULES

Elliott detailed only three rules in the entirety of his findings, and all were confined to the actions of impulsive waves.