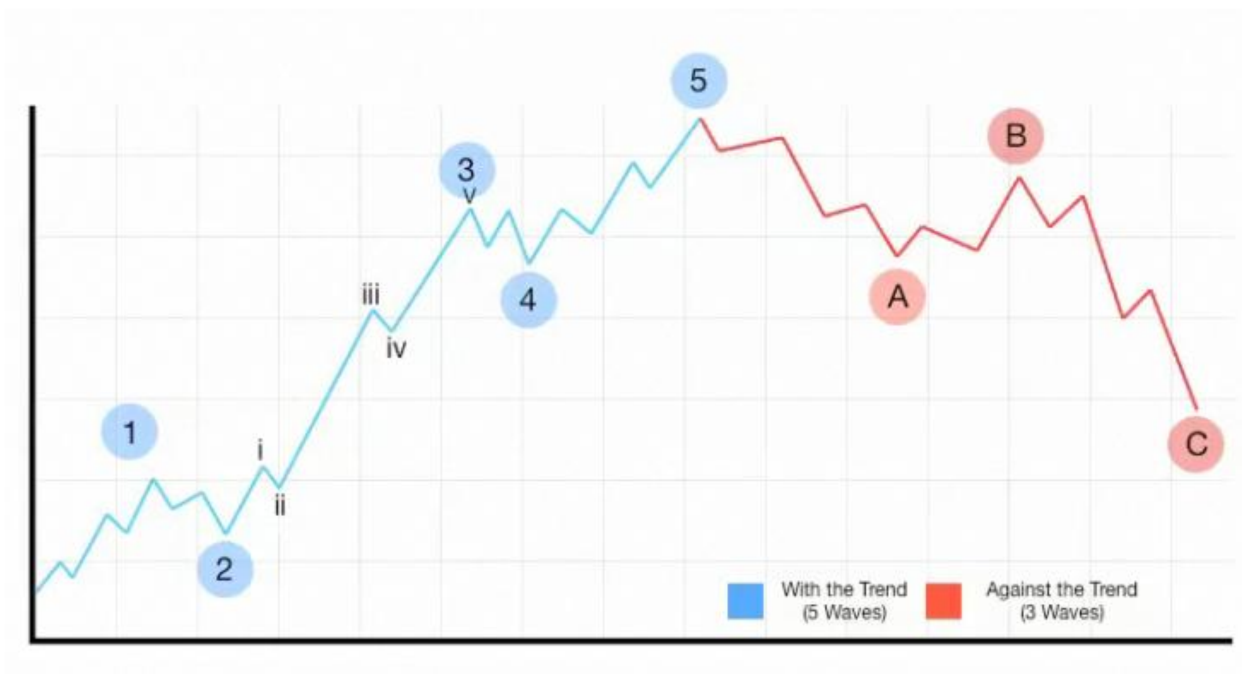
VIDEO ONE RECAP

Welcome to Elliott Wave trading Part Two, presented by Daily FX Education.

In part one we introduced the basic concept of Elliott Wave theory. We began with Ralph Nelson Elliott's discovery of the 5-3 wave pattern, which is the heart of Elliott Wave analysis. In the 5-3 pattern, 5 waves move in the direction of the larger trend, followed by 3 waves in the direction of the counter-trend. We expanded on that idea and discussed how markets are fractal, meaning the 5-3 pattern can be found across all time-frames.



To refresh your memory, notice how within wave 3 on this chart, there appears to be an even smaller 5 wave move in the direction of the larger trend. Additionally, in wave 4, there appears to be an even smaller 3 wave counter-move. We concluded the video by briefly touching on how to use Elliott Wave theory to recognize trading opportunities. But we really only scratched the surface.

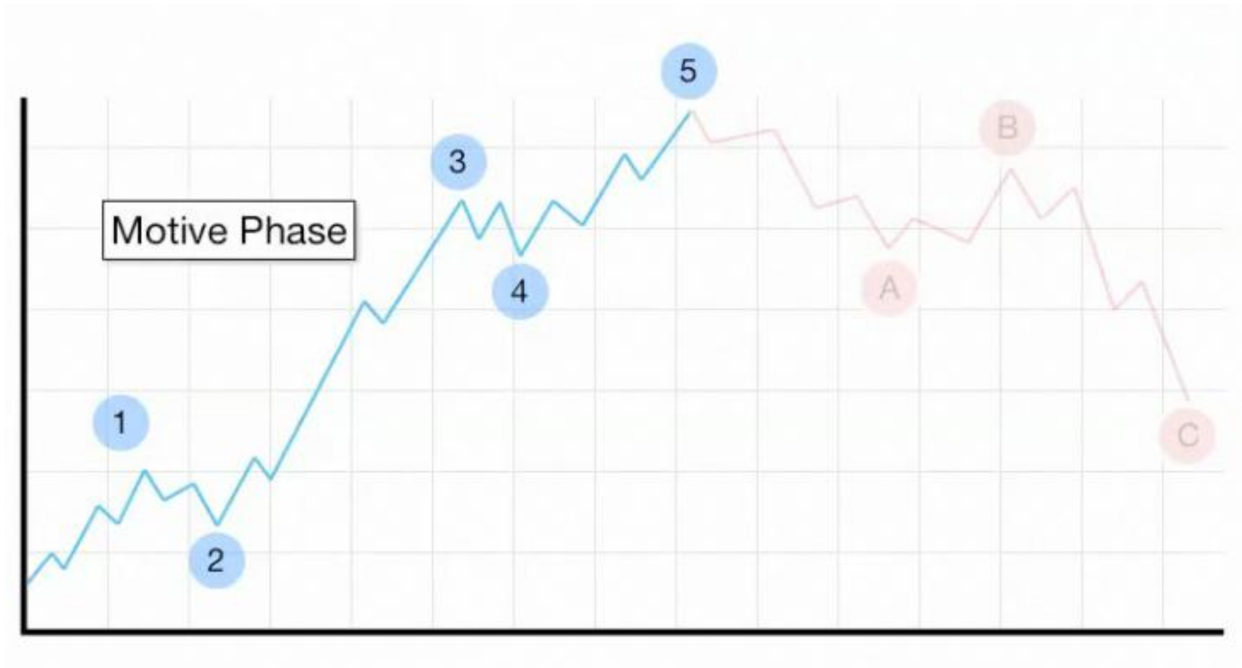
VIDEO TWO TOPICS

In this video, we're going to go beyond conceptually thinking about Elliott Wave and actually get into some of the finer details of the theory. We'll begin by establishing 3 cardinal rules that must always be met when labeling the 5 impulse waves that make up the motive phase of the wave cycle. If any of the rules are broken, the analysis will no longer be valid. After establishing our fundamental rules, we'll go over a number of guidelines that should also be incorporated into Elliott Wave theory whenever possible. You won't always be able to fit every guideline into your wave counts, but more often than not you'll find a number of them leading and guiding you through your trades.

After working out the technical details of Elliott Wave, we'll move on to application. The second half of this video will show you how to use the rules and guidelines to enter into high probability trades and manage them effectively. And finally, we'll conclude the video with a discussion of corrective wave patterns like zigzags, triangles and flats.

Now before getting into the rules and guidelines of Elliott Wave theory, I'd like to make a brief disclaimer. As popular as Elliott Wave theory is, it's a monster of a topic to learn. Think about it like learning a new language. It takes time, patience and lots of practice. Although I have little doubt that you'll quickly become enthralled by what Elliott Wave has to offer, you might also just as quickly become frustrated by the countless interpretations that traders give to wave counts and formations. So again, be patient. The important thing to remember is to move slowly. And never forget: rules are rules, so follow them. And guidelines are guidelines, so learn to watch for them.

Before defining the 3 cardinal rules that govern the impulse waves of the Elliott Wave cycle, it's probably best to first define the motive phase and a few other characteristics of the Elliott Wave cycle. From video one we explained the 5-3 wave pattern, which you can see on this chart. This 5 wave move in the direction of the prevailing trend is considered the motive phase.



The motive phase – because it is in the direction of the prevailing trend – is typically the phase that traders prefer to trade on. The corrective phase, which you can see here – labeled A, B and C – is often not traded on, as this phase moves counter to the prevailing trend. Additionally, waves 2 and 4 within the Motive Phase are considered corrective waves. Although they are a part of the Motive Phase, which moves in the direction of the prevailing trend, the waves themselves move counter to the trend. Therefore, we typically do not recommend trading these waves either. In most cases, the best trading opportunities arise from the impulse waves or waves 1, 3 and 5 of the motive phase. The rules and guidelines that we are going to cover now pertain to the impulse waves of the motive phase.

3 CARDINAL RULES TO EW

We'll begin with 3 cardinal rules that govern the motive phase of the Elliott Wave cycle.

Cardinal rule #1 states that wave 2 cannot retrace the entire price history of wave 1. To further clarify this rule, consider the following chart. Notice how the low price of wave 1 is **1.6073.**

When wave 2 completes, it only retraces a portion of wave 1's price territory, reaching a low of **1.6288**, which is higher than **1.6073.** Had wave 2 instead retraced even further, reaching a price below the low of wave 1, cardinal rule #1 would be broken and so too would the rest of our wave count.

Cardinal rule #2 states that wave 3 is never the shortest of the actionary waves, or waves 1, 3 and 5. Additionally, wave 3 is often the strongest wave, covering the most price territory. You can see from this chart that wave 3 is not the shortest wave.

Had it been the shortest wave, we could have quickly realized that our wave count was incorrect.

And finally, cardinal rule #3 states that wave 4 cannot retrace into the price territory of wave 1. You can see here that the high of wave 1 is represented by this line here. Additionally the low of wave 4 is higher than the high of wave 1.

If the low of wave 4 had instead fallen below the high of wave 1 then the cardinal rule would not be met and our wave count again would be incorrect.

To summarize, wave 2 cannot retrace 100% of wave 1, wave three cannot be the shortest of the impulse waves or waves 1, 3 and 5 and wave 4 cannot retrace into the price territory of wave 1. These are our cardinal rules for the impulse phase of the Elliott Wave cycle, and these rules must always be met for our wave counts to be valid.

EW GUIDELINES

Now let's move on to discuss some common guidelines that help identify entry points and areas to scale back or exit positions. Remember these guidelines will not always be satisfied and that's ok. However, they occur frequently in Elliot Wave counting, so watching for them can help optimize the way you trade with Elliott Wave.

The first guideline to watch for occurs on wave 2. Typically, wave 2 retraces 50-78% of wave 1. Remember the 1st cardinal rule states that wave 2 cannot fully retrace wave 1, but this guideline gets even more specific. By knowing that wave 2 typically retraces 50-78% of wave 1, we can use this to better time entry positions on a wave 3 trade. We'll cover this in greater detail a bit later.

The next guideline occurs on wave 3. Typically, the distance traveled by wave 3 is 1.618% of the distance traveled by wave 1. For example, if wave 1 covered 100 pips from its low price to its high price, then wave 3 typically will cover a distance of about 160 pips. This guideline can help determine a potential zone to scale back or exit positions.

The third guideline to discuss is that wave 4 generally retraces 38.2% of wave 3. Like the first guideline, this guideline too can better help us time an entry on a 5th wave trade. Again, we'll get into the specifics in a moment.

Finally, our last guideline is that wave 5 is typically equal to the length of wave 1. So if the distance from the high price of wave 1 to the low price of wave 1 were 200 pips, then the distance from the high price to the low price of wave 5 would likely also be around 200 pips. This guideline can also be used to determine potential targets on a wave 5 trade.

Now each of the guidelines we just mentioned included retracement or extension percentages. For example, we said wave 2 typically retraces 50-78% of wave 1 and wave 4 typically retraces 38.2% of wave 3. These percentages are not arbitrary numbers. In fact, the numbers are common Fibonacci retracement and extension percentages that are used all over the world of finance. Why these specific numbers are used will have to be left for another day but there is no doubt that the Fibonacci sequence of numbers plays a large role in developing the Elliott Wave theory.

Let's use the Fibonacci tool on the FXCM Marketscope charting package to help us recognize the guidelines we just discussed. Let's take a look at an example with the EUR/USD.

This daily chart has formed a 5 wave sequence completing the motive phase. Of course, in real time, we don't have this luxury.

We have to expect and anticipate each wave within the sequence as price action develops. But for our current purposes this will suffice. First, let's quickly confirm that the 5 wave count is correct by checking our 3 cardinal rules.

Let's first zoom in on waves 1 and 2. We can draw a horizontal line at the low of wave 1 and see that wave 2 did not retrace beyond the beginning of wave 1. Therefore, wave 2 has not retraced 100% of wave 1; so far so good.

Now let's zoom back out to see all five waves. We can see that wave **1** is in fact the shortest wave, meaning wave 3 is not. This satisfies our second rule.

Finally, drawing a horizontal line at the high of wave 1 allows us to verify that wave 4 did not move into the price territory of wave 1. So this wave count appears to be correct.

Now let's apply our guidelines to the same chart. To test the first guideline we'll need to use our Fibonacci tool from the low of wave 1 to the high of wave 1. I'm going to zoom in again on waves 1 and 2 so you can more clearly see this. You can see the Fibonacci lines are automatically calculated and placed on the chart. Using FXCM's Marketscope charts will do this for you automatically by using the Fibonacci tool. Next, we simply want to see where wave 2 ended or where wave 3 began. The first guideline suggests this often happens between the 50-78% retracement.

You can see from this chart that wave 2 concluded right between the 50-78% lines as the guideline suggested. So the first guideline was met.

Now we can check the second guideline. We won't use the Fibonacci tool here. We'll simply subtract the low of wave 1 from the high of wave 1. This tells us the number of pips covered over the course of wave 1. Again, let's zoom out to see the full picture. If we subtract the low price of 1.2455 **from the high price of** 1.3736 **this yields 1,281** pips. We can then multiply this by 1.618 to get a total of **1,640 pips.** We then need to add this to the low of wave 3.

This allows us anticipate that wave 3 will conclude around the **1.4527** price level. It doesn't look like wave 3 covered quite that much ground. So in this example, guideline two was not met.

Next let's check our 3rd guideline. To do this we use the Fibonacci tool from the low of wave 3 to the high of wave 3. Let's zoom in to wave three to get a better look. Again, the Fibonacci calculations are done automatically when using the Marketscope Fibonacci tool.

From our guideline we expect wave 4 will conclude around the 38.2% fib line and in this case, it looks like it did exactly that.

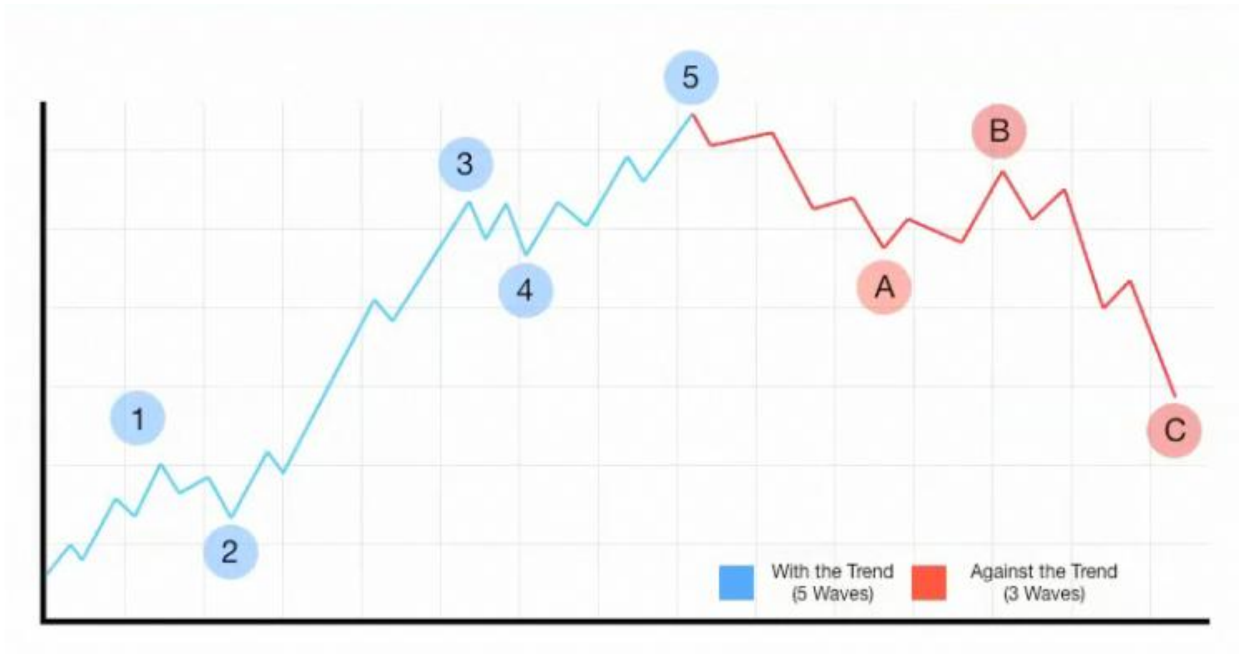
And finally, for our fourth guideline we use the calculation we already made from our second guideline. We know that wave 1 covered about **1,281** pips from its low price to its high price. Wave 5 started at a price of around **1.3747** and since we expect wave 5 to cover about the same amount of ground, we expect wave 5 to top out around the **1.5028** price level. This price is overshot just a bit, but only by about 100 pips. So this guideline too can be considered to be met.

This example illustrated several important facts about our guidelines. First, even by properly following the 3 cardinal rules, one of our guidelines was not met. Sometimes 2 or 3 of the guidelines might not be met. That's why they are called guidelines and not rules. But even more importantly, hopefully you saw the benefit these guidelines can provide when deciding when to enter and how to manage positions. If not, don't fret. That's exactly what we will cover in the next section of this video.

TRADING W/ EW USING RULES AND GUIDELINES

So let's apply what you have just learned to actual trading examples.

As you learned in video one, the foundation of Elliott Wave theory revolves around the 5-3 wave structure. The ability to accurately predict and identify this structure is required to effectively use Elliott Wave theory. However, when it comes to placing trades, traders often only trade on waves 3 and 5. Sometimes traders will attempt to time an entry at the beginning of wave 1, but this is often much more difficult than entering a position at the beginning of wave 3 or wave 5.



The primary reason waves 3 and 5 are so frequently used is because these waves move in the direction of the prevailing trend. This reduces some of the risk associated with the uncertainty of markets. Wave 1 moves in the direction of the prevailing trend as well. However, you often don't know that wave 1 has formed until after the fact. Due to our rules and guidelines it is often easier to forecast waves 3, and 5 so I am going to focus on these waves in this video.

WAVE 3 TRADE SETUP

Let's start by looking for wave 3 trading opportunities. For this trade setup we will take a look at a 60 minute AUD/USD chart as we look at a wave 3 trading setup.

On the left side of the chart I labeled the A, B, C corrective waves which followed a prior 5 wave move down. You can also see that I've labeled 5 waves with small roman numerals throughout the course of wave 1. This is actually how the smaller subdivisions within a wave are notated. So you can see within the wave 1 move down, there was a 5 wave sequence to complete the larger wave 1. Then we have a 3 wave, or lowercase a, b, c correction that forms the larger second wave. This is another example where we can point out the fractal nature of markets. As you look at a smaller and smaller time frame you'll notice that each wave can be broken down into smaller 5 or 3 wave moves.

Now this chart might look a bit complicated and on some levels it should. Remember, recognizing and properly labeling waves is not easy and will take time to master. It truly is an art rather than a science. But even here, you can see how these wave patterns are fairly recognizable to the eye. From this point, let's start checking our rules and guidelines.

For the sake of clarity let's remove all of the labels on the subdivisions as we're going to be trading off of the larger sequence. But keep in mind; if you're looking for shorter-term trading opportunities, or if you'd like to double check or get a bit more confirmation you're more than welcome to keep moving in on smaller and smaller time-frames, taking advantage of the fractal nature of markets.

Let's draw a horizontal line at the high of wave 2. This will allow us to check our first cardinal rule. It's clear that wave 2 did not retrace 100% of wave 1, which is good. Next, we can draw Fibonacci lines from the high of wave 1 to the low of wave 1.

Our first guideline suggests that price action is likely to turn around, with wave 3 starting around the 50-78% Fibonacci lines. I'll zoom in on wave 1 and 2 so we can clearly see where wave 2 ended. In this case, price action really appears to be flirting with the 50% fib line, which is not surprising. Even outside of Elliott wave analysis, the 38.2 and 50% fib lines usually act as pretty strong support and resistance.

Knowing what we now know, this is probably a good time to start looking for short entry opportunities, anticipating the beginning of wave 3. For even a bit more clarity and to help us locate a good entry opportunity, let's zoom back out and draw a trend line as well to see if it will act as further resistance as price action develops. Remember, with most trading strategies we look to sell at resistance and buy at support.

On the 11th of December, price action begins to fall. At this time, we have two options: 1) we can go short, assuming this is the beginning of the wave 3 move down or 2) we can wait for a bit more confirmation before entering. Let's take the conservative approach and see what happens. Over the course of about 2 days, the market falls a little over 100 pips but then starts retracing back upwards towards the resistance line.

Now we know that wave 3 can't be the shortest wave. So assuming our first two wave counts were correct, what just unfolded should not be waves 3 and four of the larger sequence. Instead, maybe it was waves 1 and 2 of a 5 wave sub-sequence that will make up the larger wave 3 move down. Now that's a lot of waves to talk about, so let's put some labels on this chart to get a better feel for what might be unfolding.

Let's put a Roman numeral one here and a roman numeral two here. Now what I like about this trade setup is that my original intensions were to go short on the larger wave 3, trying to catch this move down. I decided to be conservative and not get in here and by doing so it appears that sub-waves 1 and 2 of the larger wave 3 move down have formed. So, if I decide to go short now, I am actually going short at the beginning of two wave 3s. Wave 3 of this sub-wave sequence which is a part of the larger wave 3 move I was originally looking for.

This is one of the reasons I chose this chart. I wanted to clearly illustrate the fractal nature of markets and show you how you can use this characteristic to your advantage when locating trading setups. Instead of entering blindly, we can wait for sub-wave 2 to bounce off of the resistance line. This happens on the 14th of December. After going short, the market quickly sells off moving in our direction.

The last thing I'd like to talk about with this example is where to set your stops and where to set your limits. When trading wave 3, it is often good practice to place your stop just beyond the beginning of wave 1. The reason being, if the market turns against you and ends up moving to or beyond the opening price of wave 1, then our 1st cardinal rule is broken and we don't want to be in this trade any longer because it means our wave count was incorrect.

As for the limit, we do recommend looking for at least a 1:2 risk to reward ratio or better. But we can go a step further with this. We can use our second guideline to try and optimize our exit strategy. As price action develops, we'll want to closely monitor the wave patterns that form and look to exit once wave 3 moves about 1.618% of the distance traveled by wave 1.

Another benefit to trading wave 3 is that wave 3 is typically the largest and strongest wave. This typically allows for good opportunities to move up your stop through the trade as well, locking in profits.

WAVE 5 TRADE SETUP

Now let's explore trading the 5th wave.

Here we have a daily chart of the GBP/JPY. Let's assume it is around the beginning of April, here, when the GBP/JPY begins to slow its upward trajectory after making a strong move up, which started in January. It appears to me that a nice trading opportunity is developing, but let's adds a few technical tools to gain a clearer picture.

First, let's add support line. This support line here appears to have been holding up quite well. Because of this, we'll want to keep an eye on price action that develops around this line. There is a good chance that it will continue to provide support. We can also add a MACD indicator to this chart to try and keep an eye on price momentum. Notice how the MACD indicator turned from sharply negative territory in January to quite positive territory the following few months. This makes sense as price action made a strong move up during this time as well. However, right now the indicator appears to be flattening out and maybe even setting up for a MACD crossover below the signal line. We'll come back to this in a moment.

Let's go over our Elliott Wave rules and guidelines. It looks to me like wave 1 ended here, with wave 2 ending here. The bottom of wave 1 does not go beyond the beginning of wave 2, so our first cardinal rule is satisfied.

Additionally, if we draw fib lines from the low of wave 1 to the high of wave 1, we can test the retracement of wave 2. It looks to me like wave 2 retraced a little over 50% of wave 1. This fits perfectly into our 1st guideline.

The way price action has developed in this area, and knowing that the 3rd wave cannot be the shortest wave, I feel pretty confident that wave 3 has probably ended here.

And without actually calculating how far wave 1 moved, it does appear to me that wave 3 covered at least 1.5X the distance that wave 1 covered. So our second guideline appears to be inline as well.

At this time, I'm going to start looking closely for a wave 5 trading opportunity. To prepare, let's get an idea of where wave 4 is likely to end. To do that need to draw Fibonacci lines from the low of wave 3 to the high of wave 3. Based on our third guideline, wave 4 is likely to end around the 38.2% fib line, which is around 142.06. Around the 20th of April, prices begin to fall.

Now at this time we have two options. We can be a bit aggressive and simply decide to go long because wave 4 price action reached the 38.2% fib line or we can take a more conservative approach. The reason I consider entering at the 38.2% fib line to be a bit more aggressive is simply because the 50% fib line can also provide strong support as well. And remember, guidelines are guidelines. They aren't always met. So if we do decide to enter at the 38.2% fib line, we should at the very least be prepared for prices to possibly push further towards the 50% fib line before turning. Also, our trend line has been holding up pretty well for some time. So we probably want to keep an eye on price action as it moves towards the trend line and see if that coincides with the 38% or 50% fib line. From what I see right now it looks a little more likely that it will head toward 50%.

With this trade, we'd likely be placing our stop right at the high of wave 1, to make sure cardinal rule number three is not broken. Wave 1 tops out around the 137.20 price level which is lower than both the 38.2 and 50% fib lines. Therefore, both the aggressive and the conservative trades should play out. But the aggressive trade has room for a larger loss and not quite as much profit potential. The conservative entry has more room for gains and less room for loss but also has a chance that price action never reach its entry price.

I'm typically a fairly conservative trader, so I'm going to walk you through the conservative entry. For four days price action is not able to close below the 38% fib line. I'll be honest, if I were actually trading this setup I'd be getting pretty anxious. Maybe wave 5 is underway? The 38% fib line is acting as pretty strong support. But I want to stay consistent in my approach. I had a valid reason for not wanting to enter at this price and I'm going to stick with it. Also, notice how the MACD line has crossed below the signal line and is heading south. I'm convinced the GBP/JPY has a little more room to fall.

Over the next few days, price action finally breaks down to touch the 50% fib line, right near support. And even better, the candle that pierced the 50% fib line is a hammer. I want to make sure the hammer formation completes, so let's wait to enter on the open of the next candle at about 141.10.

As I previously mentioned, with this trade a good stop placement would be right at the high of wave 1. However, you could also place your stop just below the support line if you're looking for a tighter stop.

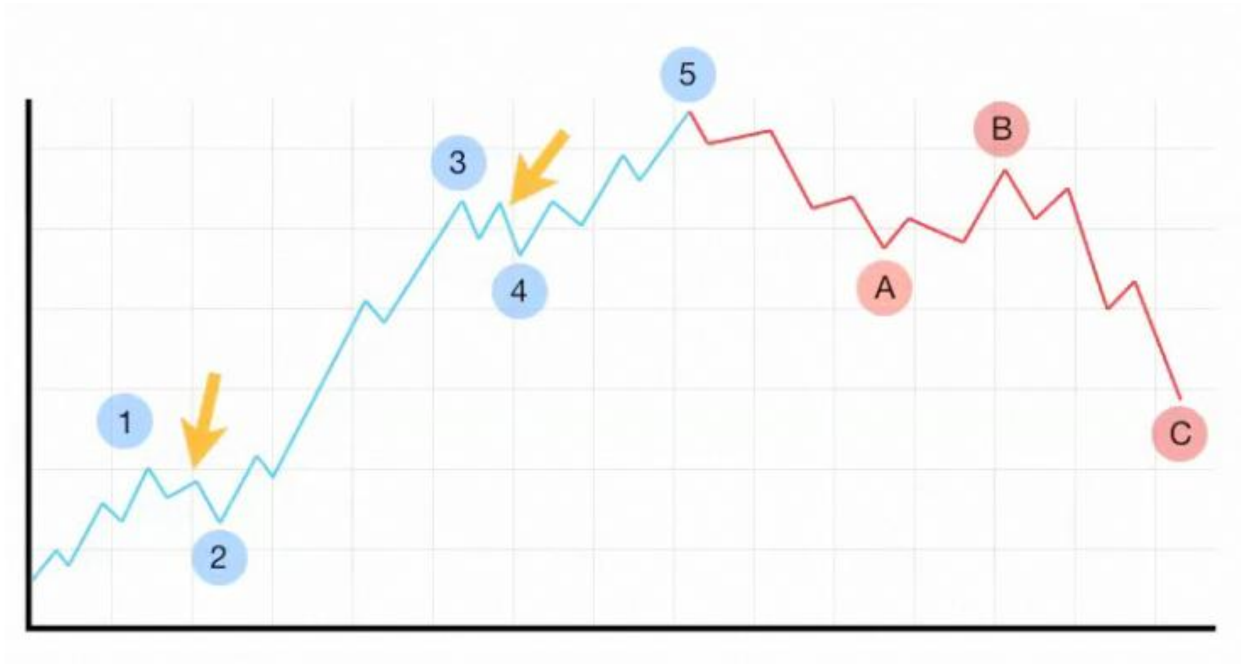
You don't allow yourself as much wiggle room but you will reduce the overall risk on a trade. Do to the unpredictable nature of markets, I prefer to give myself as much breathing room as possible without compensating the risk to reward ratio that I want to work with.

The last step we need to consider is where to take profits. It's best to try and pick up at least twice as many pips as you're risking with your stop. But it might also be wise to consider the 4th guideline we discussed earlier. Wave 5 typically covers about as much ground as wave 1. So we can use this relationship to try to further optimize our exit. Wave 1 covered about 1,797 pips. Projecting this on the low of wave 4 yields a target price of 158.77. If we bring in the rest of this charts price history, we can see that prices did find some strength that pushed prices well beyond the wave 3 high and finally reached our target of 158.77.

Before concluding this section on trading wave3 and wave 5, I'd just like to remind you not to forget to use the fractal nature of markets to your benefit. Sometimes it is helpful to zoom in to a smaller time frame to get an even clearer picture of how a 5-3 wave pattern is setting up. Wave counts in general are not always easy to label accurately. There is certainly a bit of guesswork involved with labeling wave counts. But using multiple time-frame analysis and the fractal nature of markets can be helpful.

CORRECTIONS

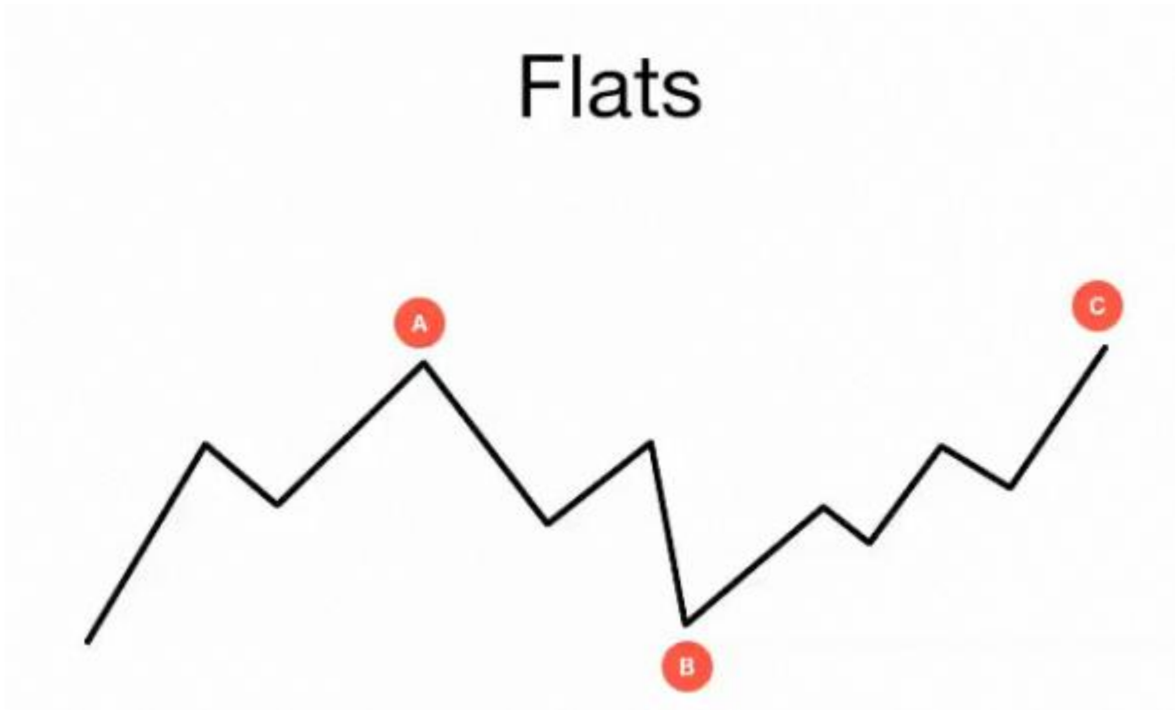
Up to this point, we have been focusing on impulse waves 3 and 5 of the motive phase, where the rules are clear and guidelines are helpful. However, following an impulse wave is always a correction.



Wave 2 and wave 4 are corrective waves within the motive phase. Additionally, when considering our basic 5-3 wave pattern, at the conclusion of waves 1-5, or the motive phase of the Elliott wave cycle, we noted that waves A, B and C form in the counter trend direction. This is the corrective phase. Although we do not recommend entering trades during the corrective phase or during corrective waves, it does make sense to conclude with a brief discussion of corrective waves. The reason we recommend not trading the corrective waves is that the counter trend moves tend not to be as clear and they are much more difficult to forecast. If you stick with the rules and guidelines provided earlier in this video on trading wave 3 & 5, then you have a basis for trading with EW analysis and a great place to start.

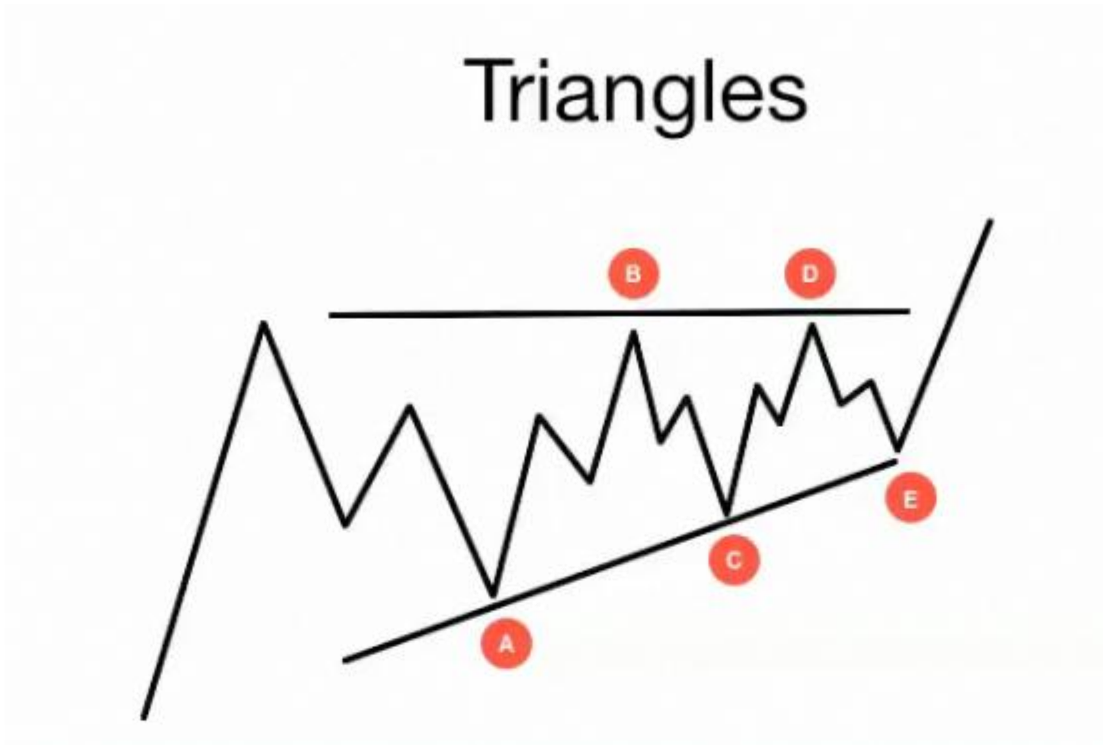
Corrective waves are a portion of Elliott Wave theory that should really be mastered after you have mastered the basics. In the remainder of this video, we'll briefly introduce 4 general categories of corrective patterns and show you what they typically look like. The 4 general categories are: zig zags, flats, triangles, and combinations. Let's first take a look at zig zags.

A zig zag is a 3 wave correction shaped just like the name implies. Its price action appears to zig zag against the prevailing trend. You might also say it looks somewhat like a lightning bolt. In a zig zag, wave A will form through a 5 wave pattern. Wave B will form through a 3 wave pattern and wave C will form through a 5 wave pattern as well. The top of wave B will be noticeably lower than the start of wave A. And typically, wave B will never retrace more than 75% of wave A. And finally wave C will always make new lows beyond the end of wave A.



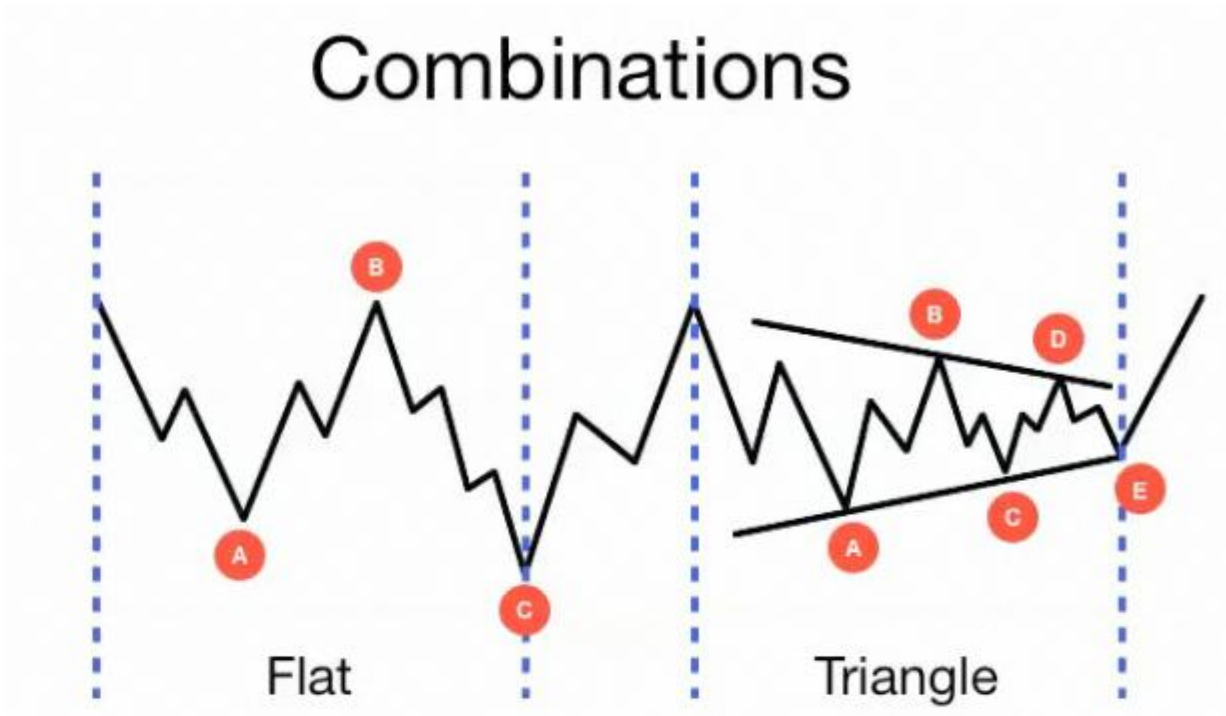
A flat is a 3 wave correction that differs from a zig zag in that the tops and bottoms of each wave are roughly equivalent. Also, instead of a 5-3-5 combination, with flats you typically get a 3-3-5 combination instead. Since this pattern does not retrace as deeply, wave B tends to end near the start or slightly exceeds the start of wave A. Then wave C will generally have a push taking it to or just beyond the end of wave A. This results in sideways action that you see in most ranges. Wave 4 of the motive phase tends to sport a fairly shallow retracement, which often causes flats to occur in the wave 4 positions.

Triangles are 5 wave corrective patterns, labeled a-b-c-d-e, where you have a balanced push between bulls and bears which create sideways movements. As this push wears on, you typically see the volume and volatility decrease as both sides become exhausted.



This sideways movement tends to create a shallow retracement. As such, triangles frequently appear in the 4th wave position.

Finally, we have combinations. Combinations, also considered complex corrections, appear when you mix and match the above corrective patterns. For example, you can have a double zig zag where you have two zig zags consecutively.



Combination patterns are going to be divided by any 3 wave move. In a rare form, complex corrections can take place in triples where you have 3 corrective patterns lined up consecutively. As you can imagine, the various possibilities of single, double, and triple patterns can make forecasting corrective waves very difficult. I would encourage you to be aware of the patterns, and not spend too much time trying to forecast or trade these corrections.

CONCLUSION

This concludes our second video on Elliott Wave analysis. You now have quite a bit of information to work with as you develop a solid Elliott Wave trading strategy. You should now have a deep understanding of the 5-3 wave pattern – made up of a motive phase and a corrective phase – which should be the building blocks to your strategy. Of course it will be highly necessary to consult the 3 cardinal rules and keep in mind common guidelines we discussed as well. Most importantly, I cannot stress enough, that truly learning to trade with Elliott Wave effectively will take time. So be patient but also have fun.

We hope you found this video helpful and we encourage you to attend one of our live webinars on Elliot Wave with one of our course instructors. In the webinar, instructors will relate what you have learned here to current market and trading conditions including some patterns that may be in the process of forming right now. Instructors will field live Q&A on the topic of Elliot Wave.

Thanks for watching this video and good luck with your trading.