

MARCH 2002 — SEPTEMBER 2004

TRADER'S CLASSROOM COLLECTION

LESSONS FROM *FUTURES JUNCTURES* EDITOR JEFFREY KENNEDY



THE TRADER'S CLASSROOM COLLECTION

Lessons from *Futures Junctures*

Editor Jeffrey Kennedy

Published by

Elliott Wave International

www.elliottwave.com

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For information, address the publishers:

Elliott Wave International

Post Office Box 1618

Gainesville, Georgia 30503 USA

www.elliottwave.com

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The Elliott Wave Principle is a detailed description of how markets behave. The description reveals that mass investor psychology swings from pessimism to optimism and back in a natural sequence, creating specific patterns in price movement. Each pattern has implications regarding the position of the market within its overall progression, past, present and future. The purpose of this publication and its associated service is to outline the progress of markets in terms of the Elliott Wave Principle and to educate interested parties in the successful application of the Elliott Wave Principle. While a reasonable course of conduct regarding investments may be formulated from such application, at no time will specific recommendations or customized actionable advice be given, and at no time may a reader or caller be justified in inferring that any such advice is intended. Readers must be advised that while the information herein is expressed in good faith, it is not guaranteed. Be advised that the market service that never makes mistakes does not exist. Long-term success in the market demands recognition of the fact that error and uncertainty are part of any effort to assess future probabilities.

Please note: In commodities, continuation chart wave counts often are not the same as the daily chart wave counts. This can be because different crop years are represented on each chart, or simply because a daily chart begins its life much higher than the current month to reflect carrying charges (or even much lower because a near term "shortage" is not expected to last until it becomes the lead contract). Of course, what happens on the nearby daily chart does have to make sense within the context of what is unfolding on the continuation charts.

Preface

In 1999, Bob Prechter asked me to edit *Monthly Futures Junctions*, a brand new service designed to find and recommend the best opportunities in commodity markets. I accepted the role and immediately loved it. Like many analysts, I love the challenge of finding the clearest wave patterns among dozens of markets. But I soon found myself needing to scratch another itch – teaching.

I began my career as a small trader, so I know firsthand how hard it can be to get simple explanations of methods that consistently work. In more than 10 years as an analyst since then, I've learned many lessons, and I don't think that they should have to be learned the hard way. That's why I decided to start writing Trader's Classroom sections for *Monthly Futures Junctions*. The response has been great.

Now, I'm pleased to present The Trader's Classroom Collection, a selection of my favorite columns from the past two years of *Monthly Futures Junctions*. I hope that the following lessons will give you some insights into analysis and trading that you won't find anywhere else. Keep in mind that the collection is not designed to be a comprehensive course or to replace essential Elliott wave resources but should be used in conjunction with the Wave Principle.

If you enjoy reading these lessons, check with us periodically for updated editions of this collection. I have many more lessons left to teach, and I will be offering new Trader's Classrooms in each issue of *Monthly Futures Junctions*.

Finally, I'd like to thank Pam Kimmons, David Moore and Clint Welsh for their help in putting this collection together.

Welcome to the Trader's Classroom,

A handwritten signature in black ink, appearing to read 'JK', with a long, sweeping flourish extending to the right.

Jeffrey Kennedy

Elliott Wave International

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NOTE: Dates listed indicate the original date published in *Monthly Futures Junctions*.

I. How To Make Yourself a Better Trader

1. Define Yourself: What Kind of Trader Are You?

As a trader, it is imperative that you define your approach to the markets. For instance, do you follow the trend or do you like to play breakouts? Are you a commodity trader or an index trader at heart? What's your trading time frame, five minutes or five weeks? Moreover, how do you analyze markets, fundamentally or technically? Do you prefer using a black box type trading system or making your own calls?

My trading style is to trade with the trend. Specifically, I like to buy pullbacks in uptrends and sell bounces in downtrends. My markets are commodities, and my time frame is three to five days. If I catch a trade that has some legs to it, and it lasts a little longer, that's fine with me. Bottom line, though, I'm a take-the-money-and-run kind of guy. This is who I am as a trader.

In addition to the Wave Principle, I include basic chart reading and bar patterns in my analysis. While I do use a few select technical studies in arriving at my decisions, I have always believed that "price" is the ultimate indicator and that everything else is secondary.

Remember, success in trading comes from the consistent application of a proven methodology. If you don't define your methodology, then your trading style could change with each new issue of Stocks and Commodities magazine. Trying a variety of analytical techniques rather than consistently following one is a problem for traders, and it's also a great way to lose your trading account.

[September 2004]

2. Why Emotional Discipline is Key to Success

To be a consistently successful trader, the most important trait to learn is emotional discipline. I discovered this lesson the hard way – trading full-time a few years ago. I remember one day in particular. My analysis told me the NASDAQ was going to start a sizable third wave rally between 10:00-10:30 the next day... and it did. When I reviewed my trade log later, I saw that several of my positions were profitable, yet I exited each of them at a loss. My analysis was perfect – it was like having tomorrow's newspaper today. Unfortunately, I wanted to hit a home run, so I missed hitting singles and doubles.

I now call this emotional pitfall the "Lottery Syndrome." People buy lottery tickets to win a jackpot, not five or ten dollars. It is easy to pass up a small profit in hopes of scoring a larger one. Problem is, home runs are rare. My goal now is to hit for singles and doubles, so I don't let my profits slip away.

Since learning that lesson, I've identified other emotional pitfalls that I would like to share. See if any of these descriptions sound familiar.

1. Inability to Admit Failure

Have you ever held on to a losing position, because you "felt" that the market was going to come back in your favor? This behavior is the "Inability to Admit Failure." No one likes being wrong, and for traders, being wrong usually costs money. What I find interesting is that many of us would rather lose money than admit failure. I now know that being wrong is much less expensive than being hopeful.

I. *How To Make Yourself a Better Trader*

2. *Fear of Missing the Party*

Another emotional pitfall that was especially tough to overcome is what I call the “Fear of Missing the Party.” This one is responsible for more losing trades than any other. Besides encouraging overtrading, this pitfall also causes you to get in too early. How many of us have gone short after a five-wave rally just to watch wave five extend?

The solution is to use a time filter, which is a fancy way of saying, wait a few bars before you start to dance. If a trade is worth taking, waiting for prices to confirm your analysis will not affect your profit that much. Anyway, I would much rather miss an opportunity than suffer a loss, because there will always be another opportunity.

This emotional pitfall has yet another symptom that tons of people fall victim to – chasing one seemingly hot market after another. For instance, because metals have been moving the past few years, everyone wants to buy Gold and Silver. Of course, the worst time to get into a market is usually when everyone is talking about it. To avoid buying tops and selling bottoms, I have found that it’s best to look for a potential trade where (and when) no one else is paying attention.

3. *Systems Junkie*

My own biggest, baddest emotional monster was being the “Systems Junkie.” Early in my career, I believed that I could make my millions if I had just the right system. I bought every newsletter, book and tape series that I could find. None of them worked. I even went as far as becoming a professional analyst – guaranteed success, or so I thought. Well, it didn’t guarantee anything really. Analysis and trading are two separate skills; one is a skill of observation, the other is a skill of emotional control. Being an expert auto mechanic does not mean you can drive like an expert, much less win the Daytona 500.

I am not a psychologist or an expert in the psychology of trading. These lessons are just a few I’ve learned along the way... at quite a cost most times. But if you are serious about trading, I strongly recommend that you spend as much time examining your emotions while you are in a trade as you do your charts before you place one. What you discover may surprise you.

Recommended reading: “The Disciplined Trader” and “Trading In The Zone” by Mark Douglas

[February 2004]

II. Six Ways the Wave Principle Helps Traders

1. *Elliott wave analysis identifies the trend.*

Elliott wave analysis is based upon two types of wave development: impulsive and corrective. An impulsive wave, or five-wave move, identifies the direction of the larger trend. For example, a five-wave advance identifies the trend as up. Conversely, a five-wave decline determines that the trend is down. As traders, we always want to trade in the direction of the trend; we want the wind at our backs. Why? Trading in the direction of the trend is like taking the path of least resistance. Simply put, the probability of success is much greater if you are long Corn (or any other commodity) and the daily and weekly trends are up.

2. *Elliott wave analysis identifies countertrend moves within the trend.*

A corrective wave is a response to the preceding impulse wave and goes against the trend. Corrective waves typically subdivide into only three waves. As traders, these countertrend moves or corrections present an opportunity to position ourselves in the direction of the overall trend of a market.

3. *Elliott wave analysis also identifies upcoming changes in trend.*

Elliott waves are fractal in nature: the impulsive legs of a five-wave move comprise smaller five-wave moves. Knowing this enables a trader to identify the maturity of the current progression. For example, if prices are advancing in wave 5 of a five-wave advance, and wave 5 has already completed three or four smaller waves, we know that this is not the time to be adding long positions. Instead, this information would let us know that some profit taking is in order or that protective stops need to be raised.

4. *Elliott wave analysis confirms the resumption of the trend.*

Typically, countertrend moves unfold in three waves, A-B-C. When price action exceeds the extreme of wave B, the previous pattern is confirmed as a three-wave structure, implying that the larger trend has resumed. A move past the extreme of wave D of a contracting triangle also confirms the resumption of the uptrend.

5. *Elliott wave analysis provides high probability objectives.*

When R.N. Elliott wrote Nature's Law, he specifically stated that the Fibonacci sequence was the mathematical basis for the Wave Principle. And as time has proved, he was right. Elliott waves, both impulsive moves and corrections, adhere to specific Fibonacci proportions.

6. *Elliott wave analysis provides a built-in mechanism for changing one's mind.*

Where are you wrong? This seems to be the eternal question for traders. At what price is a stock or commodity bullish or bearish? Is a move through 1500 bullish in Cocoa? If so, what about 1501 or 1499? I am aware of very few analytical methodologies that can tell you to the tick when a trade has gone awry or if a new trend is beginning. The three cardinal rules of the Wave Principle (listed below) provide such guidance.

Cardinal Rule 1: Wave 2 can never retrace more than 100% of wave 1.

Cardinal Rule 2: Wave 4 may never end in the price territory of wave 1.

Cardinal Rule 3: Out of the three impulse waves 1, 3 and 5, wave 3 can never be the shortest.

[December 2003]

III. How the Wave Principle Fits Certain Trading Styles: Corrective Patterns

So how does the Wave Principle fit into my trading style? Simple. R.N. Elliott's work on corrective wave patterns allows me to identify countertrend moves within trending markets. Because I'm familiar with these patterns and characteristics, I can determine the most likely points where and when countertrend moves will end. The more you familiarize yourself with corrective wave patterns, the closer you are to being in the right place at the right time when the larger trend resumes.

That said, familiarizing yourself with any kind of wave pattern only helps if you can recognize it as it unfolds in real time. In my early years as an Elliott wave student, I relentlessly memorized all the wave patterns diagrammed in Frost and Prechter's *Elliott Wave Principle: Key to Market Behavior*. But when I looked for similar patterns on price charts, I had difficulty seeing them, because my eyes were trained to see line diagrams rather than real-world wave patterns. So in this review of corrective wave patterns, I am giving you the textbook line diagrams, along with some examples of real-world price charts.

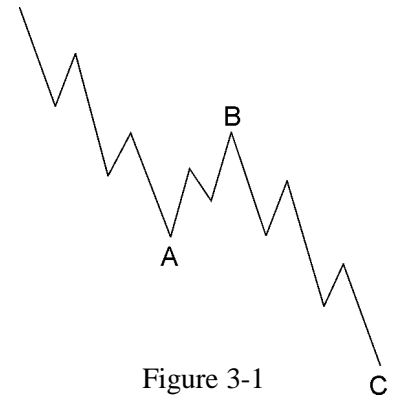


Figure 3-1

1. Zigzags

Figure 3-1 shows a single zigzag wave pattern in a bull market. Wave A subdivides into five waves, wave B three waves and wave C five waves. That's why Elliotticians commonly refer to waves A, B and C in a zigzag as a 5-3-5 pattern. In a bear market, this pattern would appear inverted as a three-wave advance. That's what you can see in Figure 3-2 (Wheat) – a single zigzag as a three-wave advance within a larger downtrending market. As you can see, I have drawn solid lines to highlight waves A, B and C.



Figure 3-2

Zigzags most often occur as a single wave pattern, but occasionally I observe double and even triple zigzags. In Figure 3-3 (Wheat), I have outlined the waves within a double zigzag. The proper notation of this pattern is (W)-(X)-(Y) because it indicates the actual degree of impulsive subdivisions of each pattern. However, I still prefer the old-school practice of simply using A-B-C-X-A-B-C, which is also shown in Chart 2.

Another example of a zigzag is evident in Figure 3-4 (Live Cattle). Here, you'll see that wave B took the shape of a contracting triangle. At first glance, this may seem a little complicated until you realize that triangles are also corrective wave patterns, and, in this instance, wave B is correcting wave A.

III. How the Wave Principle Fits Certain Trading Styles: Corrective Patterns

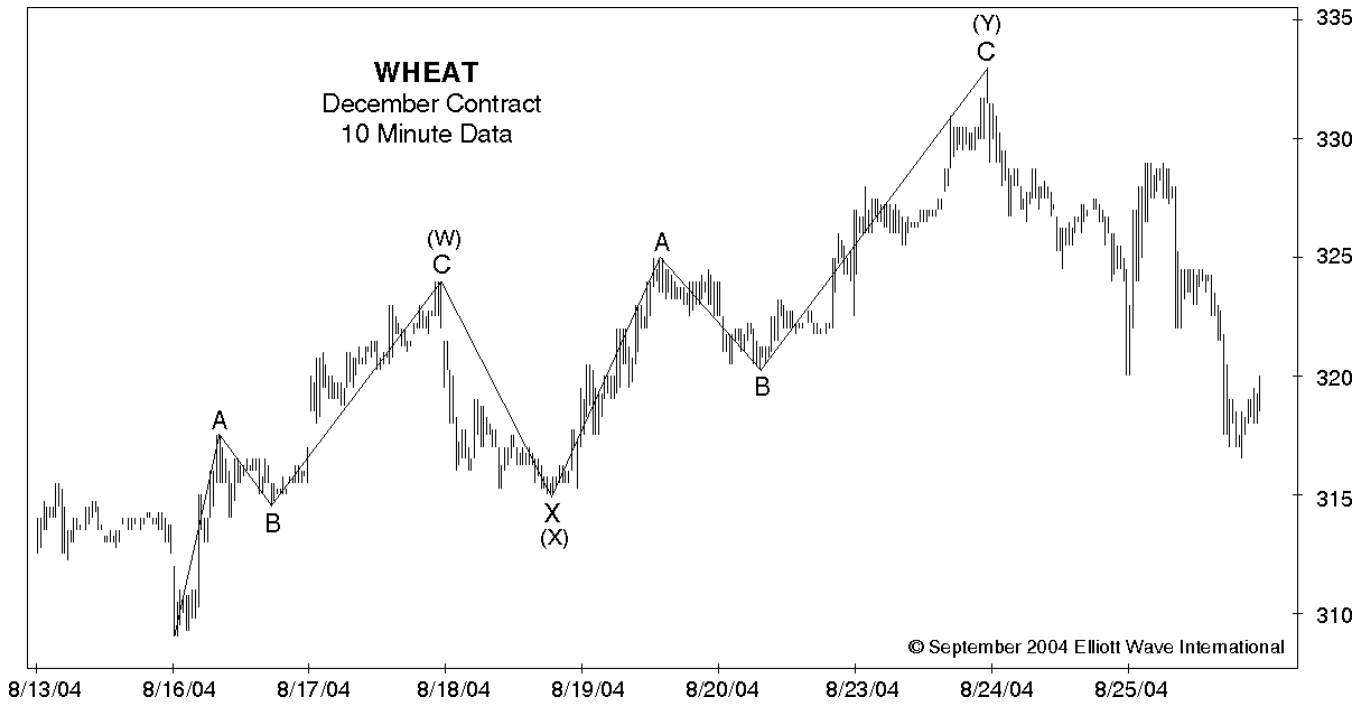


Figure 3-3

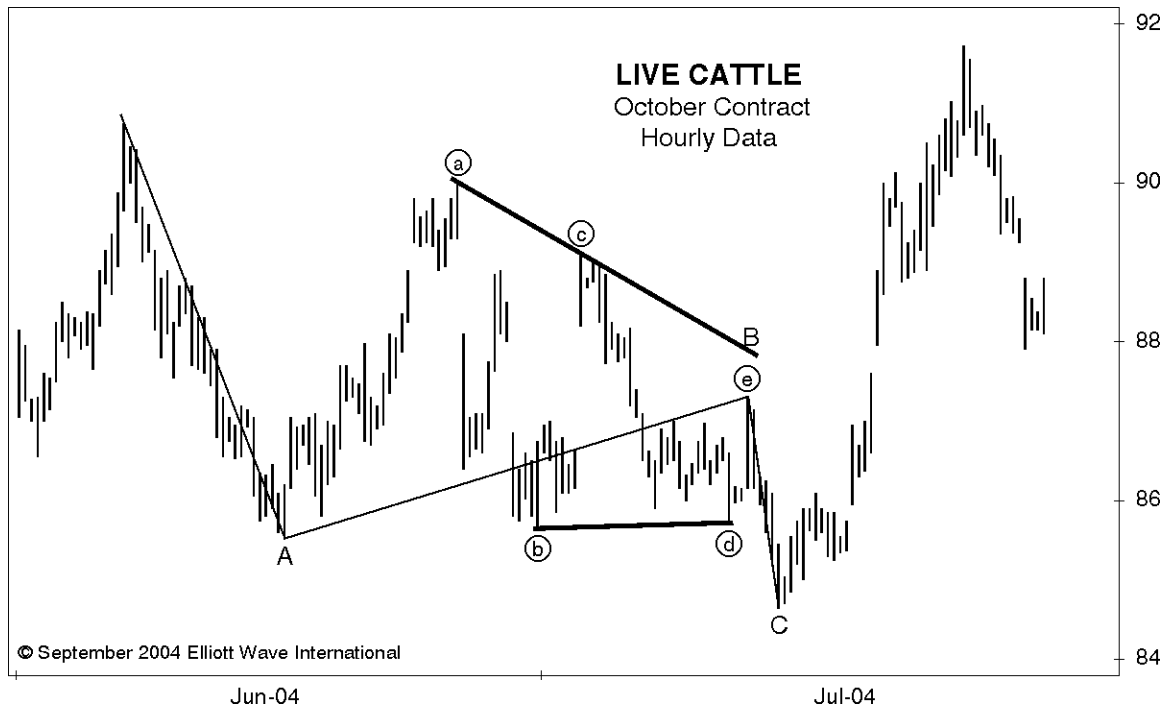
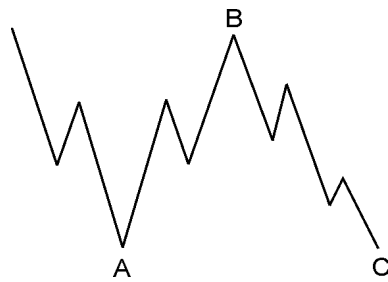


Figure 3-4

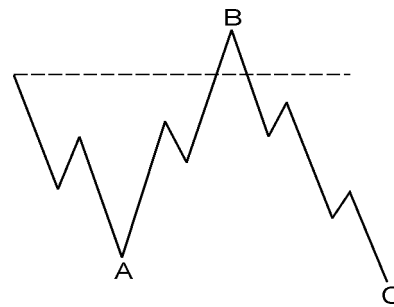
III. How the Wave Principle Fits Certain Trading Styles: Corrective Patterns

2. Flats

Flats are a group of corrective wave patterns that are especially common in commodity markets. This category includes regular flats and irregular or expanded flats. Two primary characteristics of flats make them easy to identify. First, both waves A and B subdivide into only three waves (3-3-5). Second, wave B ends near the origin of wave A or moderately beyond it. If wave B ends below the origin of wave A, the pattern is a regular flat correction (Figure 3-5). In the case of an expanded flat correction, Wave B pushes beyond the origin of wave A before prices reverse in wave C (Figure 3-6).



Regular Flat
Figure 3-5



Expanded Flat
Figure 3-6

An excellent example of a regular flat correction is evident in Figure 3-7 (Unleaded Gas). Notice how the subdivisions of each wave are easily discernible.

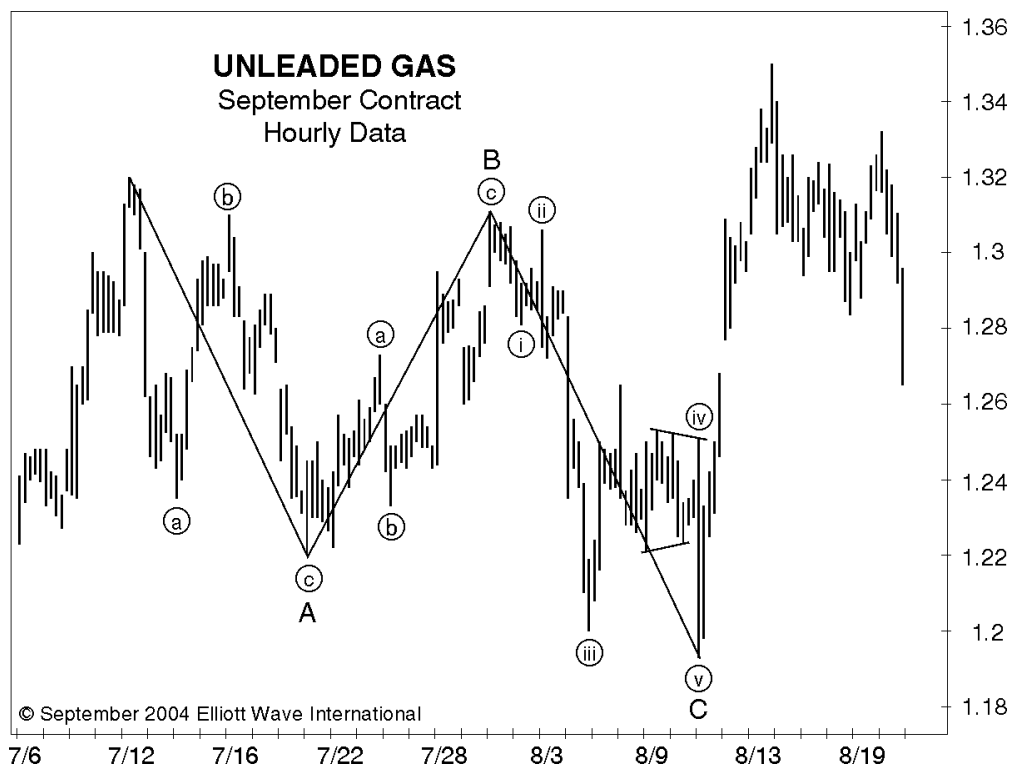


Figure 3-7

III. How the Wave Principle Fits Certain Trading Styles: Corrective Patterns

Figure 3-8 (Lumber) shows a more complex example of a regular flat correction. As you can see, wave B ends near the origin of wave A, but not beyond it. Personally, when I'm labeling regular flats, I like to see wave B terminate within the range of the high bar that marks the origin of wave A. Now, at first glance, you might think that wave B is too impulsive to be a B wave. However, if you count the subdivisions within wave B, you'll see that there are seven. If you don't remember, seven equals three according to the Wave Principle, because a seven-wave move represents a double zigzag.

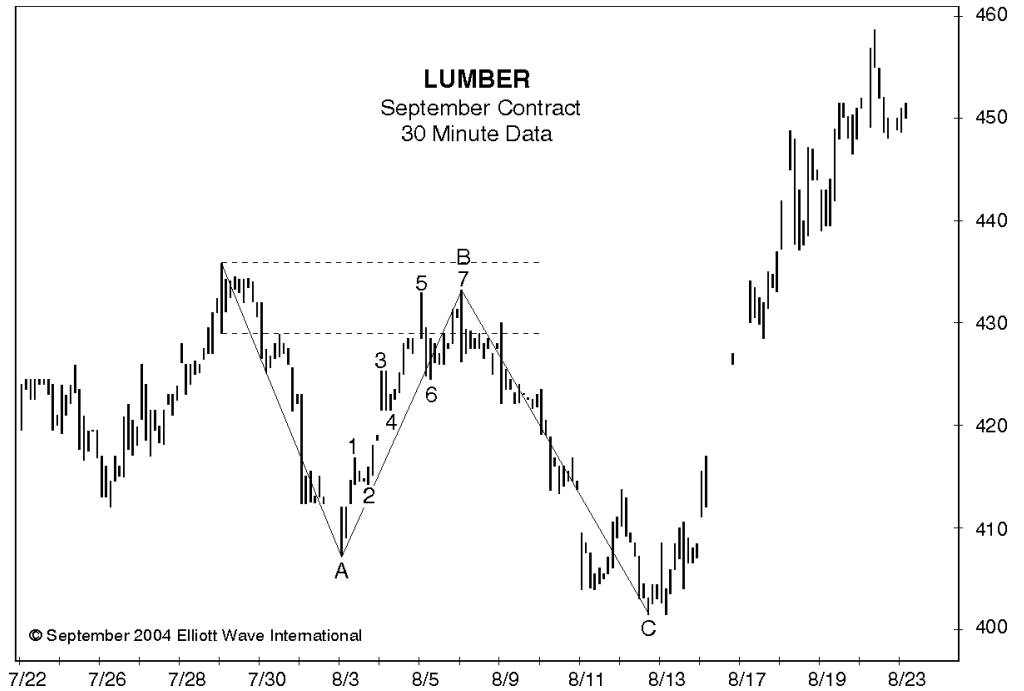


Figure 3-8

Now look at Figure 3-9 (Live Cattle). I wouldn't initially label this pattern as a flat correction, because wave B ended well above the origin of wave A. Normally, I like to see wave B terminate a little closer to this level. However, in this instance, wave A is clearly a three-wave structure, and wave B failed to end within the range of the hourly bar that marks the origin of wave A by only a tick. You may also notice that wave C ended in a slight failure or truncation at 89.87. A failed wave or truncated wave occurs when prices are unable to register a new extreme when they normally would.

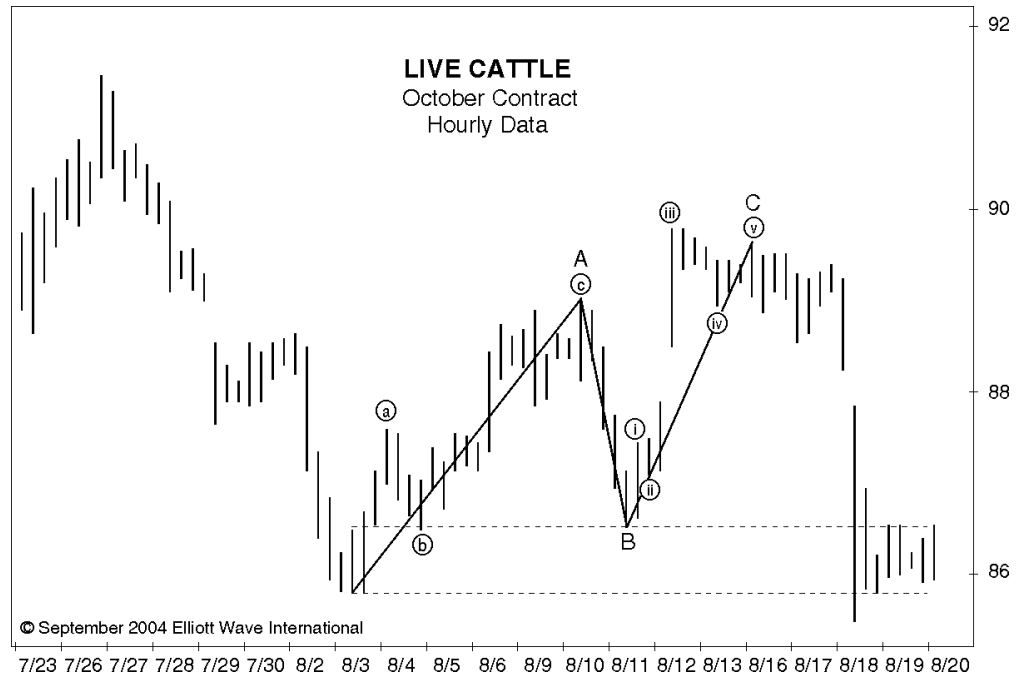


Figure 3-9

III. How the Wave Principle Fits Certain Trading Styles: Corrective Patterns

Figures 3-10, 3-11 and 3-12 (Coffee, Lean Hogs and Sugar) all show examples of expanded flats. In each instance, you'll see that wave B ends moderately beyond the extreme of wave A, which is this pattern's distinguishing characteristic. As with every other example, I have included a solid line to clarify the primary subdivisions.



Figure 3-10



Figure 3-11

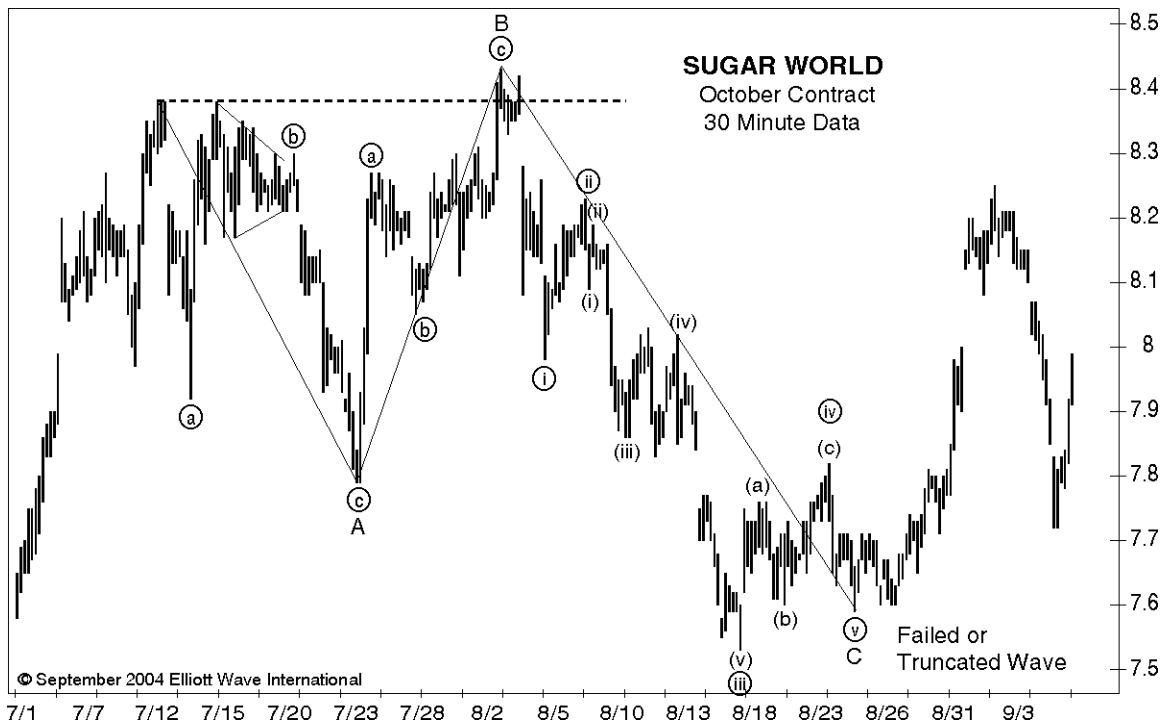


Figure 3-12

3. Triangles

Triangles are probably the easiest corrective wave pattern to identify, because prices simply trade sideways during these periods. Figure 3-13 shows the different shapes triangles can take, although I find the symmetrical or contracting variety most common. While they may be easy to spot, they can be nasty little fellows, too. To an options trader, triangles represent time decay (and no price movement), which decreases an option's value.

Depending on a triangle's size, it can represent to futures traders the depletion of what I call "emotional capital." Let me explain. As a trader, your trading account represents one form of capital (dollars), while your state of mind represents another (emotions). Have you ever had a losing trade that was devastating or a series of losers that made you question yourself or your methodology? Too often, the result is that you either hesitate or pass on the next signal. Triangles, especially the big ones with wide price swings, can eat away at your emotional capital, because you don't know if the market is going to go your way, or if you'll be stopped out of the position. Often, a negative frame of mind translates into bad trading decisions or missed opportunities.

Although sometimes troublesome, triangles offer an important piece of forecasting information – they only occur just prior to the final wave of a sequence. This is why triangles are strictly limited to the wave four, B or X positions. In other words, if you run into a triangle, you know the train is coming into the station.

Corrective Wave (Horizontal) Triangles

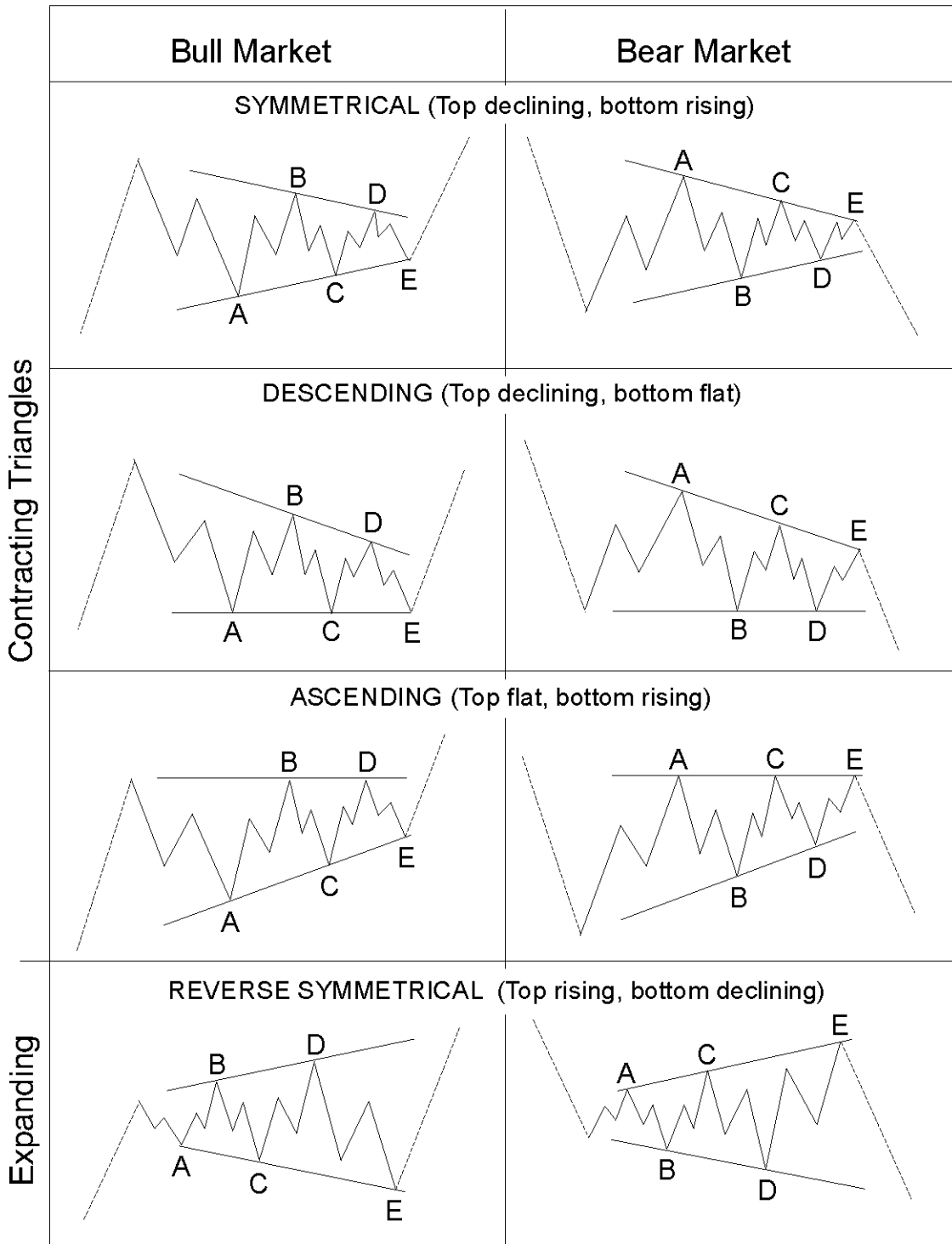


Figure 3-13

III. How the Wave Principle Fits Certain Trading Styles: Corrective Patterns

Figures 3-14, 3-15 and 3-16 (Live Cattle, Feeder Cattle and Oats) illustrate contracting triangles in the real world. Figures 3-15 and 3-16 show a slight variation of a contracting triangle, called a running triangle. A running triangle (see Figure 3-12) occurs when wave B makes a new extreme beyond the origin of wave A. This type of corrective wave pattern occurs frequently in commodities.

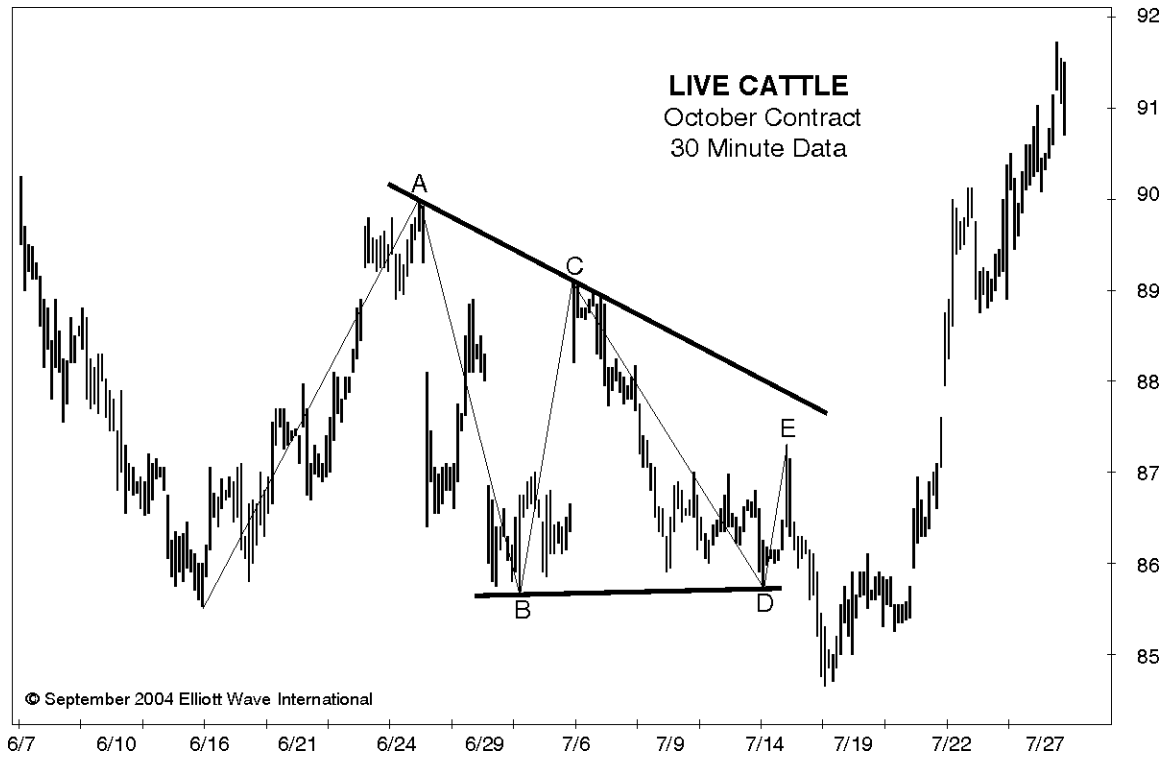


Figure 3-14

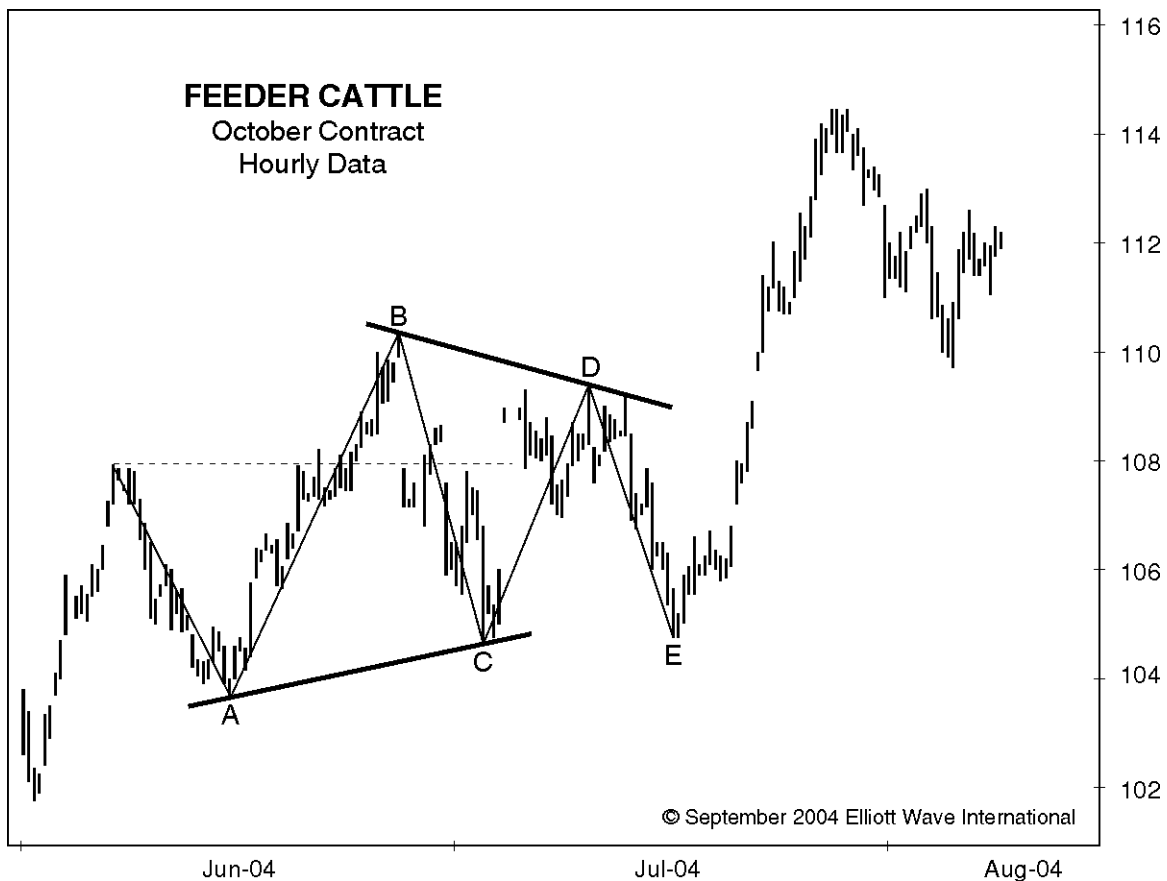


Figure 3-15

III. How the Wave Principle Fits Certain Trading Styles: Corrective Patterns

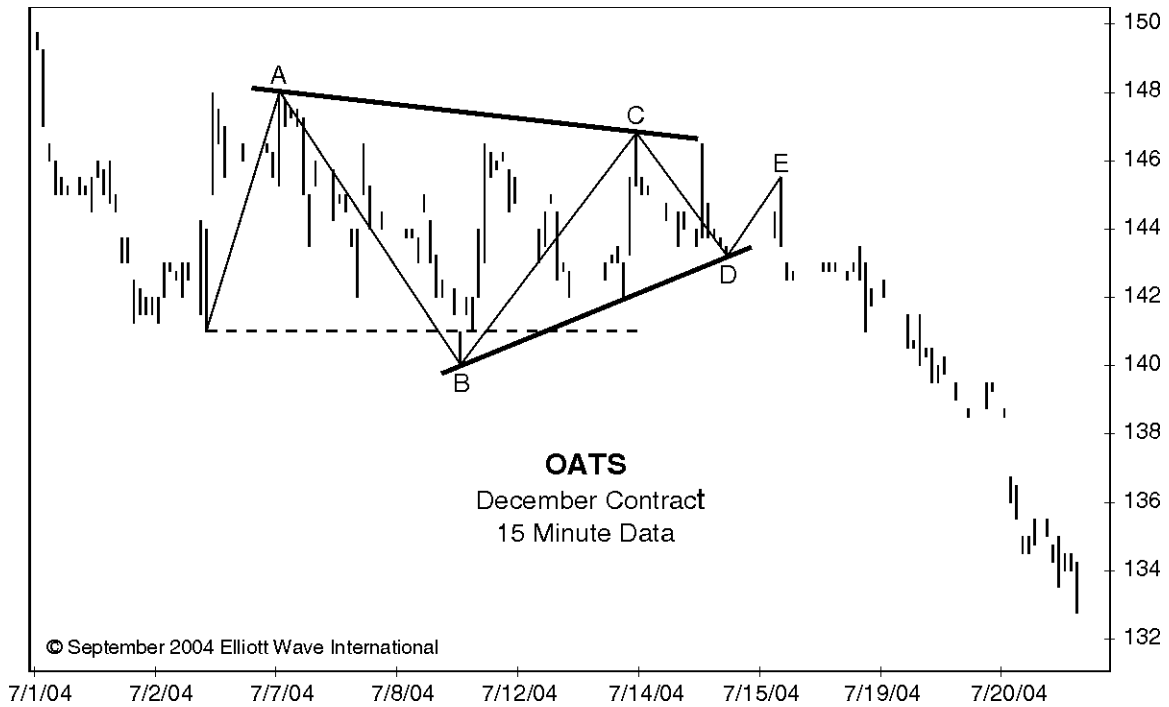


Figure 3-16

One Last Thought

Labeling corrective waves in real time can be tricky. Sometimes, corrections are extremely clear, demonstrating textbook qualities. More often than not, though, you'll encounter complex wave patterns that are mentally taxing to properly identify. The intricacies of each of these patterns are numerous and well deserving of more detailed study. To become more familiar with corrective wave patterns, review your copy of the *Elliott Wave Principle* or the videotape or DVD entitled "Characteristics of Corrective Waves" (VHS/DVD #4), which is part of our home study video course.

[September 2004]

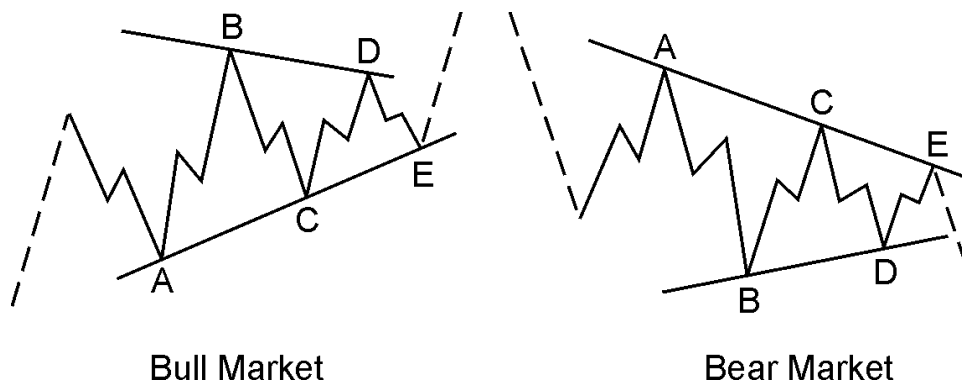
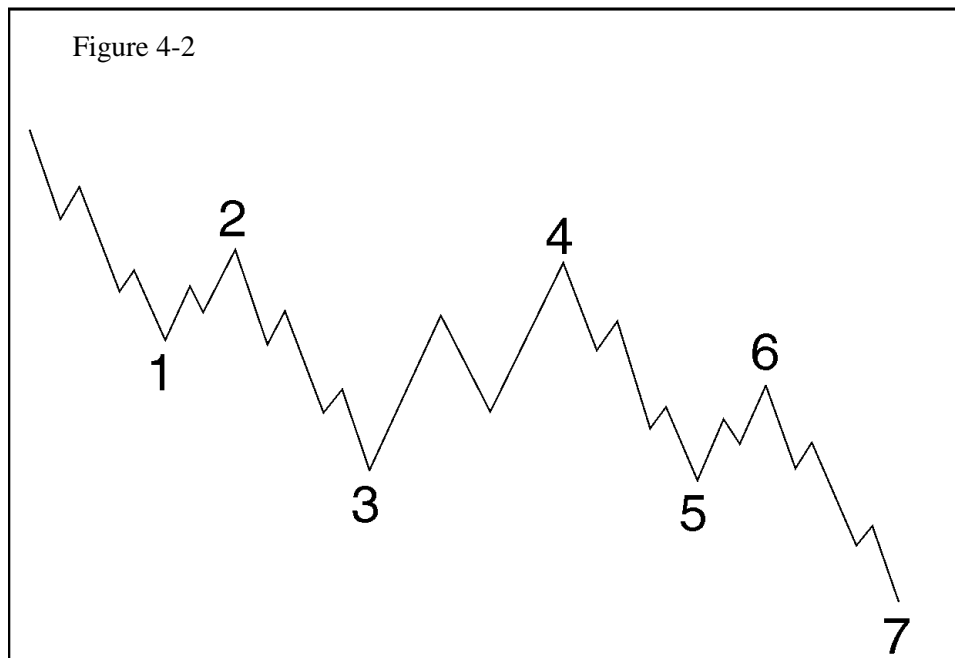
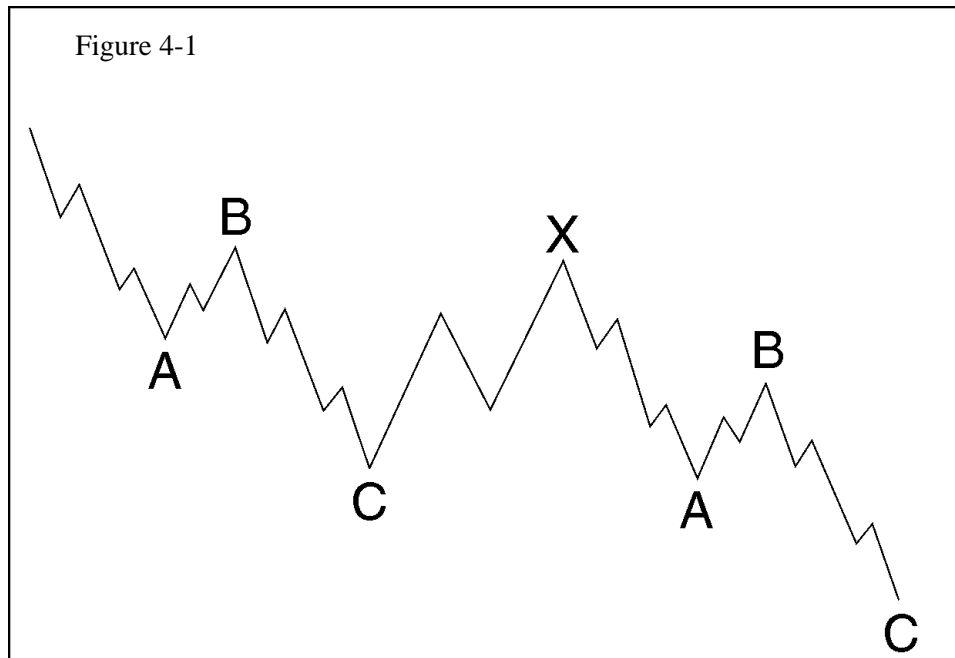


Figure 3-17

IV. When Does Seven Equal Three?



According to the Wave Principle, prices move in fives and threes. Regardless of the variation, the message is always the same: impulsive five-wave moves define the trend, and corrective three-wave moves go against it. A variation of the three-wave correction is a double zigzag.

Figure 4-1 illustrates a double zigzag correction (A-B-C-X-A-B-C). What's important is how this pattern subdivides – seven waves or swings (Figure 4-2).

IV. When Does Seven Equal Three?

Three, 7 and 11 swings are significant, because they represent zigzags, double zigzags and triple zigzags. Even when the subdivisions of a structure are unclear, by focusing simply on the number of major moves, it is possible to identify the pattern as corrective (against the trend) or impulsive (with the trend).

Now examine Live Cattle (Figure 4-3), and you'll see why I bring this up: the advance from 72.65 into the June 2004 high subdivides into seven distinct swings or waves. This implied that Live Cattle was about to tip over.

If this view is correct, the high of the year is most likely in place (basis the weekly chart) and prices will continue to decline steadily lower while holding below the weekly June highs of 88.25-90.20. At the very least, I expect a test of Fibonacci support at 80.30-76.95, the .618 and .786 retracements of this advance.

For more examples of this seven-wave swing count and its result, look at Coffee (Figure 4-4), Lean Hogs (Figure 4-5) and Sugar (Figure 4-6). In each instance, sizable moves in the opposite direction occurred as a result of the seven-wave pattern. Coffee and Lean Hogs more than completely retraced these moves. In Sugar, the result was a trend defining five-wave move to the .618 retracement of the selloff.

[July 2004]

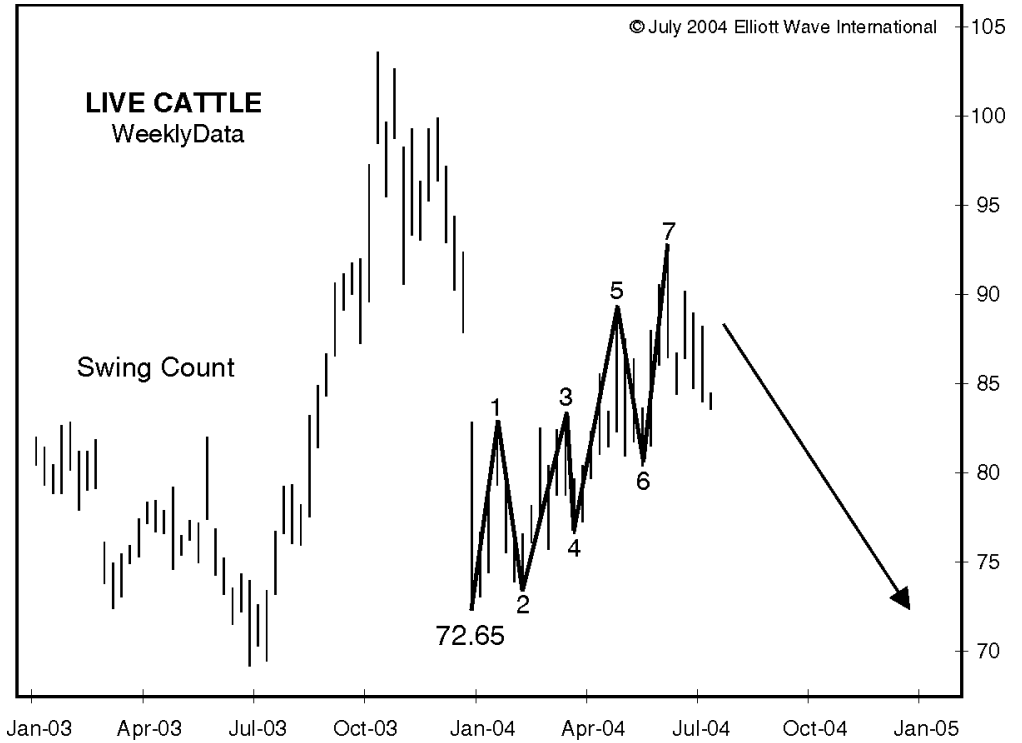


Figure 4-3

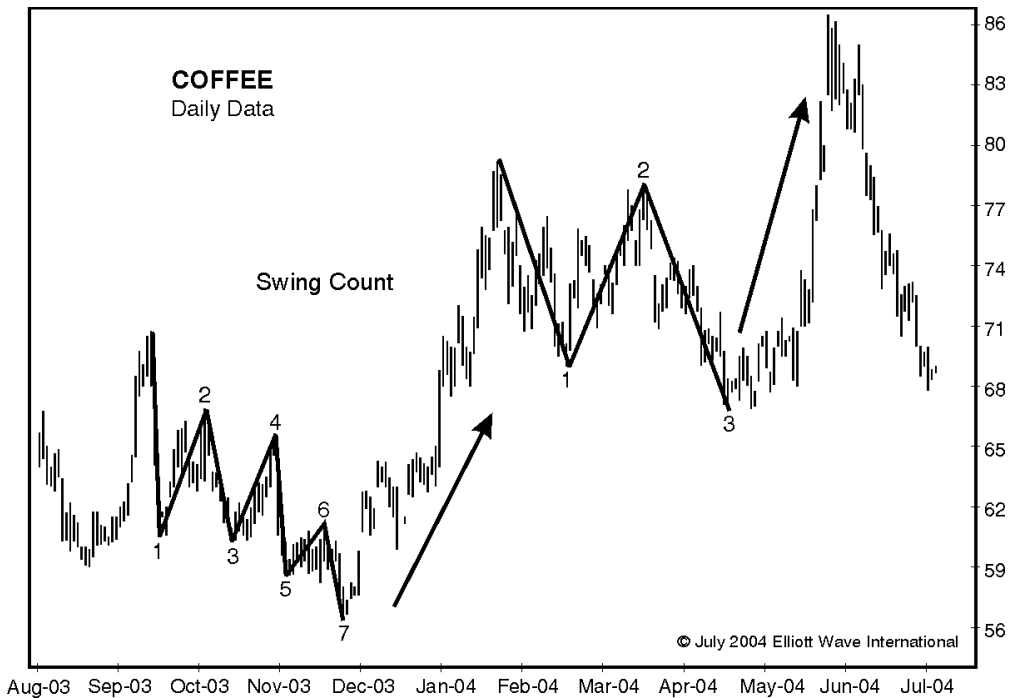


Figure 4-4

IV. When Does Seven Equal Three?

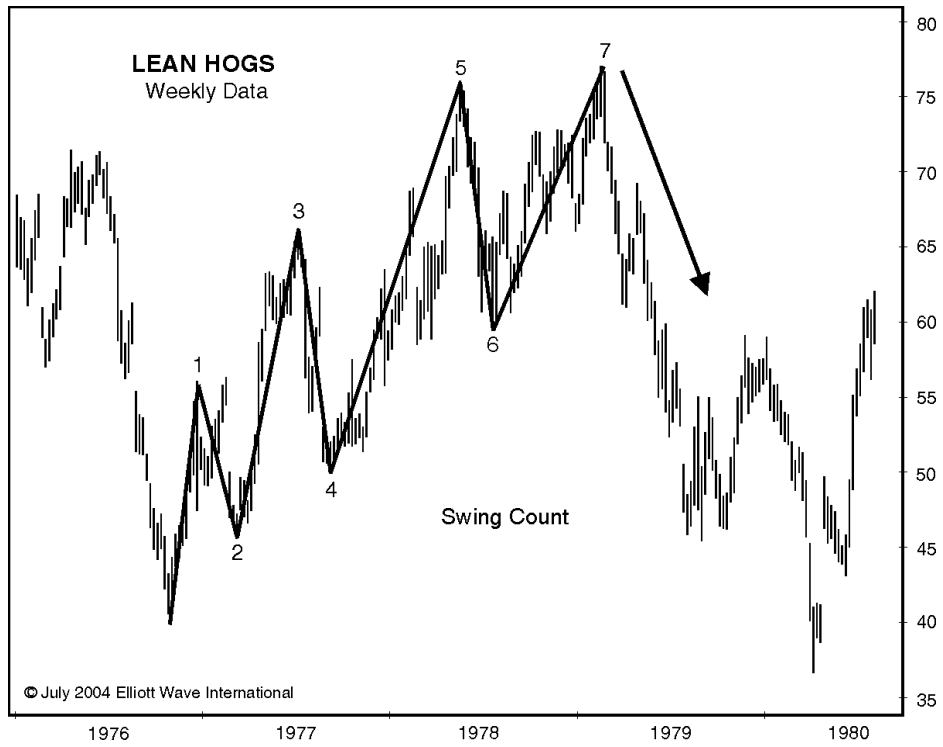


Figure 4-5

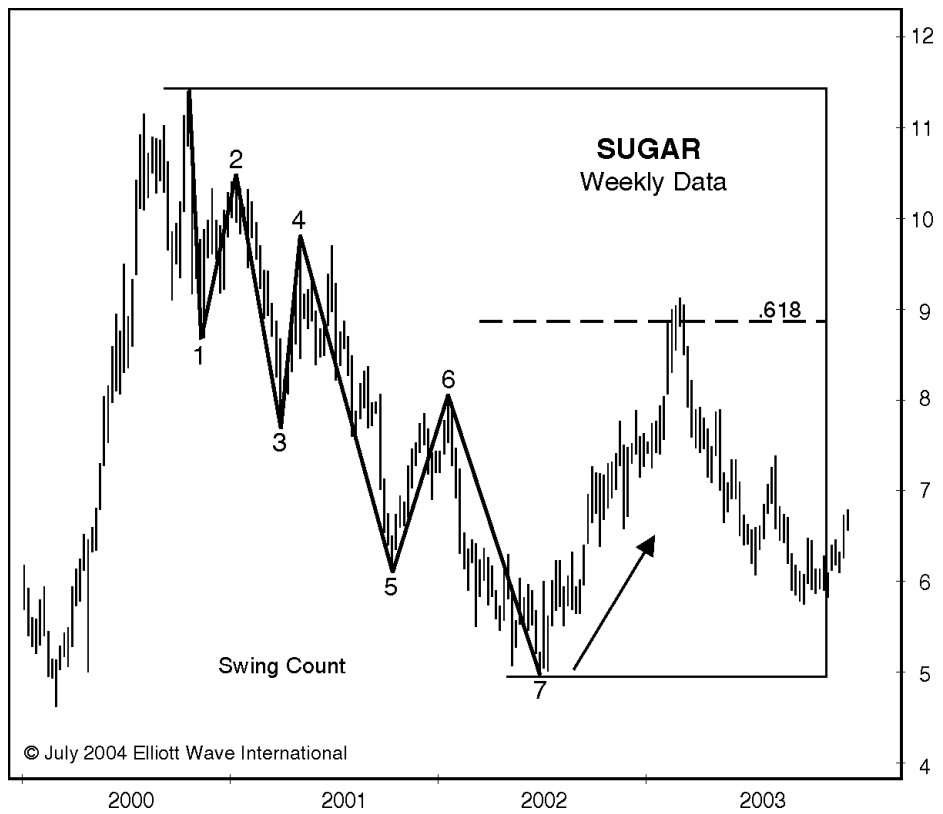
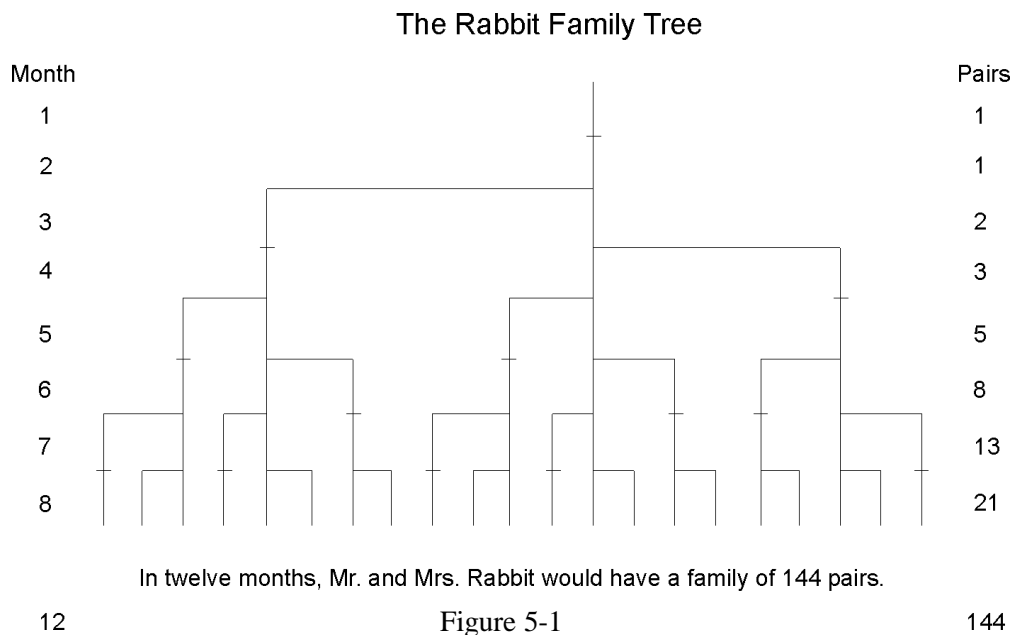


Figure 4-6

V. Origins and Applications of the Fibonacci Sequence

From Fibonacci to Elliott

You can tell that a trendy word or phrase has reached “buzzword” status when it is more often used to impress than to explain. A few years ago, the buzzword I heard most often was “win-win,” a concept popularized by Stephen Covey. Technical analysts, in recent years, have unfortunately elevated “Fibonacci” to the same level. A better understanding of Fibonacci may not save the term from buzzword status, but it will provide some insight to its popularity.



Leonardo Fibonacci da Pisa was a thirteenth-century mathematician who posed a question:

How many pairs of rabbits placed in an enclosed area can be produced in a single year from one pair of rabbits, if each gives birth to a new pair each month starting with the second month? The answer: 144.

The genius of this simple little question is not found in the answer, but in the pattern of numbers that leads to the answer: 1, 1, 2, 3, 5, 8, 13, 21, 34, 55, 89, and 144. This sequence of numbers represents the propagation of rabbits during the 12-month period and is referred to as the Fibonacci sequence.

Fibonacci Ratio Table

NUMERATOR		1	2	3	5	8	13	21	34	55	89	144
DENOMINATOR	1	1.00	2.00	3.00	5.00	8.00	13.00	21.00	34.00	55.00	89.00	144.00
	2	.50	1.00	1.50	2.50	4.00	6.50	10.50	17.00	27.50	44.50	72.00
	3	.333	.667	1.00	1.667	2.667	4.33	7.00	11.33	18.33	29.67	48.00
	5	.20	.40	.60	1.00	1.60	2.60	4.20	6.80	11.00	17.80	28.80
	8	.125	.25	.375	.625	1.00	1.625	2.625	4.25	6.875	11.125	18.00
	13	.077	.154	.231	.385	.615	1.00	1.615	2.615	4.23	6.846	11.077
	21	.0476	.0952	.1429	.238	.381	.619	1.00	1.619	2.619	4.238	6.857
	34	.0294	.0588	.0882	.147	.235	.3824	.6176	1.00	1.618	2.618	4.235
	55	.01818	.03636	.0545	.0909	.1455	.236	.3818	.618	1.00	1.618	2.618
	89	.011236	.02247	.0337	.05618	.08989	.146	.236	.382	.618	1.00	1.618
	144	.006944	.013889	.0208	.0347	.05556	.0903	.1458	.236	.382	.618	1.00

Towards perfect ratios

Figure 5-2

The ratio between consecutive numbers in this set approaches the popular .618 and 1.618, the Fibonacci ratio and its inverse. (Relating non-consecutive numbers in the set yields other popular ratios - .146, .236, .382, .618, 1.000, 1.618, 2.618, 4.236, 6.854....)

Since Leonardo Fibonacci first contemplated the mating habits of our furry little friends, the relevance of this ratio has been proven time and time again. From the DNA strand to the galaxy we live in, the Fibonacci ratio is present, defining the natural progression of growth and decay. One simple example is the human hand, comprised of five fingers with each finger consisting of three bones.

In addition to recognizing that the stock market undulates in repetitive patterns, R. N. Elliott also realized the importance of the Fibonacci ratio. In Elliott's final book, *Nature's Law*, he specifically referred to the Fibonacci sequence as the mathematical basis for the Wave Principle. Thanks to his discoveries, we use the Fibonacci ratio in calculating wave retracements and projections today.

1. How To Identify Fibonacci Retracements

The primary Fibonacci ratios that I use in identifying wave retracements are .236, .382, .500, .618 and .786. Some of you might say that .500 and .786 are not Fibonacci ratios; well, it's all in the math. If you divide the second month of Leonardo's rabbit example by the third month, the answer is .500, 1 divided by 2; .786 is simply the square root of .618.

There are many different Fibonacci ratios used to determine retracement levels. The most common are .382 and .618. However, .472, .764 and .707 are also popular choices. The decision to use a certain level is a personal choice. What you continue to use will be determined by the markets.

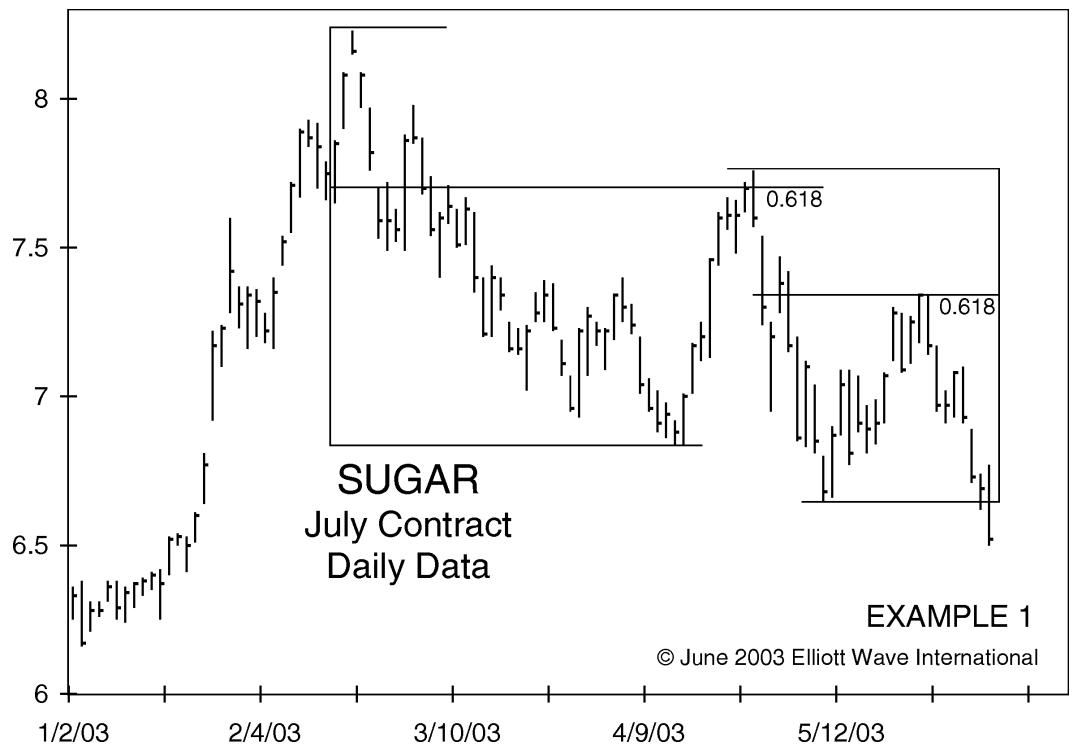


Figure 5-3

The accompanying charts demonstrate the relevance of .236, .382, .500, .618 and .786. It's worth noting that Fibonacci retracements can be used on any time frame to identify potential reversal points. An important aspect to remember is that a Fibonacci retracement of a previous wave on a weekly chart is more significant than what you would find on a 60-minute chart.

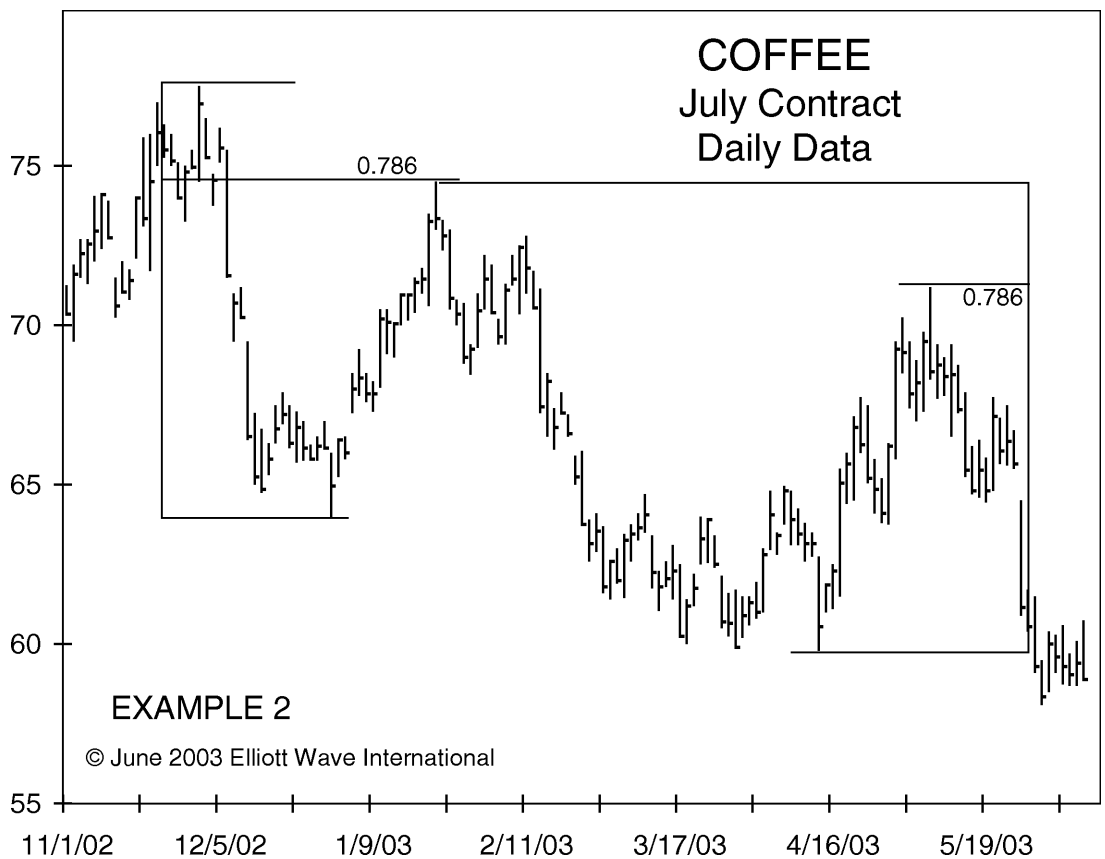
With five chances, there are not many things I couldn't accomplish. Likewise, with five retracement levels, there won't be many pullbacks that I'll miss. So how do you use Fibonacci retracements in the real world, when you're trading? Do you buy or sell a .382 retracement or wait for a test of the .618 level, only to realize that prices reversed at the .500 level?

The Elliott Wave Principle provides us with a framework that allows us to focus on certain levels at certain times. For example, the most common retracements for waves two, B and X are .500 or .618 of the previous wave. Wave four typically ends at or near a .382 retracement of the prior third wave that it is correcting.

In addition to the above guidelines, I have come up with a few of my own over the past 10 years. The first is that the best third waves originate from deep second waves. In the wave two position, I like to see a test of the .618 retracement of wave one or even .786. Chances are that a shallower wave two is actually a B or an X wave. In the fourth-wave position, I find the most common Fibonacci retracements to be .382 or .500. On occasion, you will see wave four retrace .618 of wave three. However, when this occurs, it is often sharp and quickly reversed. My rule of thumb for fourth waves is that whatever is done in price, won't be done in time. What I mean by this is that if wave four is time-consuming, the relevant Fibonacci retracement is usually shallow, .236 or .382. For example, in a contracting triangle where prices seem to chop around forever, wave e of the pattern will end at or near a .236 or .382 retracement of wave three. When wave four is proportional in time to the first three waves, I find the .500 retracement significant. A fourth wave that consumes less time than wave two will often test the .618 retracement of wave three and suggests that more players are entering the market, as evidenced by the price volatility. And finally, in a fast market, like a "third of a third wave," you'll find that retracements are shallow, .236 or .382.

In closing, there are two things I would like to mention. First, in each of the accompanying examples, you'll notice that retracement levels repeat. Within the decline from the February high in July Sugar (Figure 5-3), each countertrend move was a .618 retracement of the previous wave. Figure 5-4 demonstrates the same tendency with the .786 retracement. This event is common and is caused by the fractal nature of the markets.

Second, Fibonacci retracements identify high probability targets for the termination of a wave; they do not represent an absolute must-hold level. So when using Fibonacci retracements, don't be surprised to see prices reverse a few ticks above or below a Fibonacci target. This occurs because other traders are viewing the same levels and trade accordingly. Fibonacci retracements help to focus your attention on a specific price level at a specific time; how prices react at that point determines the significance of the level.



[July 2003]

Figure 5-4

2. How To Calculate Fibonacci Projections

The Fibonacci ratio isn't just helpful for labeling retracements that have already occurred, it's equally helpful when projecting future market moves.

Impulse Waves

Beginning with impulse waves three and five, the primary Fibonacci ratios are 1.000, 1.618, 2.618 and 4.236. The most common Fibonacci multiples for third waves are 1.618, 2.618 and least often, 4.236. To calculate a wave-three projection, you take the distance traveled in wave one, multiply it by 1.618, and extend that sum from the extreme of wave two. The result is a high probability target for wave three.

In Figure 5-5, a 1.618 multiple of wave 1 identifies 643 as an ideal objective for wave 3 up from the August low. The wave 3 high came in at 635, moderately below our objective. Sometimes prices will fall short of an objective, while exceeding it at other times. Fibonacci projections and retracements identify highly probable areas or regions of termination, not absolute objectives. Figure 5-6 illustrates a third wave rally that attained a 2.618 multiple of wave 1.

There is little difference between calculating fifth waves and third waves, except that with fifth waves we have more "history," namely in waves one and three. Within a five-wave move, wave three will typically be the "extended" wave, while waves one and five will tend toward equality (see Figure 5-7). So our first Fibonacci ratio is equality (1.000) between waves one and five. When wave five is the extended wave (as is often the case in commodities), wave five will equal a Fibonacci multiple of waves one through three.

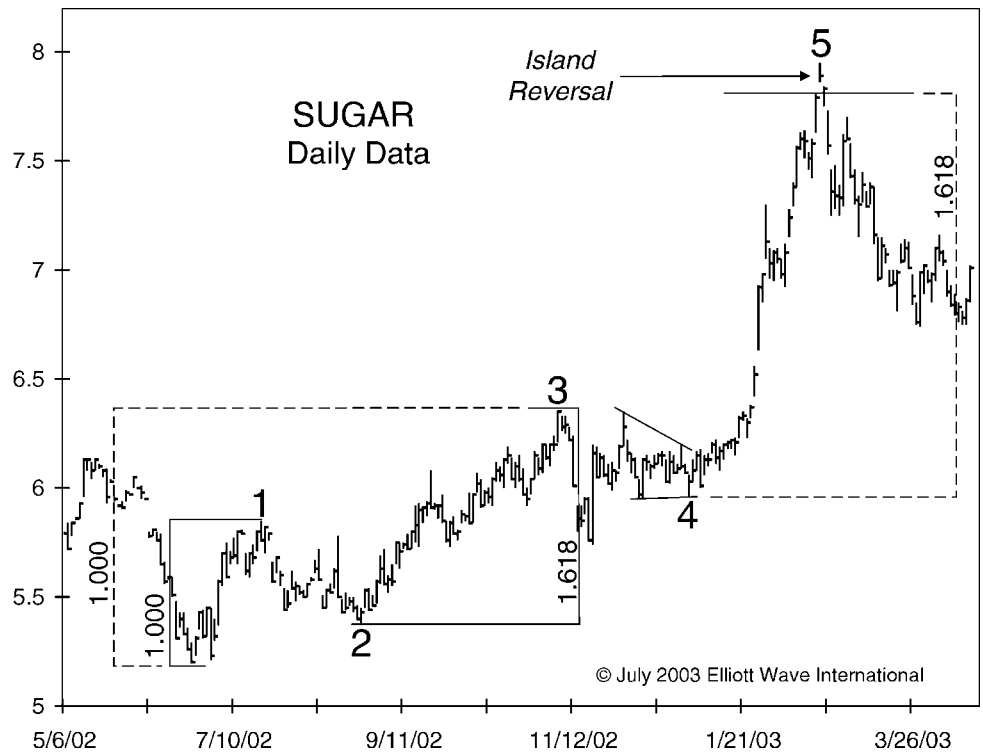


Figure 5-5

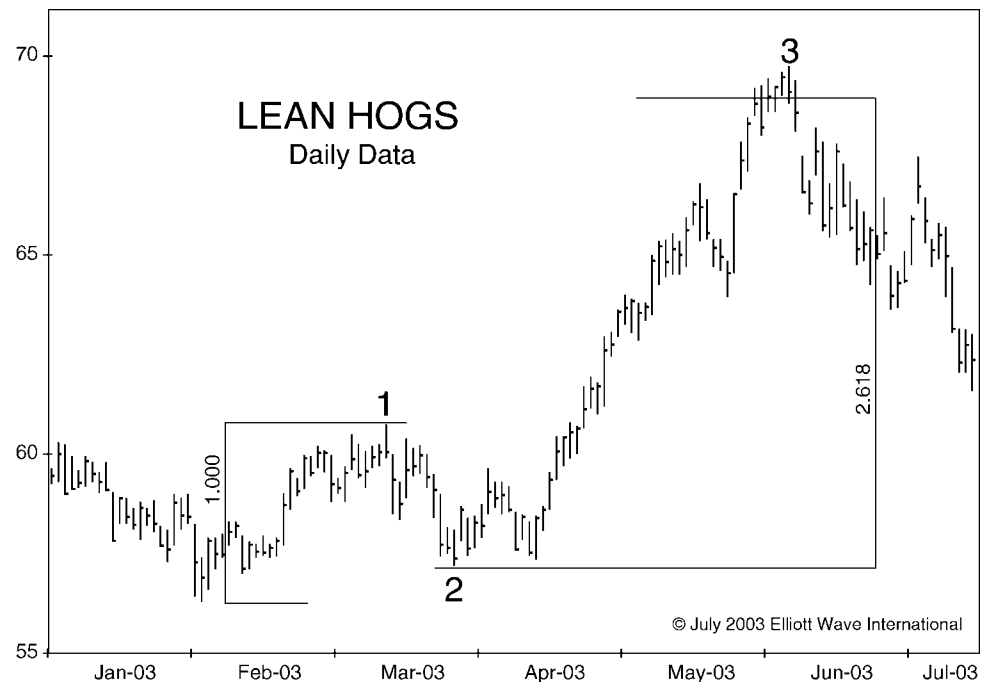


Figure 5-6

In Figure 5-7, we see that wave 5 was the extended wave within this impulsive sequence and that it pushed moderately above the 1.618 multiple of waves 1 through 3 at 782 before reversing dramatically.

For you die-hard technicians, that lonely little bar at the top of the chart just above 782 (February 20th) is an “island reversal.” (see Figure 5-5). This pattern occurs when the low on a bar is above the previous day’s high, and the high on the following day is below the preceding low. At highs, this chart pattern has a bearish implication, and vice versa at lows. Seeing this traditionally bearish chart pattern — especially when Elliott wave analysis identified a highly probable termination point for wave 5 — was a red flag for the ensuing decline.

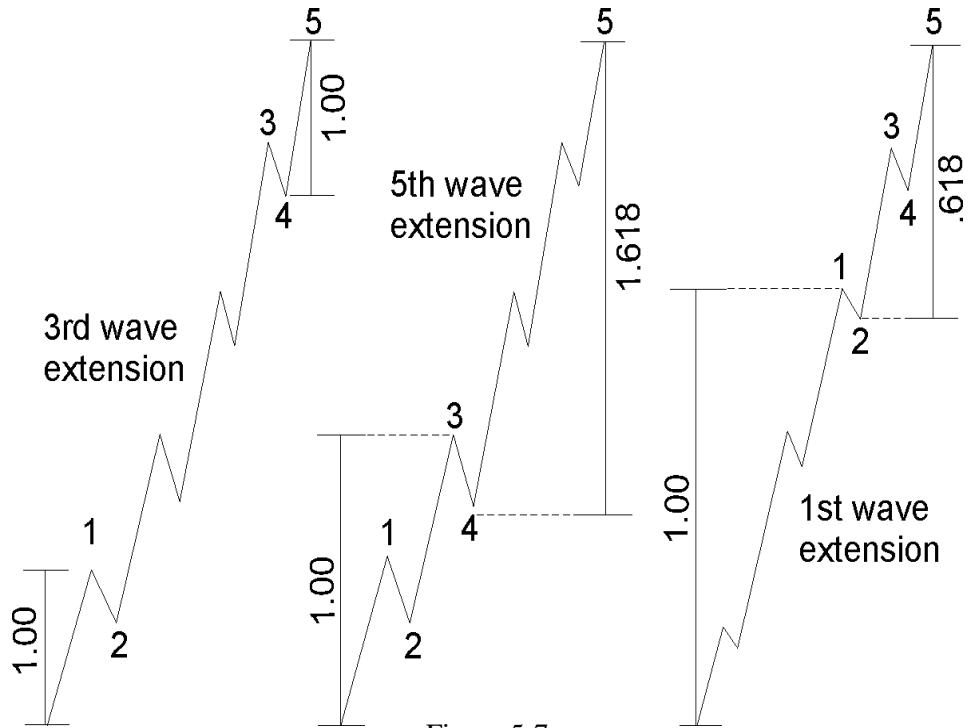


Figure 5-7

When wave one is the extended wave, waves three through five will tend toward a .618 relationship of the distance traveled in wave one.

Corrective Waves

Corrective patterns fall into three categories: Zigzags, Flats and Triangles. You can project the probable path of Zigzags and Flats using the same method we use for impulsive moves as long as you observe that corrective patterns commonly involve different Fibonacci ratios.

A Zigzag subdivides as 5-3-5. Five waves within wave A, three waves within wave B and five waves within wave C. Normally, waves C and A will tend toward equality, much like waves five and one when wave three is extended (see Figure 5-8). Sometimes you will see wave C equal a 1.382 multiple of wave A or even a 1.618 multiple of wave A. When wave C equals a 1.618 multiple of wave A, and it is indeed a true corrective pattern, it can reflect increased volatility or imply that certain market participants are trying to stop out as many traders as they can before the correction is fully retraced.

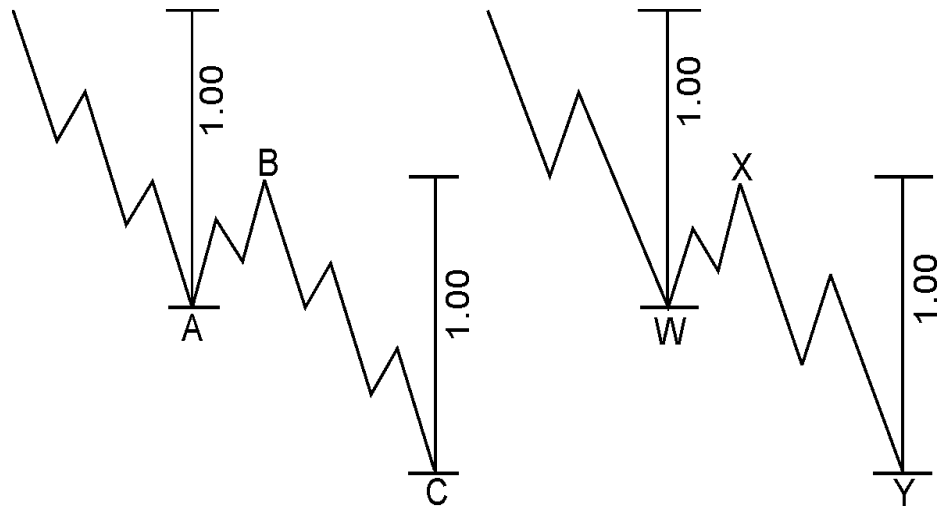


Figure 5-8

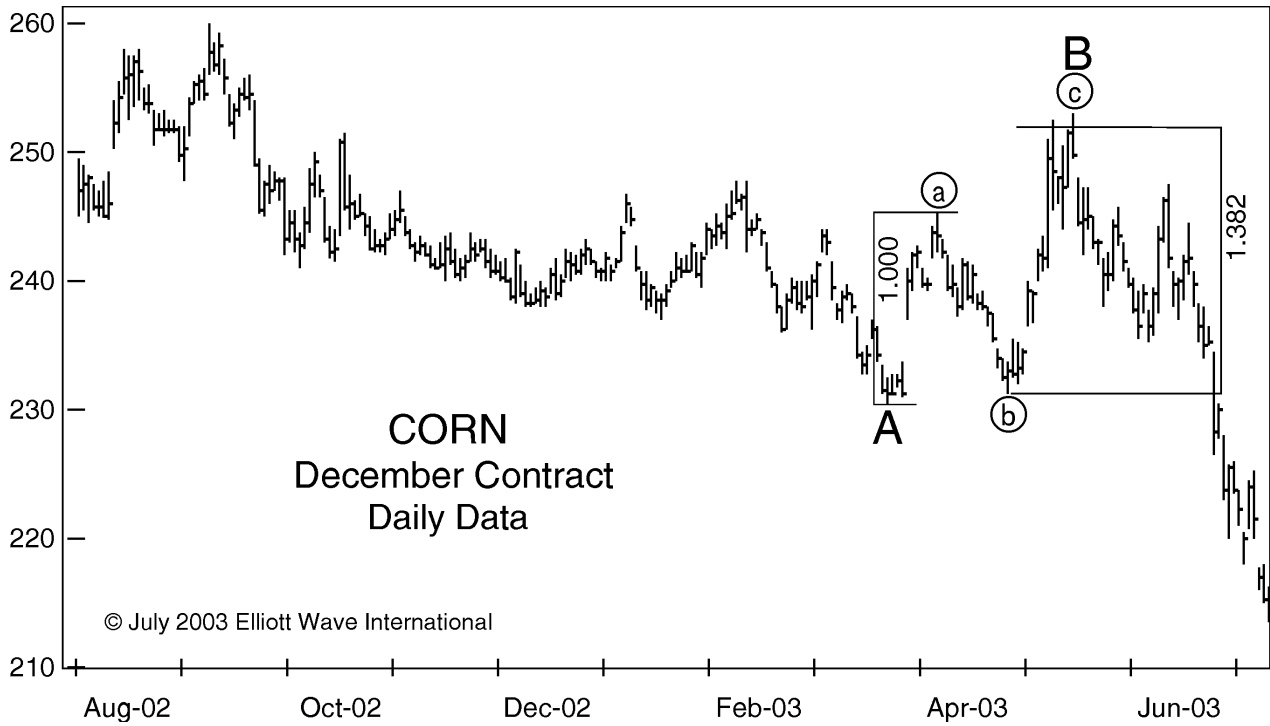


Figure 5-9

Flat corrections subdivide as 3-3-5; waves A and B consist of three waves, and wave C, as always, is made up of five. Within a normal flat correction, each wave tends toward equality. Wave B will end at or near the origin of wave A, and wave C will finish just below the extreme of wave A. In addition to waves A and C tending toward equality, I often find that wave C will equal a 1.382 multiple of wave A (Figure 5-9). An expanded flat correction subdivides just like a normal or regular flat, except that wave B exceeds the origin of wave A. In this case, wave C will equal either a 1.618 multiple of wave A or a .618 multiple of wave A extended from the extreme of wave A (see Figure 5-10).

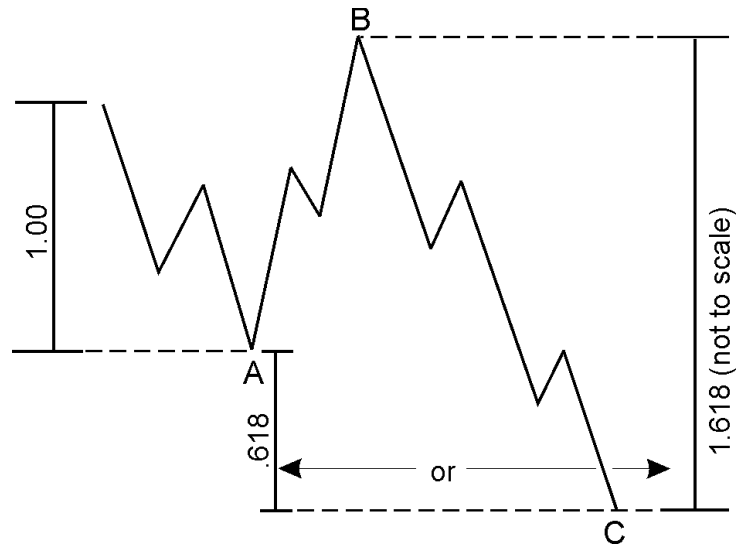


Figure 5-10

Because of the unique way that triangles unfold, you should use Fibonacci retracements, rather than projections, to evaluate price targets for triangle corrections. Typically, alternating waves within a triangle will adhere to a .618 or .786 relationship.

For example, waves E, D and C will equal approximately a .618 relationship of waves C, B and A, respectively.

Non-traditional Application

So far we have covered the traditional application of Fibonacci ratios to various Elliott wave patterns. A non-traditional approach that uses the previous wave to project the current wave. For example, wave four would be used to calculate wave five or wave B to project wave C. The most significant Fibonacci ratios I have found using this technique are 1.382 and 2.000. To apply this reverse Fibonacci technique, multiply the previous wave by 1.382 or 2.000 and add the sum to

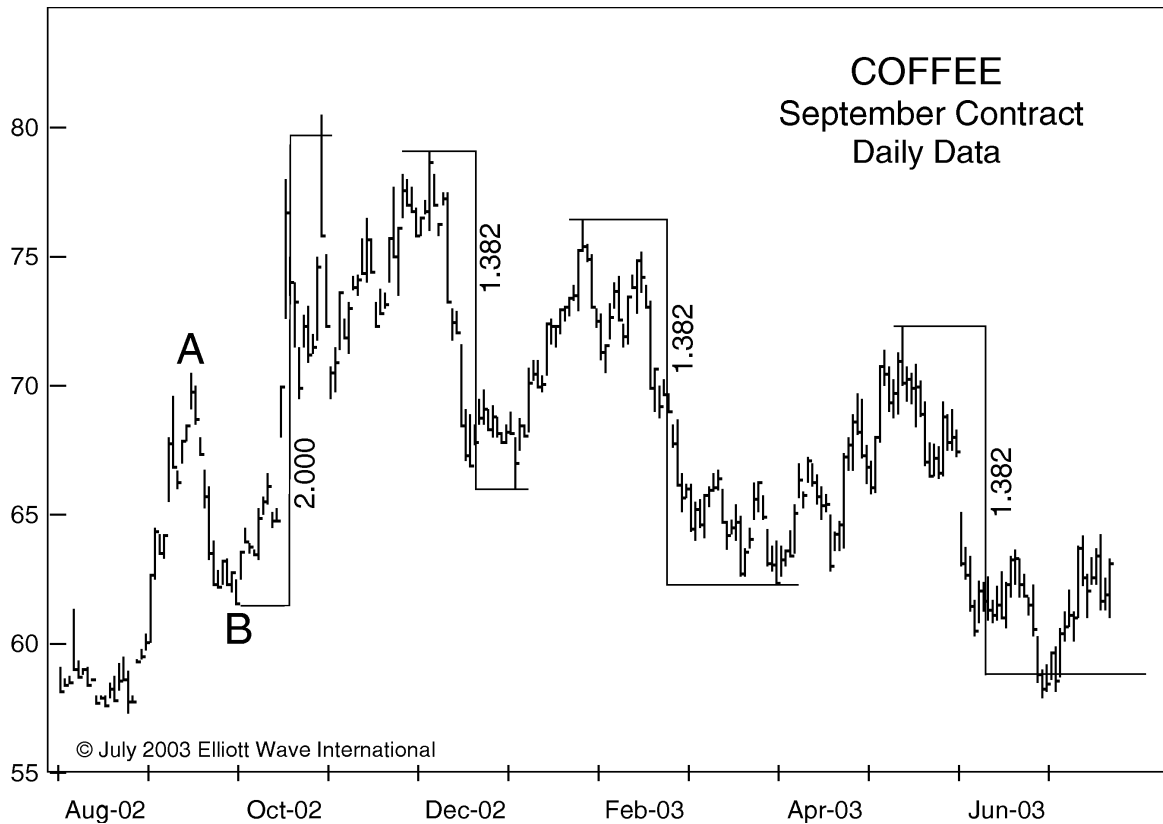


Figure 5-11

the origin of the developing wave. For example, in Figure 5-11, the distance between point A and point B is multiplied by 2.000 and projected upward from point B. The objective for this advance was 7950 while the actual high came in at 8050. As you work your way from left to right, you can see that each significant decline in Coffee since the October 2002 high adhered to a 1.382 multiple of the previous wave.

As Figure 5-11 illustrates, this technique has merit. However, it is presented to illustrate the versatility of Fibonacci and the inherent mathematical nature of markets, and is not a substitute for the traditional method of calculating wave retracements and projections. I use both applications in order to identify concentrations of Fibonacci objectives. As I often mention, the more numerous the Fibonacci relationships, the more significant the identified region or Fibonacci cluster. By combining Fibonacci retracements and Fibonacci projections together, you can truly begin to identify the most highly probable area that prices will react to or strive to attain.

More Information

Additional information on the application of Fibonacci ratios and Elliott wave theory can be found in *Elliott Wave Principle: Key to Market Behavior*, by A.J. Frost and Robert Prechter. Even after 10 years of wave counting, I continue to view this book as the definitive work on the subject and reference it often. To learn more about the history of Fibonacci, see *Leonard of Pisa* by Joseph and Frances Gies. Both books are available in the Elliottwave.com bookstore.

[July 2003]

VI. How To Identify and Use Support and Resistance Levels

In a recent Daily Futures Junctions, I mentioned “structural” support and resistance. Since then, I’ve received a few requests for more details and possibly some examples... So – here we go!

Structural support and resistance is a catch-all phrase for significant areas and levels that serve to identify possible turning points in price. Think of support as a “price floor” and resistance as a “price ceiling.” As prices decline, they encounter support or a “price floor” and react by turning up. Conversely, as prices rise, they encounter resistance or a “price ceiling” and turn down. I don’t rely on these tools alone, but I do use them to supplement to my normal Fibonacci analysis.

Congestion

“Congestion” is my term for sideways price movement or range trading. And the Elliott wave pattern that best fits this description is a triangle. Those of you who have held a position during these periods know that it’s not fun. But the upside is that congestion often provides support or resistance for future price movements regardless of when it occurs. In May Coffee (Figure 6-1), notice how the brief period of congestion that occurred in early November 2003 acted as support for the December pullback. This happened again when the January selloff fell into listless trading for the rest of the month. The weekly chart of Sugar (Figure 6-2) shows how these periods can also act as resistance.

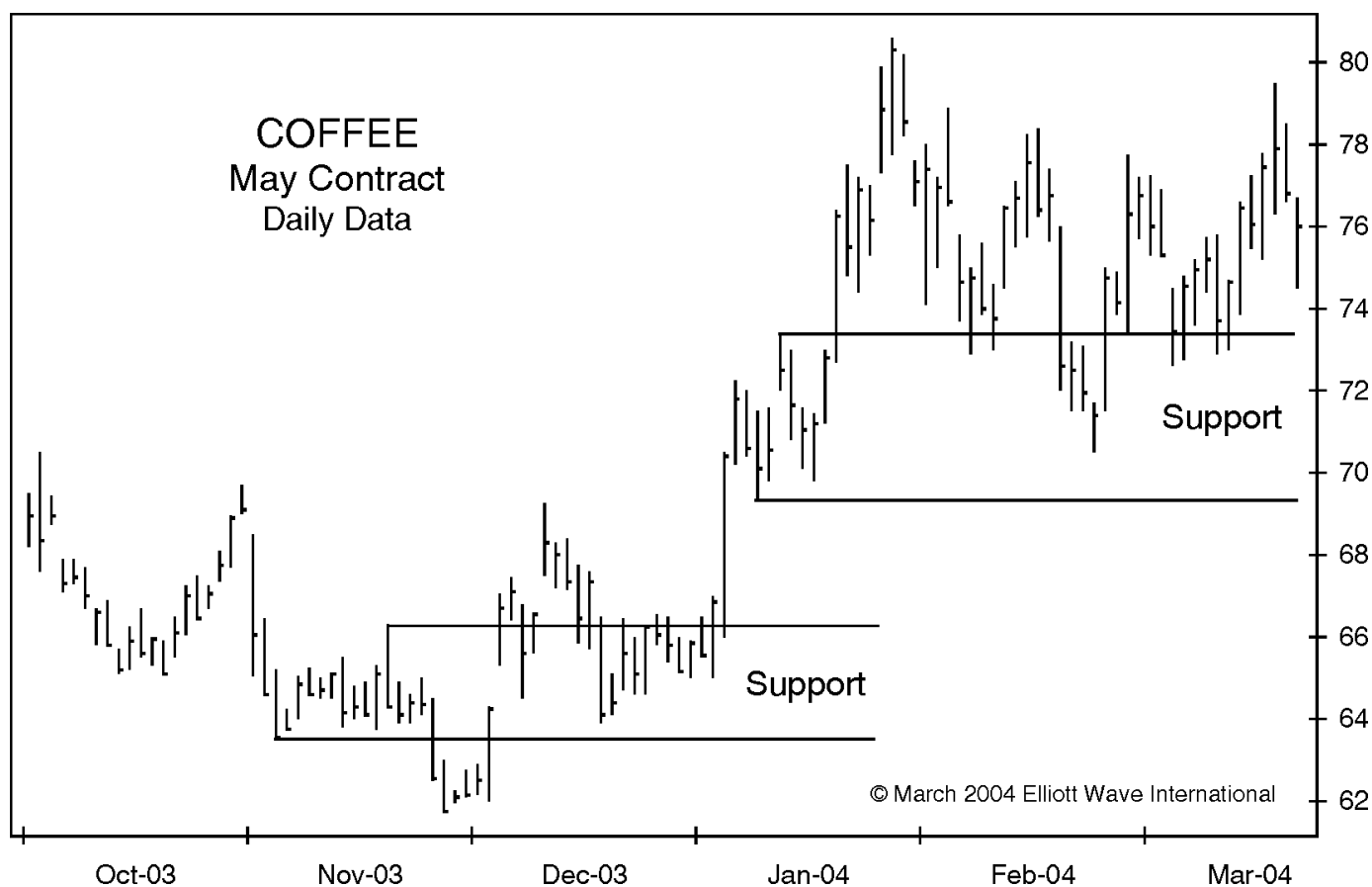


Figure 6-1

VI. How To Identify and Use Support and Resistance Levels

And if you think about it, the tendency of congestion phases to act as support or resistance is right in line with the Elliott wave guideline on fourth wave retracements: support for a fourth wave pullback is the previous fourth wave extreme of one lesser degree.

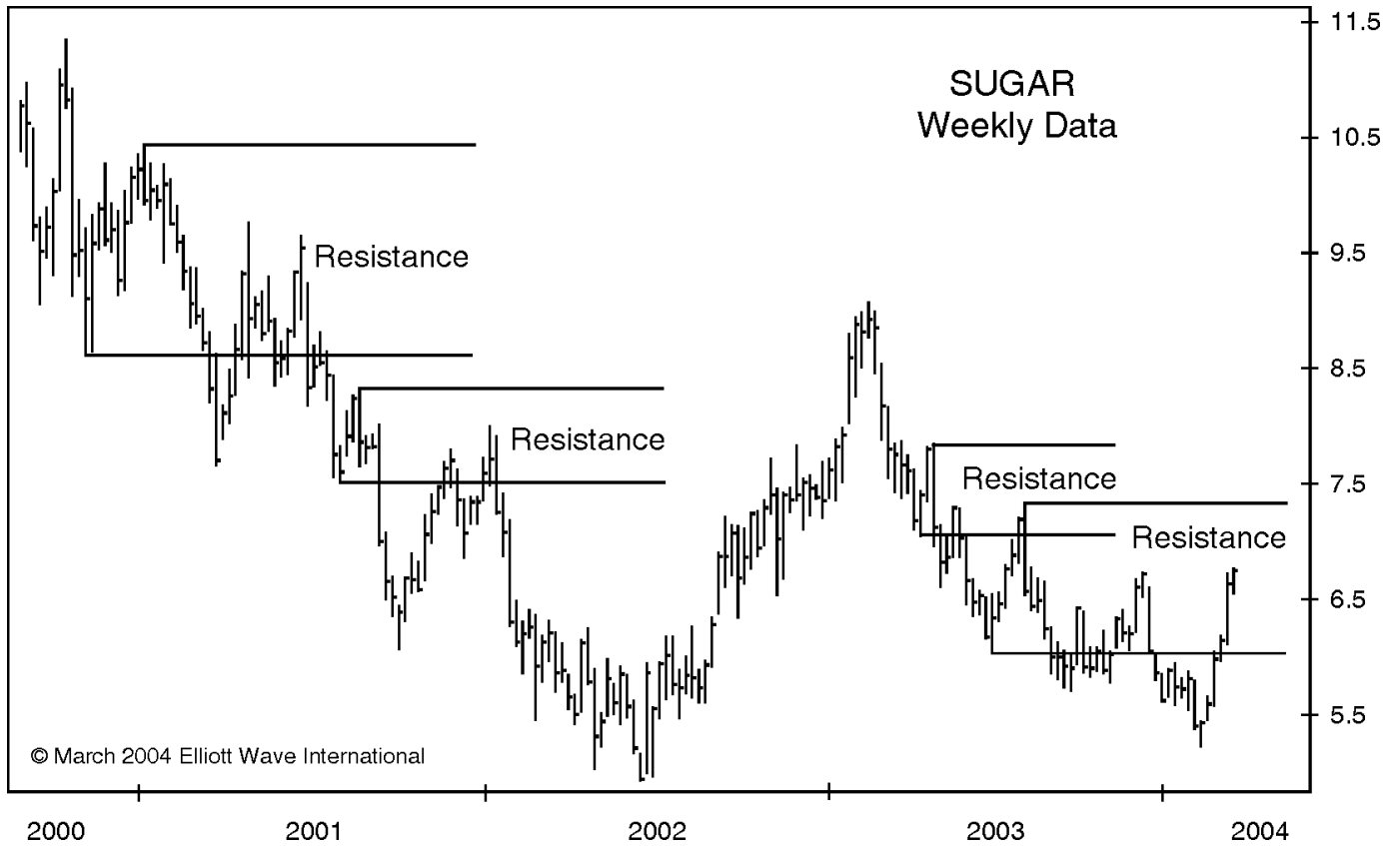


Figure 6-2

Highs, Lows and Gaps

Other areas to watch for price reversals are previous highs and lows and also gaps. You can see on the chart of May Corn (Figure 6-3), for instance, that the September 2003 high was a significant hurdle for prices to overcome. For three months, each attempt to break through this level failed to produce a sizable decline. Also notice the small gap that occurred in early October. The December selloff closed this gap, and in doing so, introduced the subsequent rally. I have mentioned before how gaps often attract prices like magnets at first. Then they repel them – literally. Prices fill the gap and flee the scene, you could say.

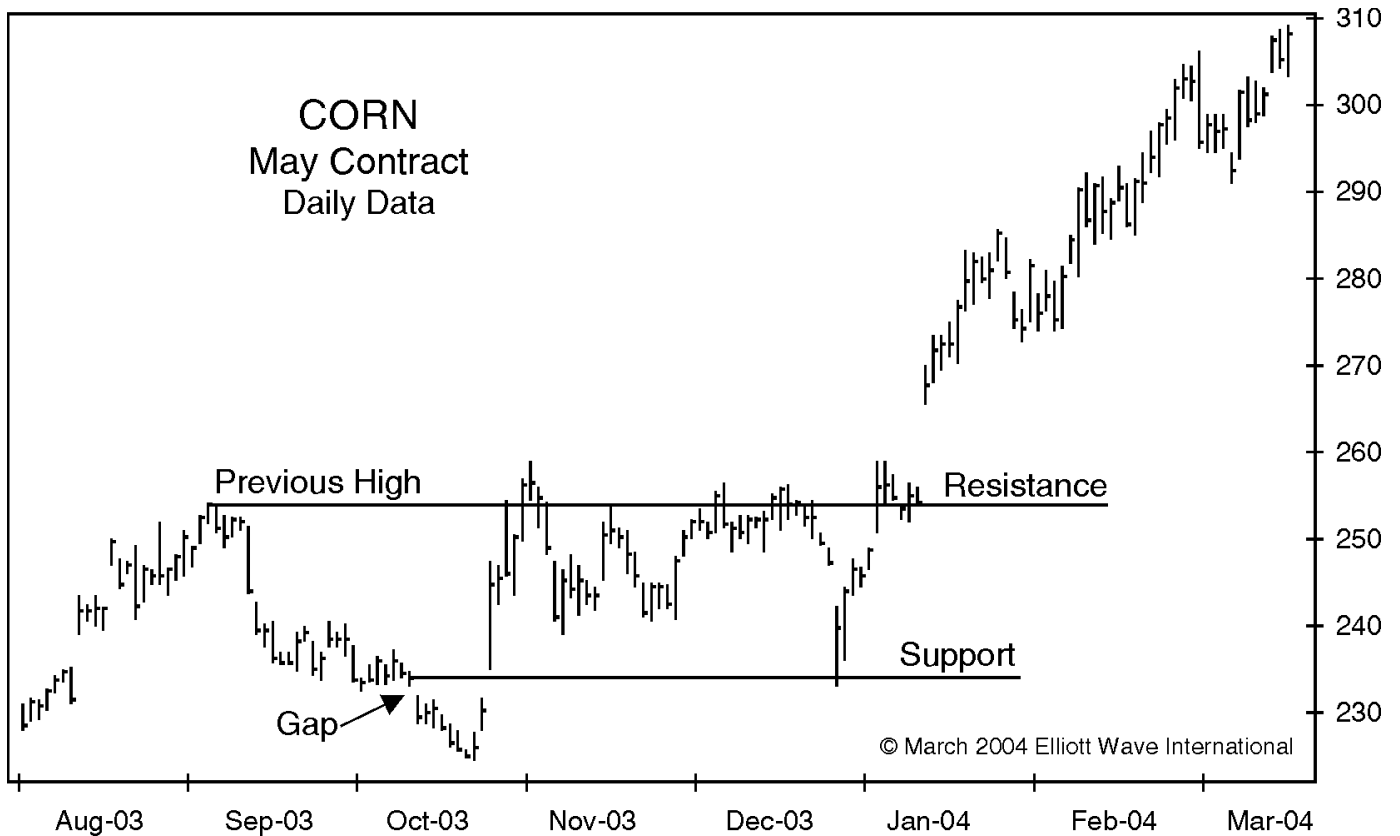


Figure 6-3

VI. How To Identify and Use Support and Resistance Levels

The April chart of Lean Hogs (Figure 6-4) gives us two examples of the same setup: The February advance failed at the previous high made in November 2003, and then fell back to close the late January gap. Prices failed at a previous high again in March and then closed the gap that occurred in late February.

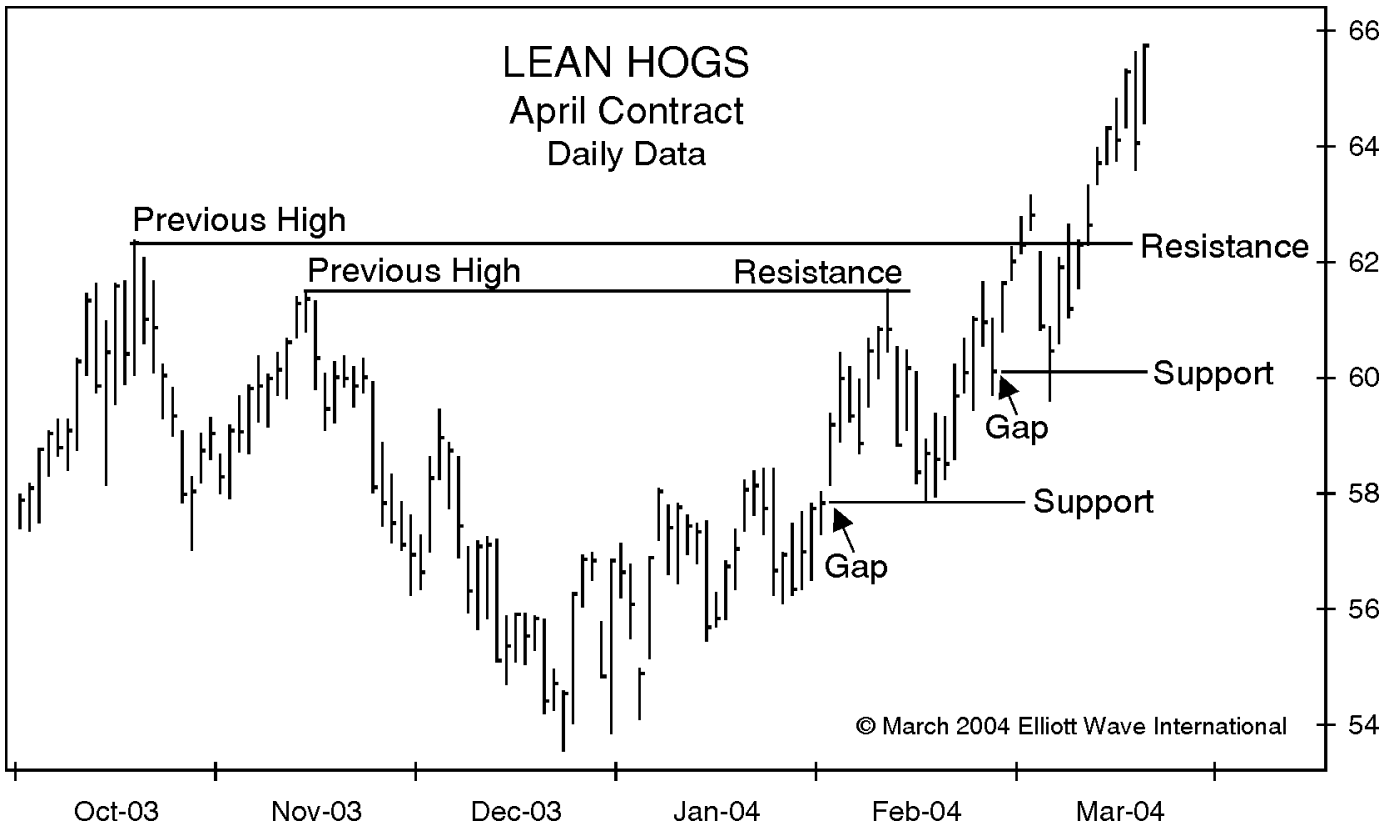


Figure 6-4

VI. How To Identify and Use Support and Resistance Levels

This last chart for Orange Juice (Figure 6-5) offers one example of how previous lows can provide resistance. Each bounce within the last ten months in OJ has met resistance at or near a previous low.

[March 2004]

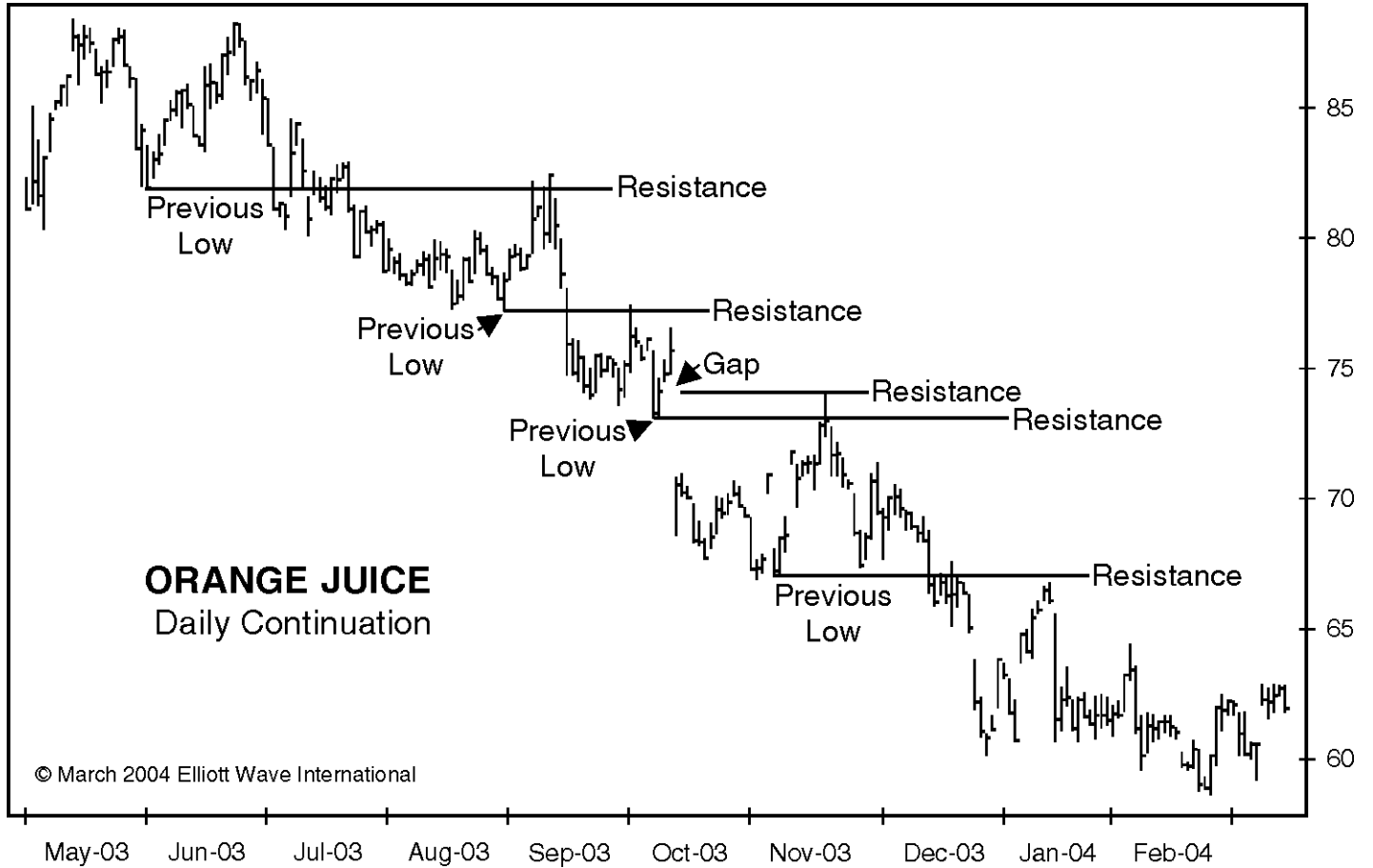


Figure 6-5

VII. How To Draw and Use Trendlines

1. The Basics: “How a Kid with a Ruler Can Make a Million”

When I began my career as an analyst, I was lucky enough to spend some time with a few old pros. I will always remember one in particular, who told me that a kid with a ruler could make a million dollars in the markets. He was talking about trendlines. And I was sold.

I spent nearly three years drawing trendlines and all sorts of geometric shapes on price charts. And you know, that grizzled old trader was only half right. Trendlines are one of the simplest and most dynamic tools an analyst can employ... but I have yet to make my million dollars, so he was either wrong or at least premature on that point.

Despite being extremely useful, trendlines are often overlooked. I guess it's just human nature to discard the simple in favor of the complicated. (Heaven knows, if we don't understand it, it must work, right?)

In Figure 7-1, I have drawn a trendline using two lows that occurred in early August and September 2003. As you can see, each time prices approached this line, they reversed course and advanced. Sometimes, Soybeans only fell to near this line before turning up. And other times, prices broke through momentarily

before resuming the larger uptrend. But what still amazes me is that two seemingly insignificant lows last year pointed out the direction of Soybeans – and identified several potential buying opportunities – for the next six months!

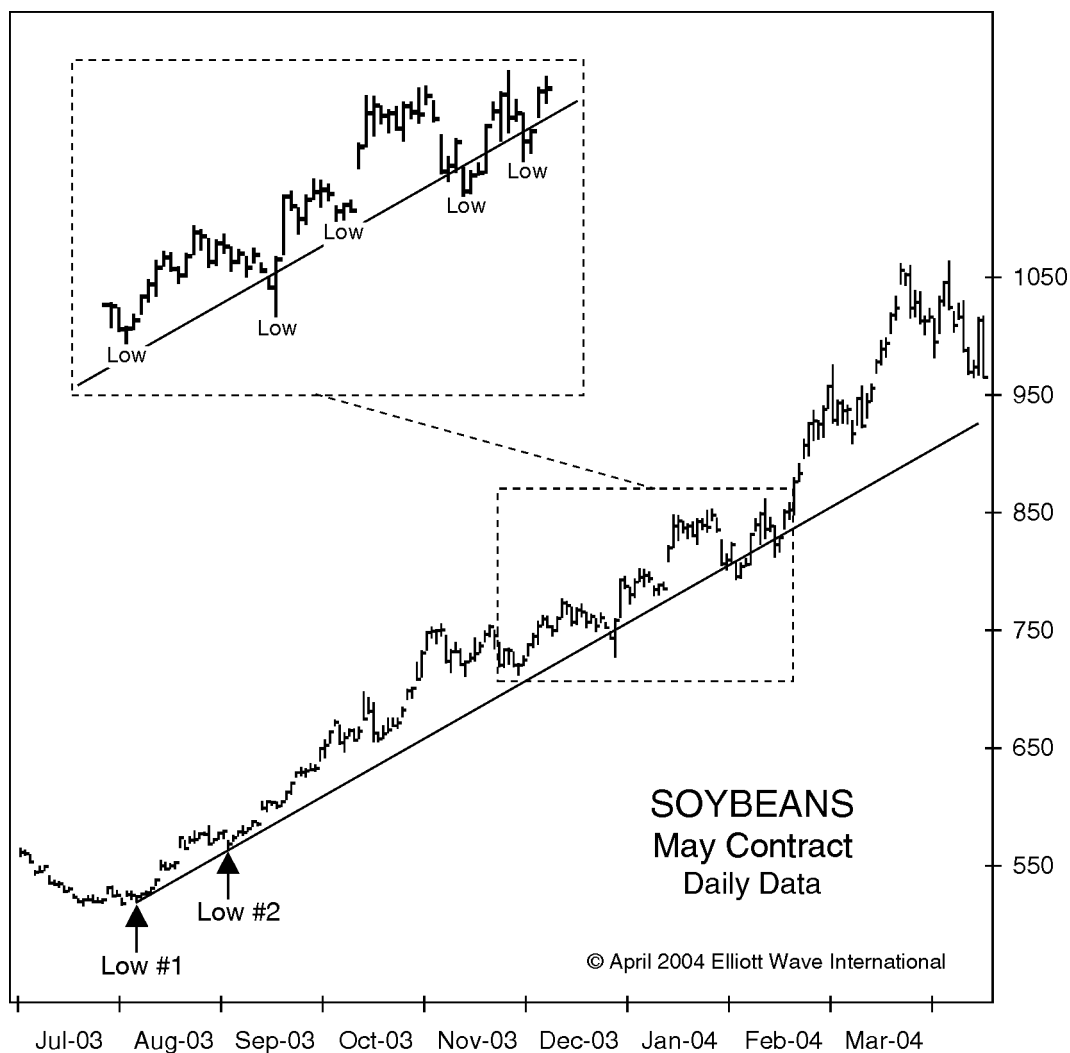


Figure 7-1

Primary Angle

Besides simply connecting highs and lows, you can draw trendlines in many other ways that are just as exciting and informative. Figure 7-2 shows a technique I call Primary Angle. Notice the upward trendline drawn in Sugar in late 1999 (A1). Now look at the trendline up from the 2002 low (A2). See anything interesting? These two trendlines are parallel! The slope of the late 1999 rally is the same for the 2002 advance. In fact, the range of the weekly high for the 2002 advance encompasses this line. The same is true for the two downward sloping trendlines drawn off the 2000 and 2003 highs (B1 & B2); the angle of the decline is the same.

Another way to use Primary Angle besides identifying possible trend changes is clear in Figure 7-3. The trendline up from the March low is a parallel of the late February advance. As you can see, prices were falling off of this trendline by the March high. I interpret this move as weak price action with waning momentum. And resulting price action supports this conclusion. In Figure 7-4, notice how prices are to the right of the downward trendline from the March high. Again, this selloff lacks the intensity of its predecessor. You can see in Figure 7-5 why this makes sense from an Elliott perspective. The wave pattern from the late February 35.05 peak is an expanded flat correction (3-3-5). Wave (a) bottomed at 31.75 (basis May), and wave (b) topped at 35.18 [after making a moderate new high beyond the extreme of wave (a)]. Wave (c) of 9 is under way, targeting Fibonacci support at 30.44-29.63. It's not surprising to see prices behave like this near the end of a wave pattern.

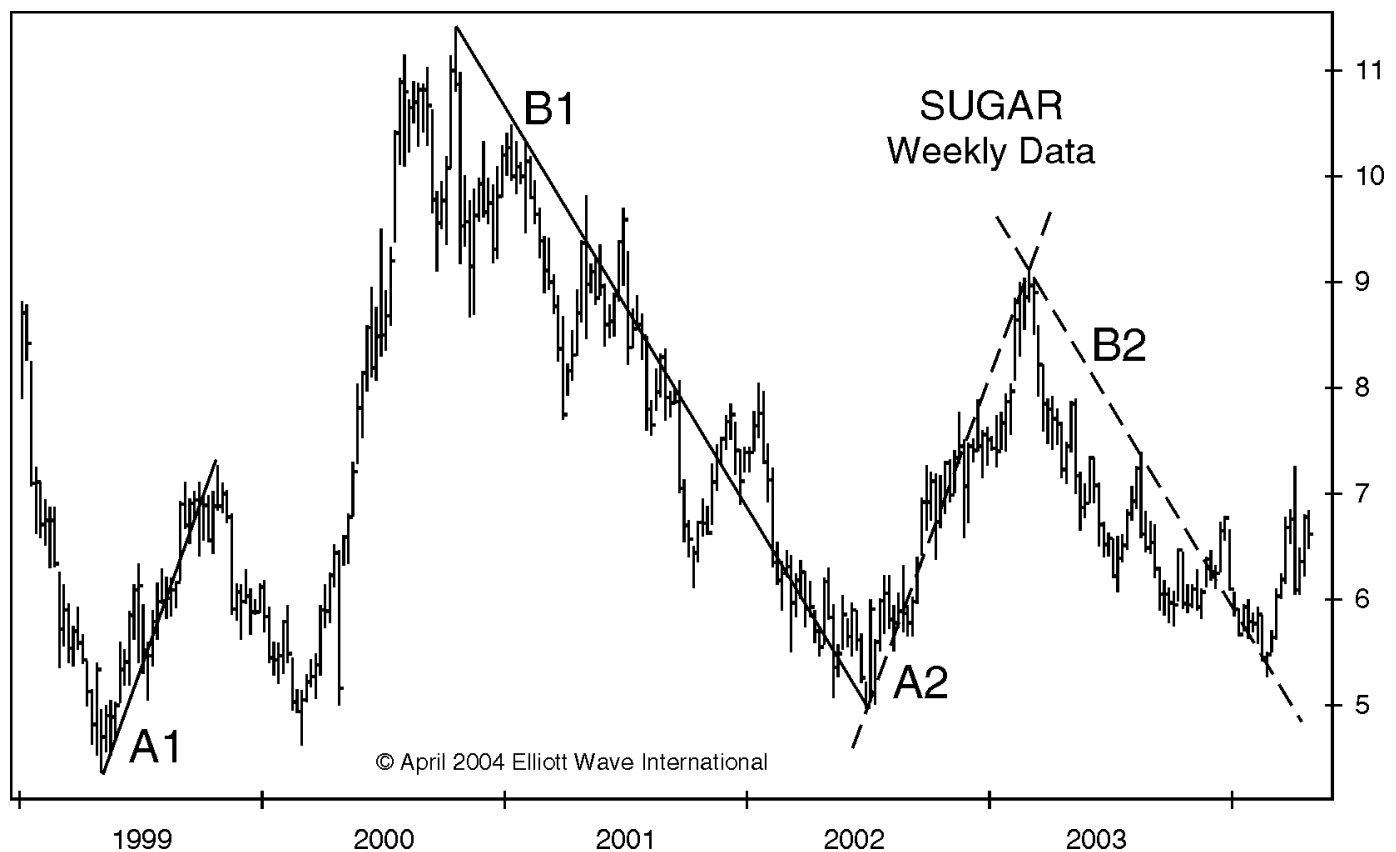


Figure 7-2

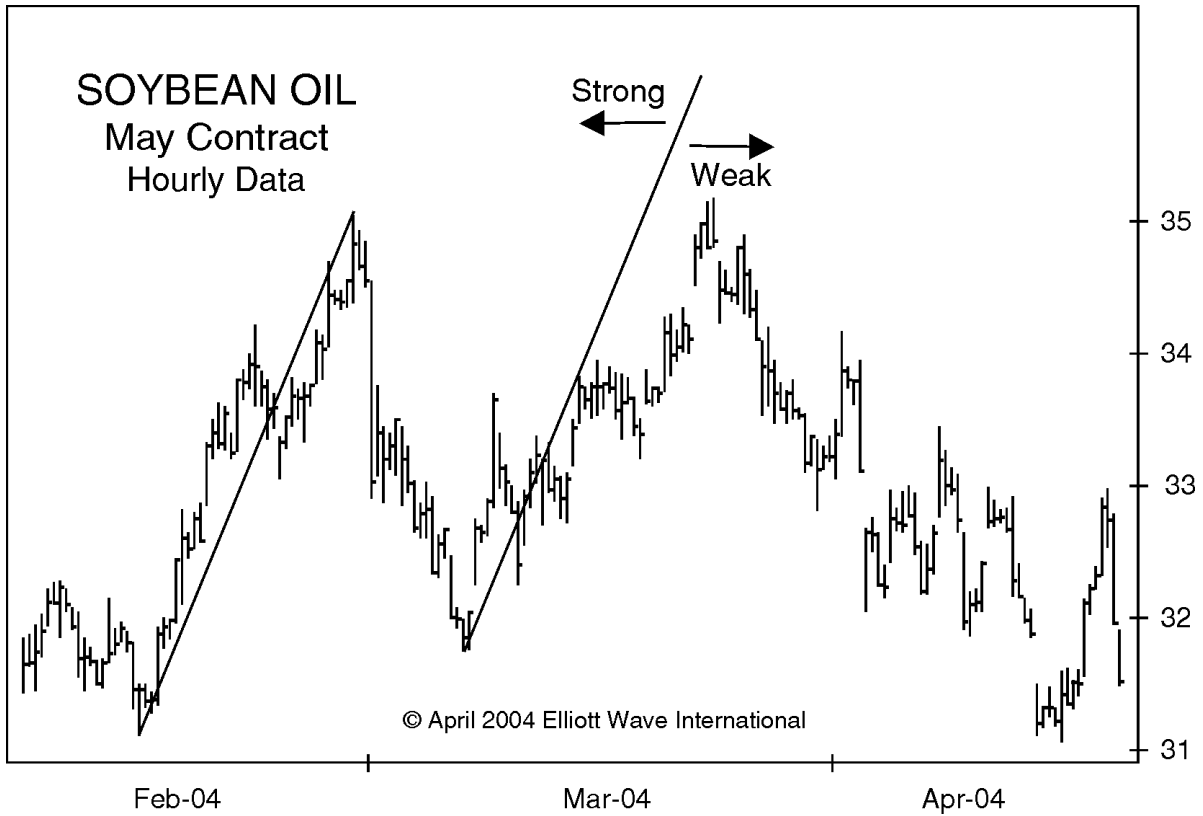


Figure 7-3

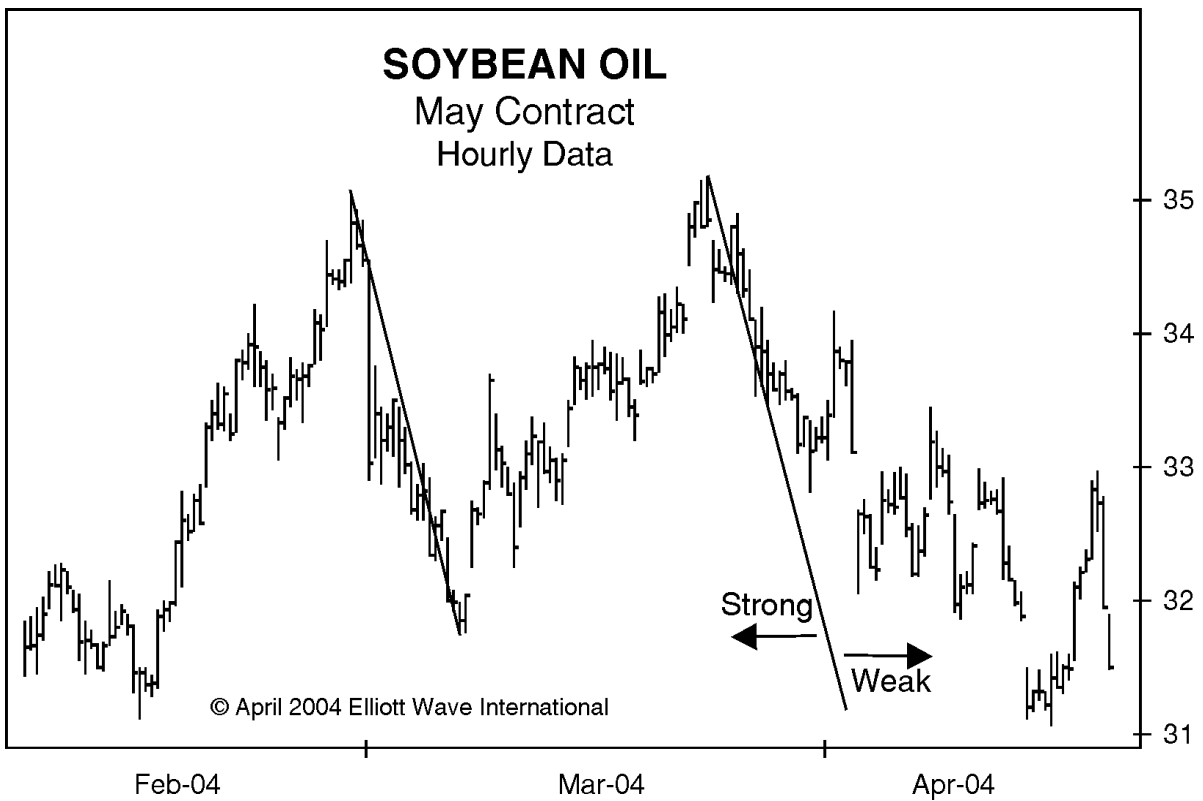


Figure 7-4

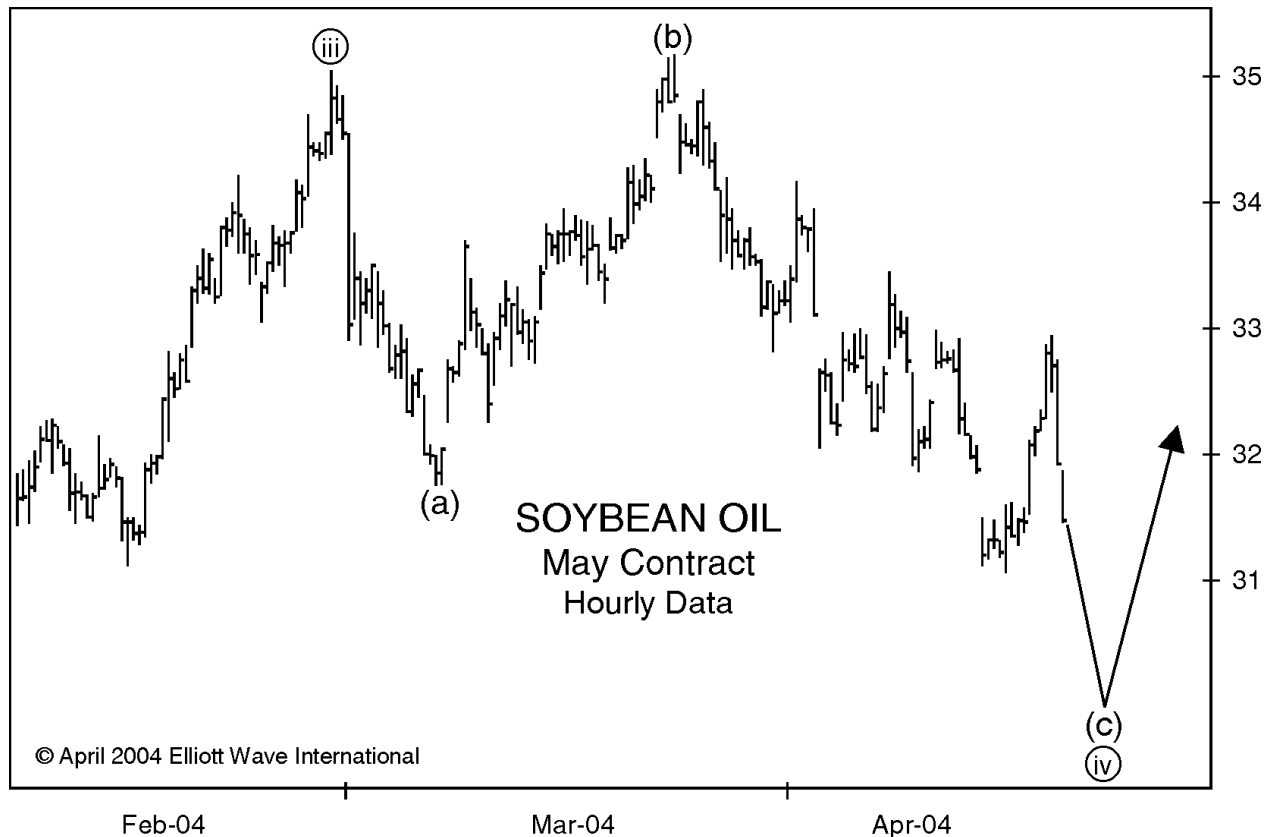


Figure 7-5

Triple Fan

Figure 7-6 displays another trendline technique called the “Triple Fan.” I picked this up from a wonderful book called *Timing the Market* by Curtis Arnold. I am surprised at how often this tool ushers in significant moves. Down from the September 2003 high in Coffee, three downward sloping trendlines are drawn against peaks 1, 2 and 3; this is your fan. A break of the third trendline often signals a significant move or change in trend, which it did in this case. In December 2003, Coffee gapped above this line and tried to test the top of it before rallying to 80.60.

A similar example is illustrated in Figure 7-7, June Live Cattle. Beginning with a significant extreme, three downward sloping trendlines are drawn across the tops of three following peaks. Clearly, these lines provided important support during the mad cow incident in December 2003 and the late selloff in March.

In short, even the most basic trendlines are a great analytical tool. They work on any time frame and any market. You can draw them vertically (for timing purposes), horizontally (for marking support and resistance) and diagonally (to identify possible turning points).

Note: A special thanks goes out to that old pro who emphasized the basics and told me about the kid with the ruler, Pete Desario.

[April 2004]

VII. How To Draw and Use Trendlines

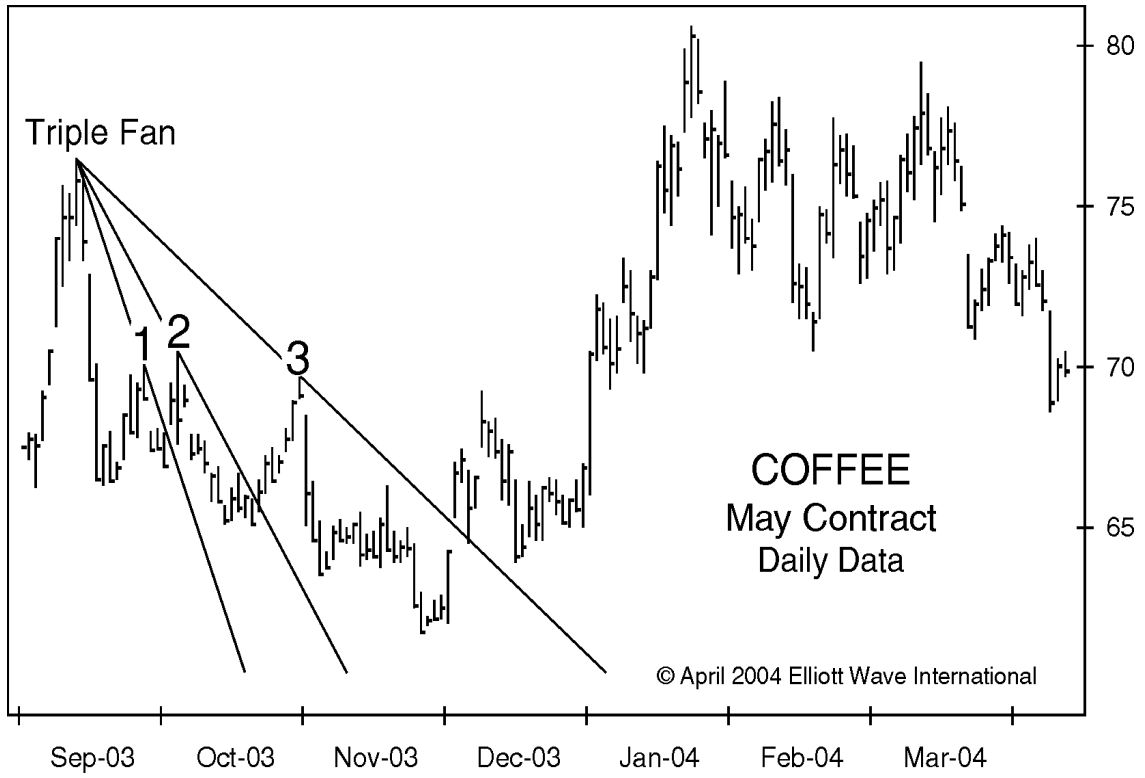


Figure 7-6

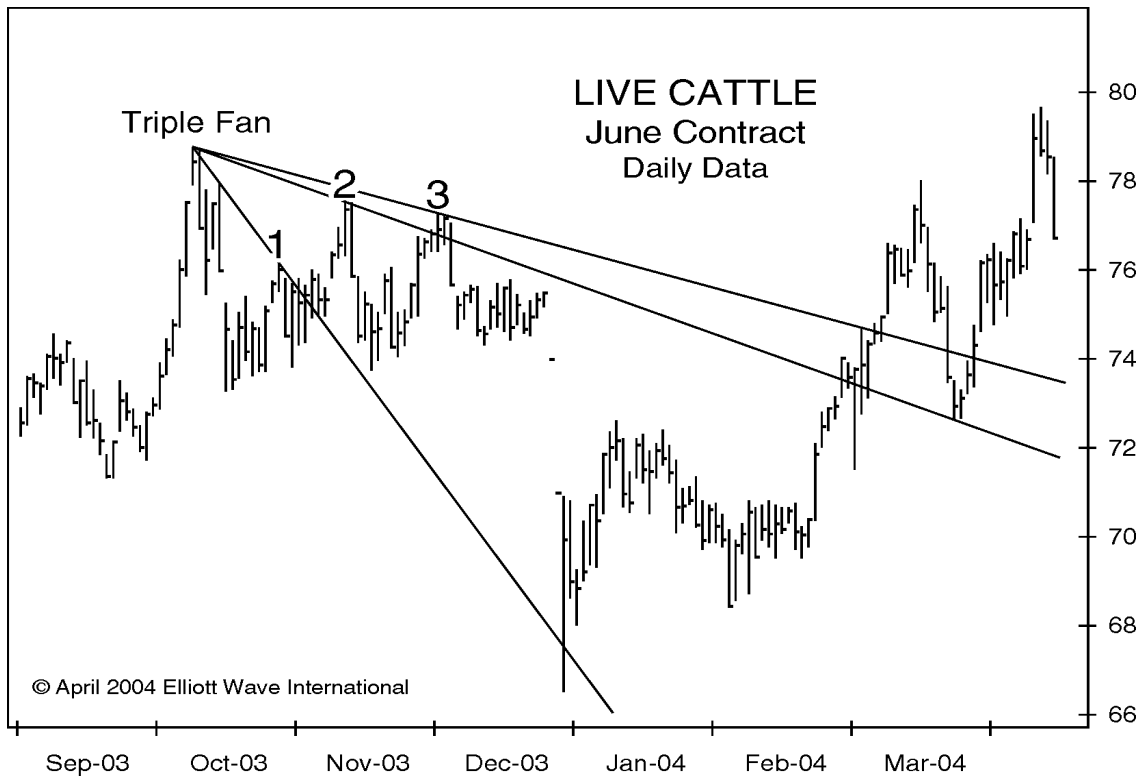


Figure 7-7

2. How To Use R.N. Elliott's Channeling Technique

Now let's take the subject one step further and discuss R.N. Elliott's Channeling Technique. Elliott saw that parallel lines often mark the upper and lower limits of impulse waves, specifically waves four and five. In other words, prices trend within a channel. And it's a good thing they do, because it gives us yet another reliable method for identifying support and resistance. What's more, a channel's "life-span" – how long price action keeps within its boundaries – speaks directly to how big or small a move to expect once prices have broken the channel and a reversal is at hand.

So here's how you draw them.

First, when you need to identify support for wave four, draw a line connecting the ends of waves one and three (see Figure 7-8). Then, draw a parallel line that touches the extreme of wave two. These two lines outline your channel, and the lower line shows you the likeliest support for wave four.

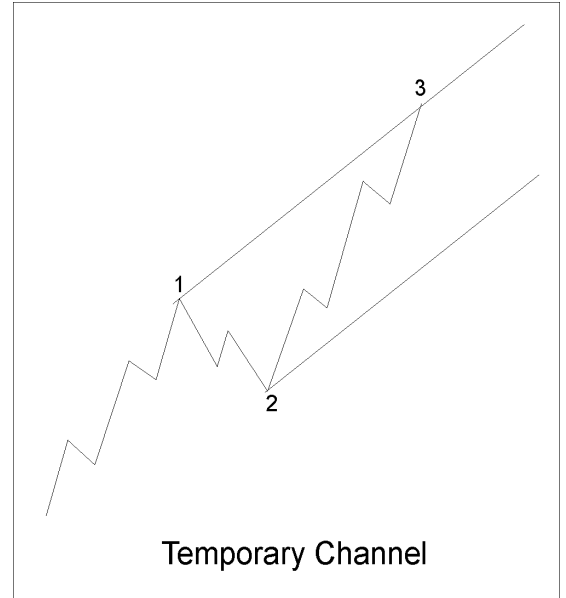


Figure 7-8

A trick I have picked up over the years is to double the channel (see Figure 7-9). To do this, place a third parallel line beneath your lower line, at the point where all three lines have equal space between them. The channel width is now double that of the Elliott channel. When your original channel doesn't hold, and evidence continues to argue for a fourth wave, this lower line will provide support.

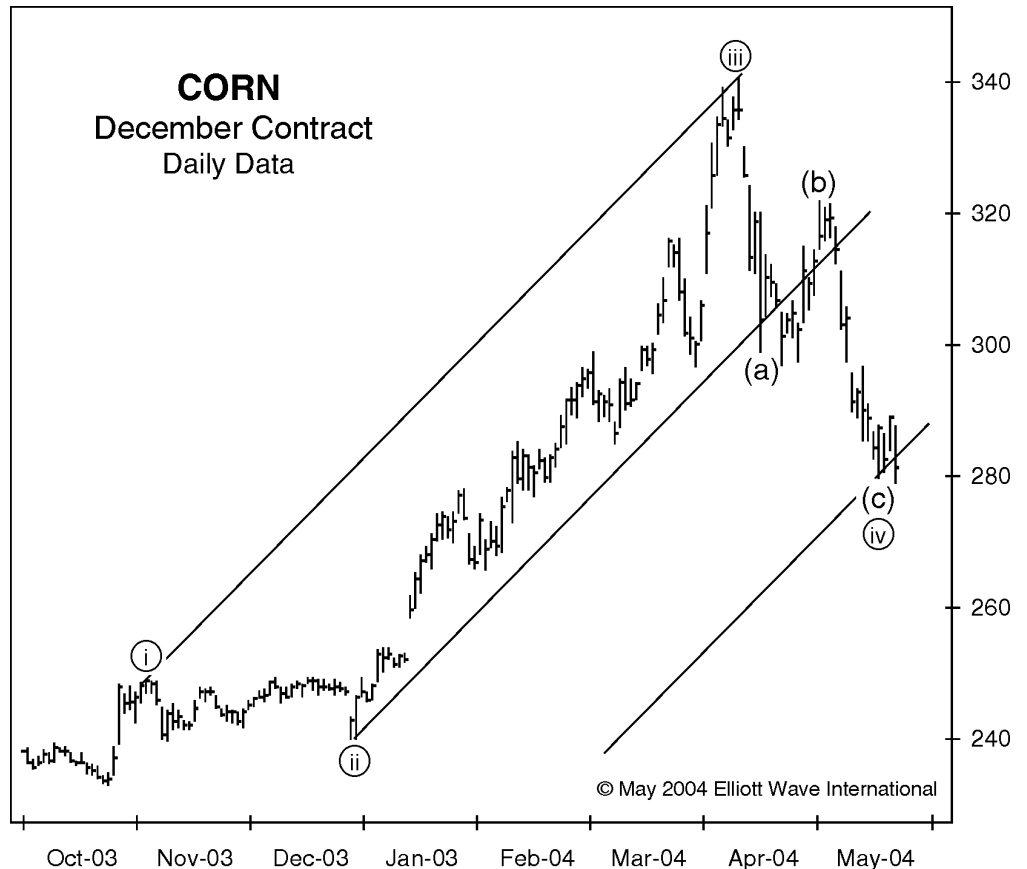


Figure 7-9

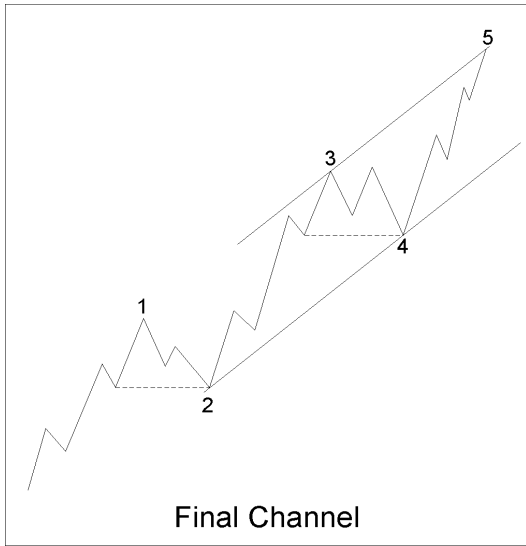


Figure 7-10

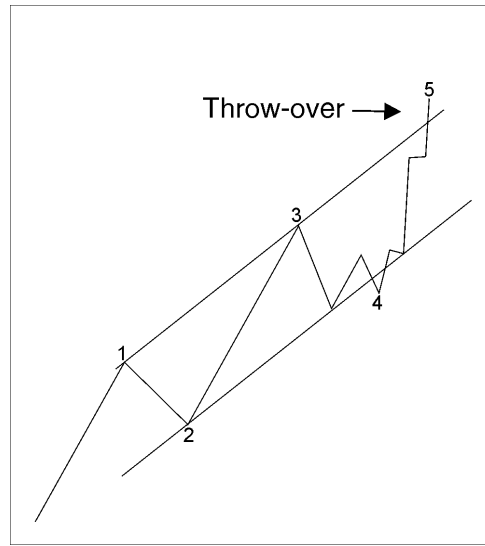


Figure 7-11

The next channel we'll draw serves to identify a likely target for wave five. Your first line connects the ends of waves two and four. Draw a parallel line at the extreme of wave three (see Figure 7-10). The upper boundary of this channel identifies fifth-wave resistance. If you're contending with a third wave that is parabolic, then use the extreme of wave one. (Parabolic is simply a term used to describe price action that travels far in a short period of time.)

Fifth waves are tricky, and sometimes prices will exceed this upper boundary line (called a throw-over — see Figure 7-11) or undershoot it. R.N. Elliott noted this possibility and discovered a significant clue that helps determine when a throw-over will or will not occur: Volume. When volume is heavy as prices approach the upper boundary line of the channel, chances are high that a throw-over will occur (see Figure 7-12). When volume is light, wave five will either meet the upper boundary line or fall short. I've got another hint of my own that may help: when volume is light, the center of the Elliott channel will act as resistance (see Figure 7-13).

[May 2004]

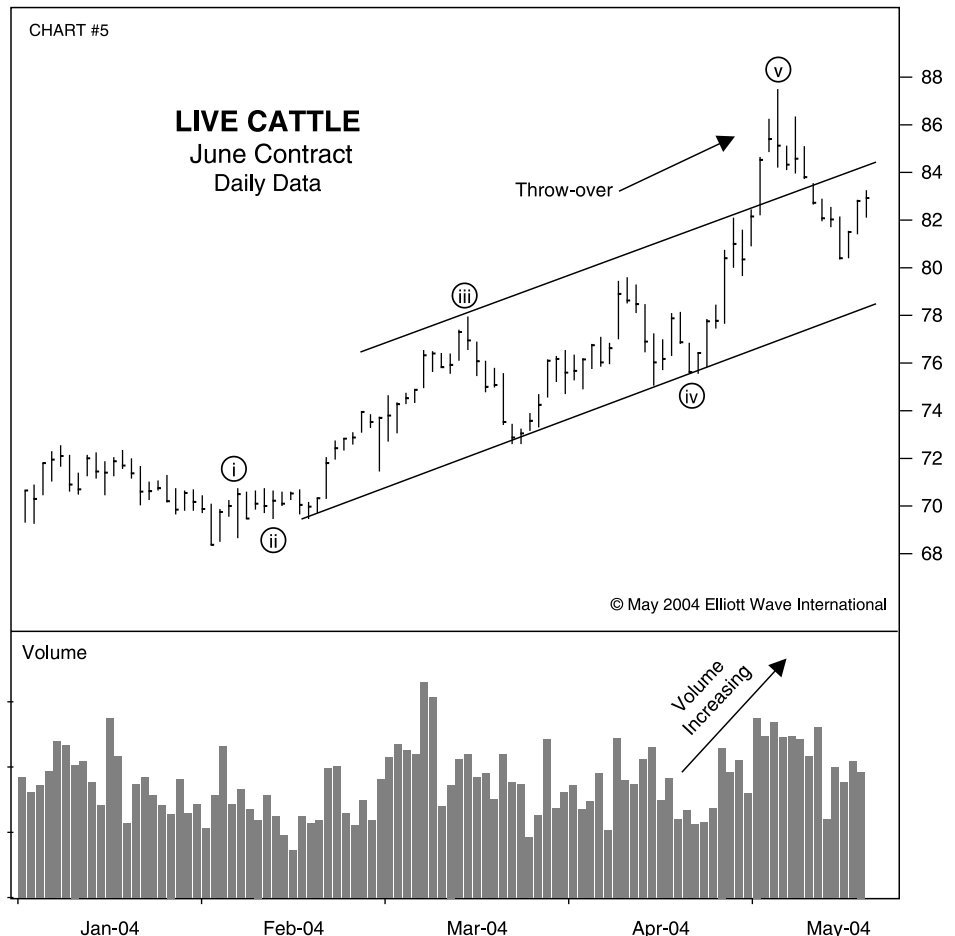


Figure 7-12

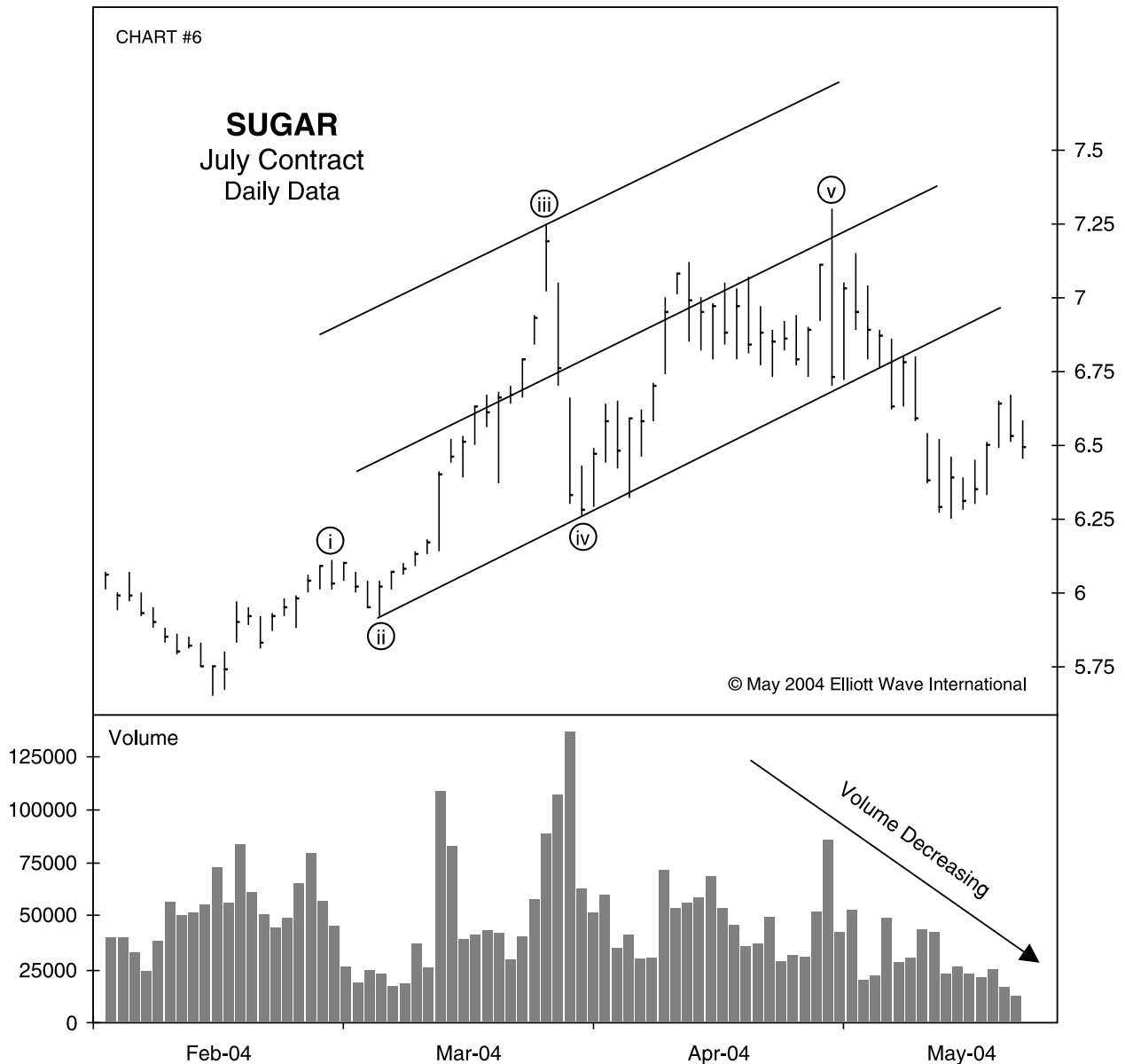


Figure 7-13

3. How To Use Jeffrey Kennedy's Channeling Technique

We've now dealt with trendlines and Elliott's channeling technique. Before I move on to a different topic, I'd like to share my own channeling technique.

All too often, Elliotticians balance a bullish wave count with a bearish alternate. It's frustrating to find out that what you thought was wave C was actually wave three. So when does a C wave become a third wave? Or how do you know if the wave 4 you're counting goes with wave 2, and not a smaller or larger degree wave two? I spent years trying to design a tool or technique that would confirm wave patterns and answer these questions. Here's what I came up with.

My theory is simple: Five waves break down into three channels, and three waves need only one. The price movement in and out of these channels confirms each Elliott wave.

Base Channel

Figure 7-14 shows three separate five-wave patterns with three different channels drawn: the base channel, the acceleration channel and the deceleration channel.

The base channel contains the origin of wave one, the end of wave two and the extreme of wave one (Figure 7-14A). Of the three channels, the base channel is most important, because it defines the trend. As long as prices stay within the base channel, we can safely consider the price action corrective. Over the years, I've discovered that most corrective wave patterns stay within one price channel (Figure 7-15). Only after prices have moved through the upper or lower boundary lines of this channel is an impulsive wave count suitable, which brings us to the acceleration channel.

Acceleration Channel

The acceleration channel encompasses wave three. Use the extreme of wave one, the most recent high and the bottom of wave two to draw this channel (Figure 7-14B). As wave three develops, you'll need to redraw the acceleration channel to accommodate new highs.

Once prices break through the lower boundary line of the acceleration channel, we have confirmation that wave three is over and that wave four is unfolding. I have noticed that wave four will often end near the upper boundary line of the base channel or moderately within the parallel lines. If prices break through the lower boundary line of the base channel decisively, it means the trend is down, and you need to draw new channels.

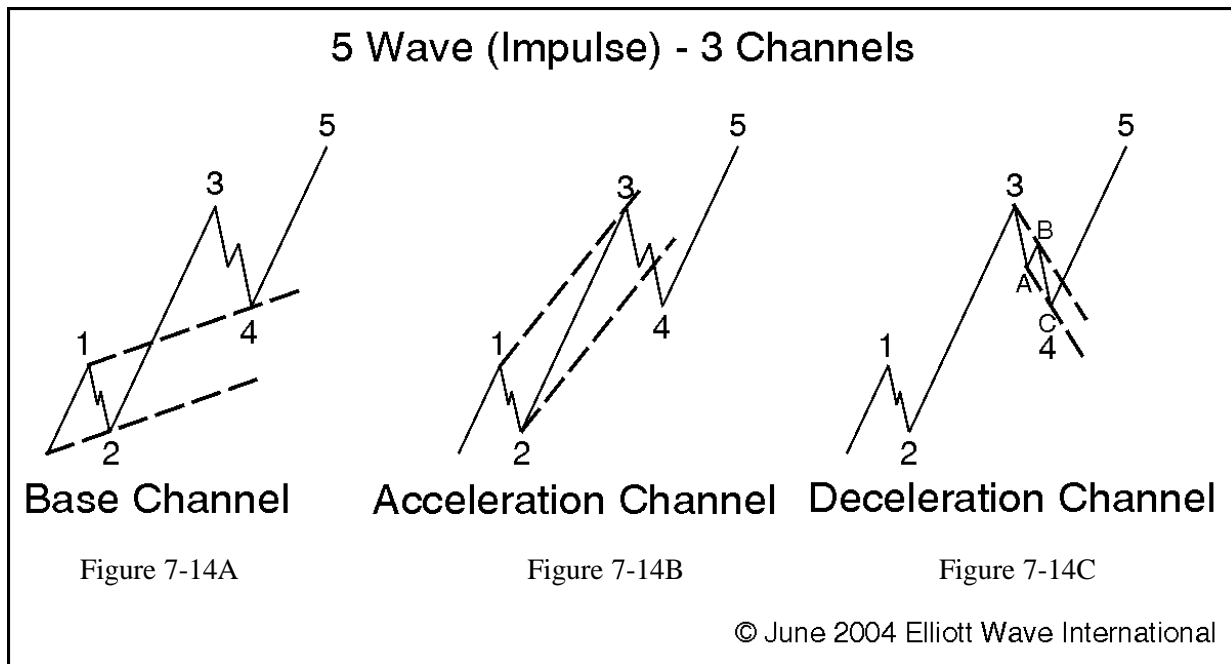


Figure 7-14

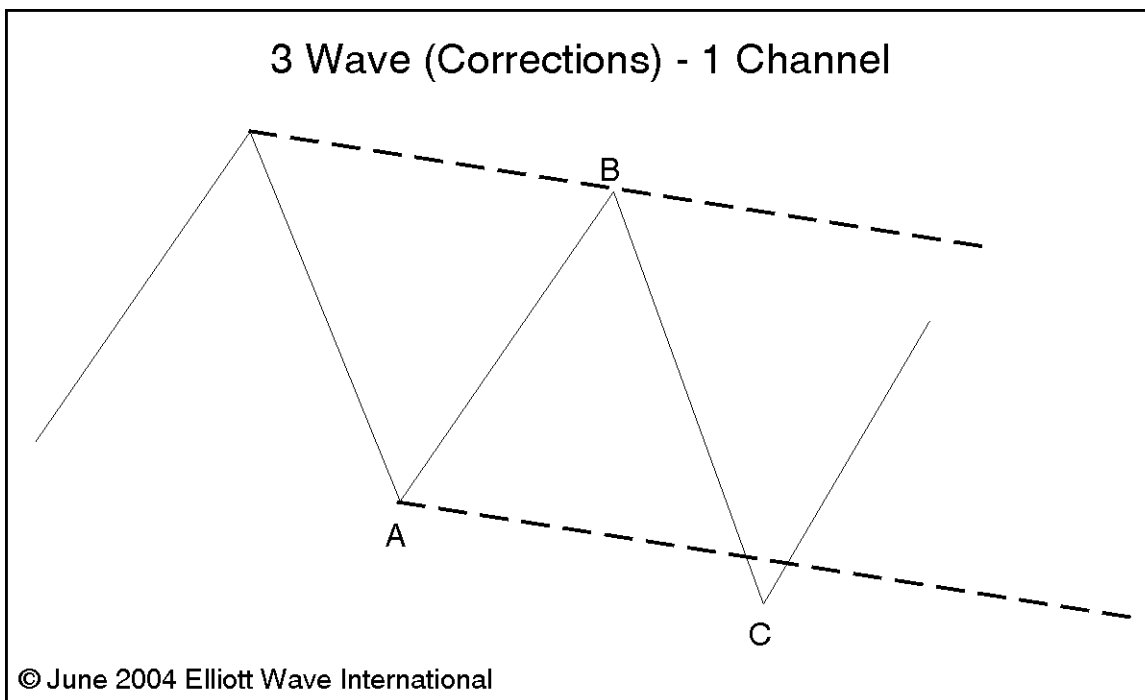


Figure 7-15

Deceleration Channel

The deceleration channel contains wave four (Figure 7-14C). To draw the deceleration channel, simply connect the extremes of wave three and wave B with a trend line. Take a parallel of this line, and place it on the extreme of wave A. As I mentioned before, price action that stays within one price channel is often corrective. When prices break through the upper boundary line of this channel, you can expect a fifth-wave rally next.

In a nutshell, prices need to break out of the base channel to confirm the trend. Movement out of the acceleration channel confirms that wave four is in force, and penetration of the deceleration channel lines signals that wave five is under way. Now for some real examples:

In Figure 7-16, you can see that most of the January selloff in Coffee was within one channel. Since price action within one channel is typically corrective, I still considered the larger trend up. This approach was helpful in alerting me to a possible one-two, one-two setup in Coffee.

In May 2004, I cited many reasons for a further rally in December Corn. In Figures 7-17, 7-18 and 7-19 you can see the underlying progression of the base, acceleration and deceleration channels and how they supported the wave count.

In August Lean Hogs (Figure 7-20), you'll notice how prices broke the base channel momentarily in wave (c) of 4. Normally, this would be troubling, because the base channel defines the trend. But Figure 7-22 shows that prices were still within the deceleration channel, which implied the move was still countertrend. A combined break of the base and deceleration channels would have signaled a trend change. And, finally, Figure 7-23 illustrates how the Elliott wave channeling technique identifies fifth-wave objectives.

As an analyst and trader, I am slow to adopt anything new, yet quick to get rid of anything that doesn't work consistently. I developed this channeling technique in the mid-1990s and still use it today. No, it doesn't always work, but I believe it offers great value in the proper labeling and identification of Elliott waves.

[June 2004]

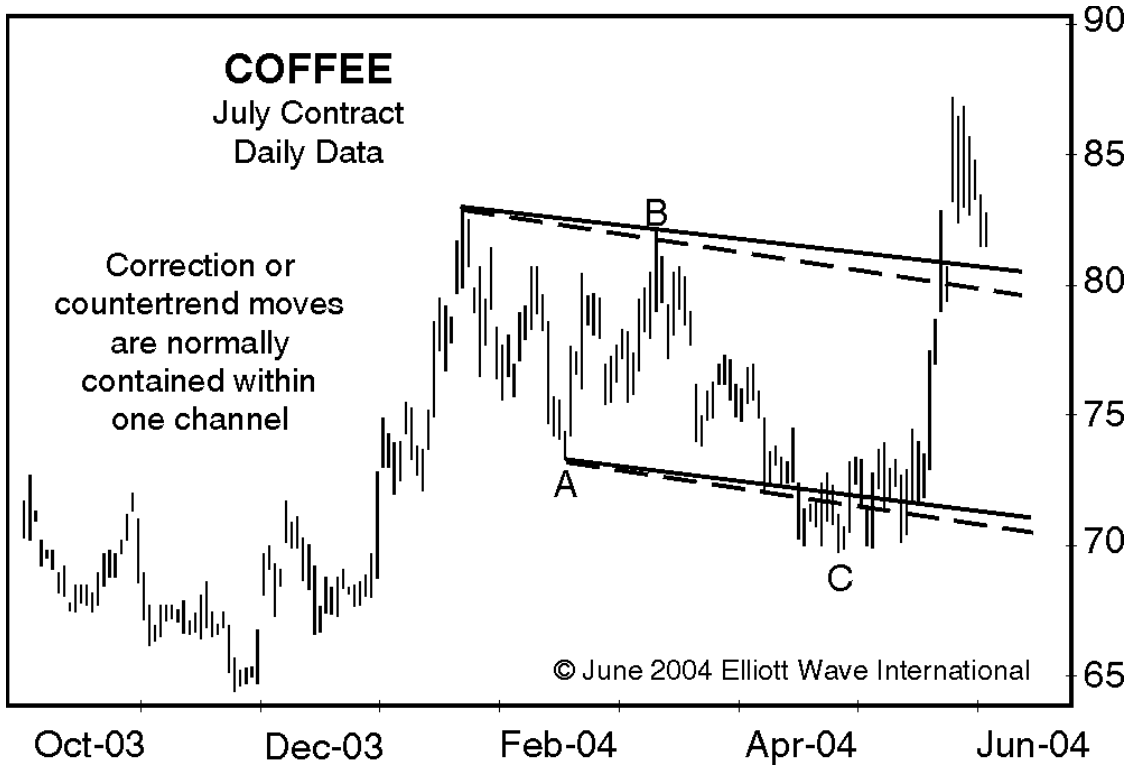


Figure 7-16

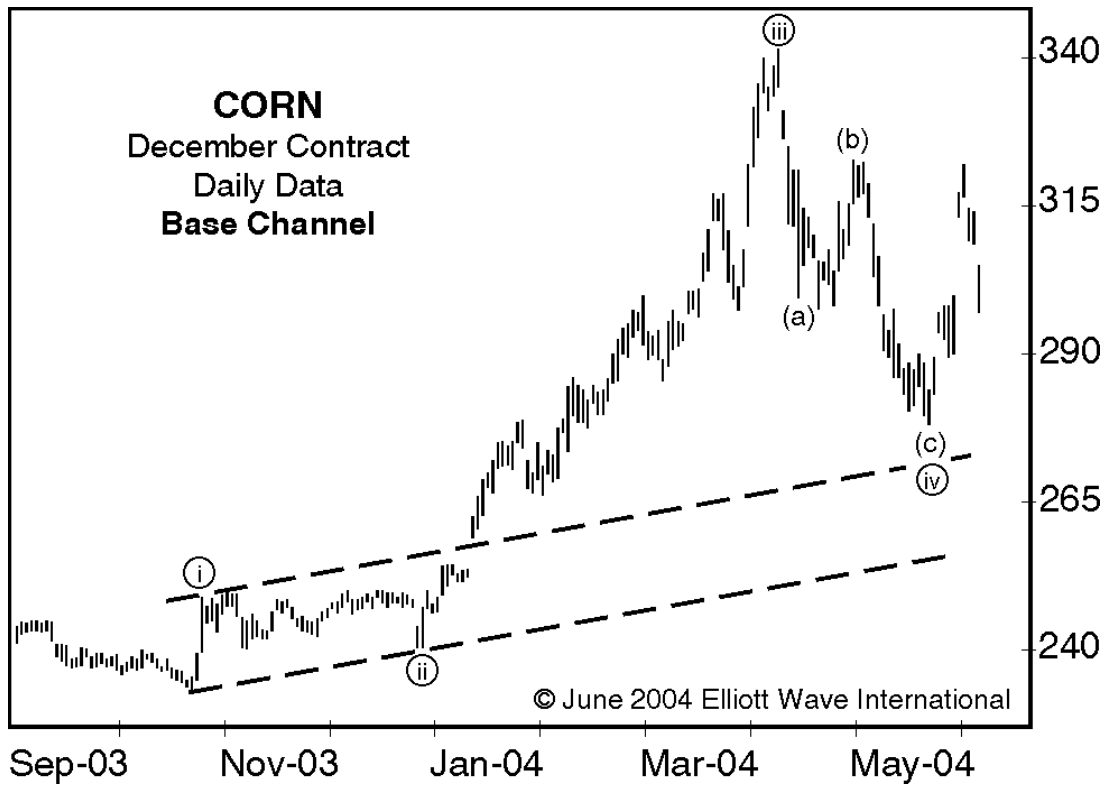


Figure 7-17

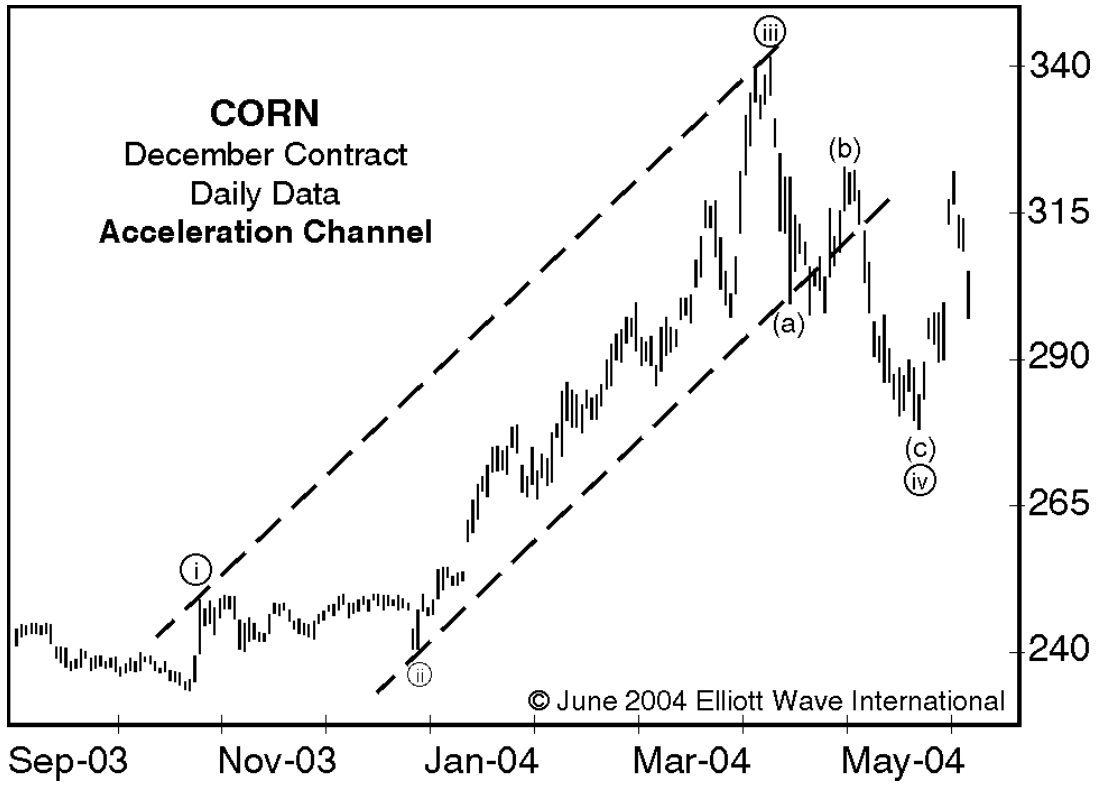


Figure 7-18

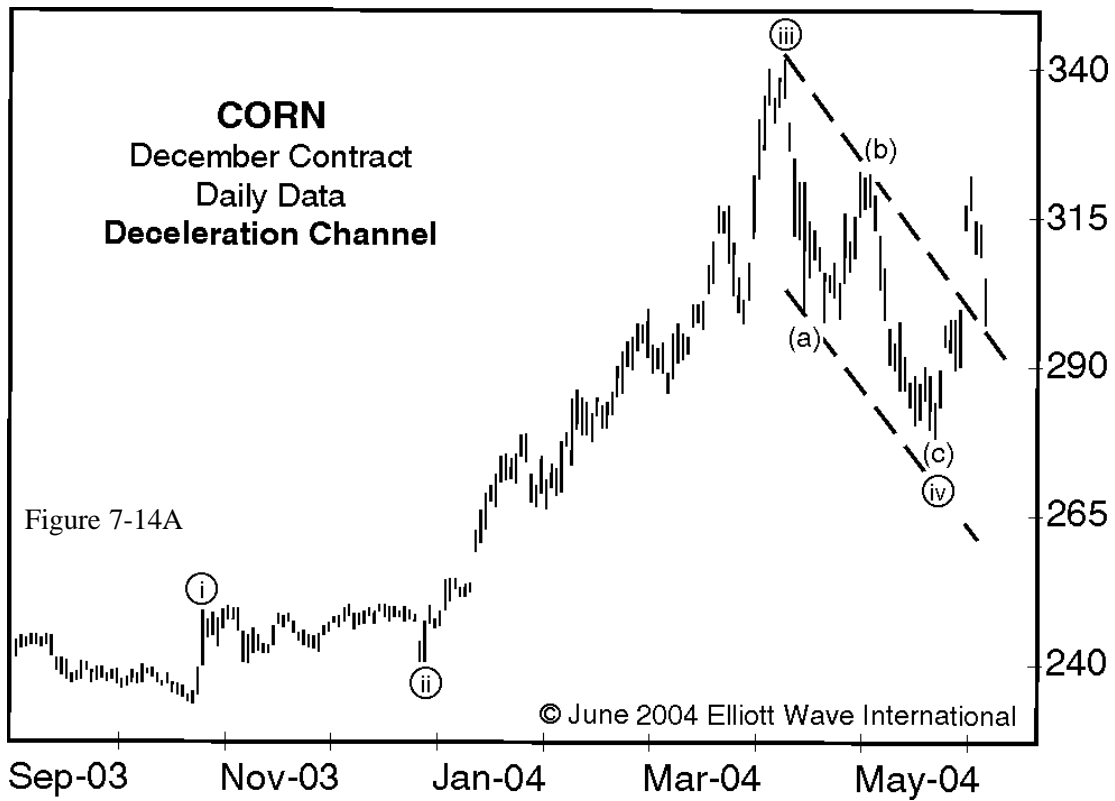


Figure 7-19

VII. How To Draw and Use Trendlines



Figure 7-20

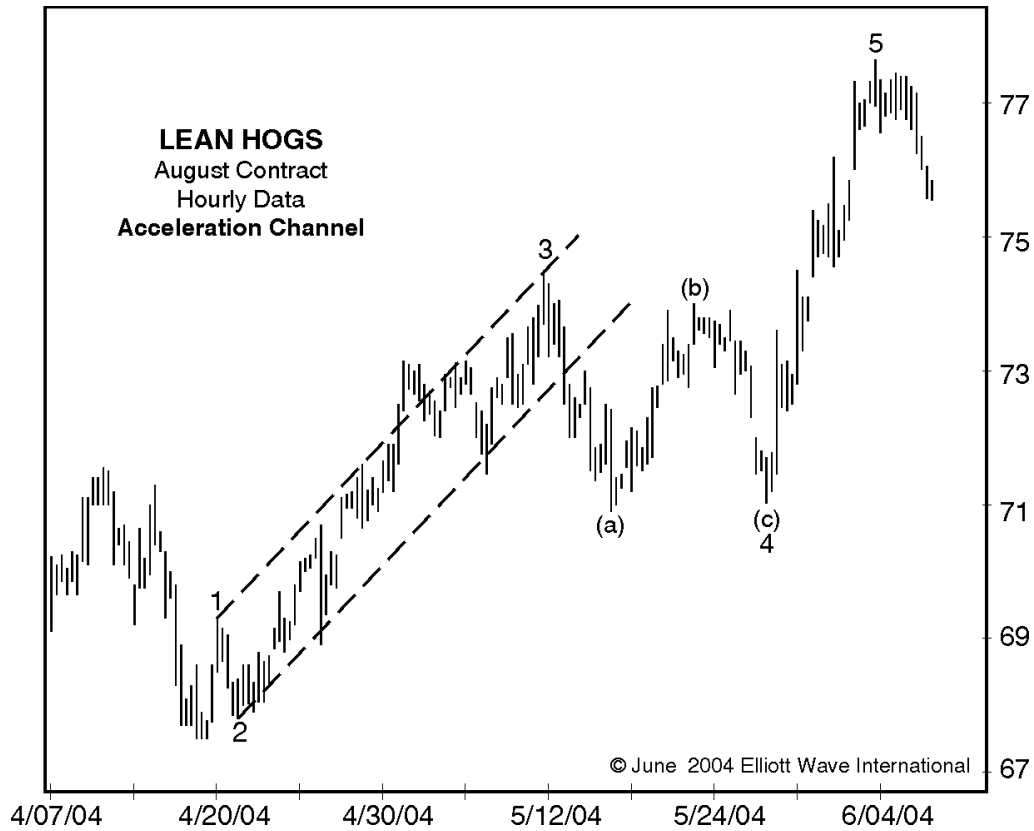


Figure 7-21

VII. How To Draw and Use Trendlines

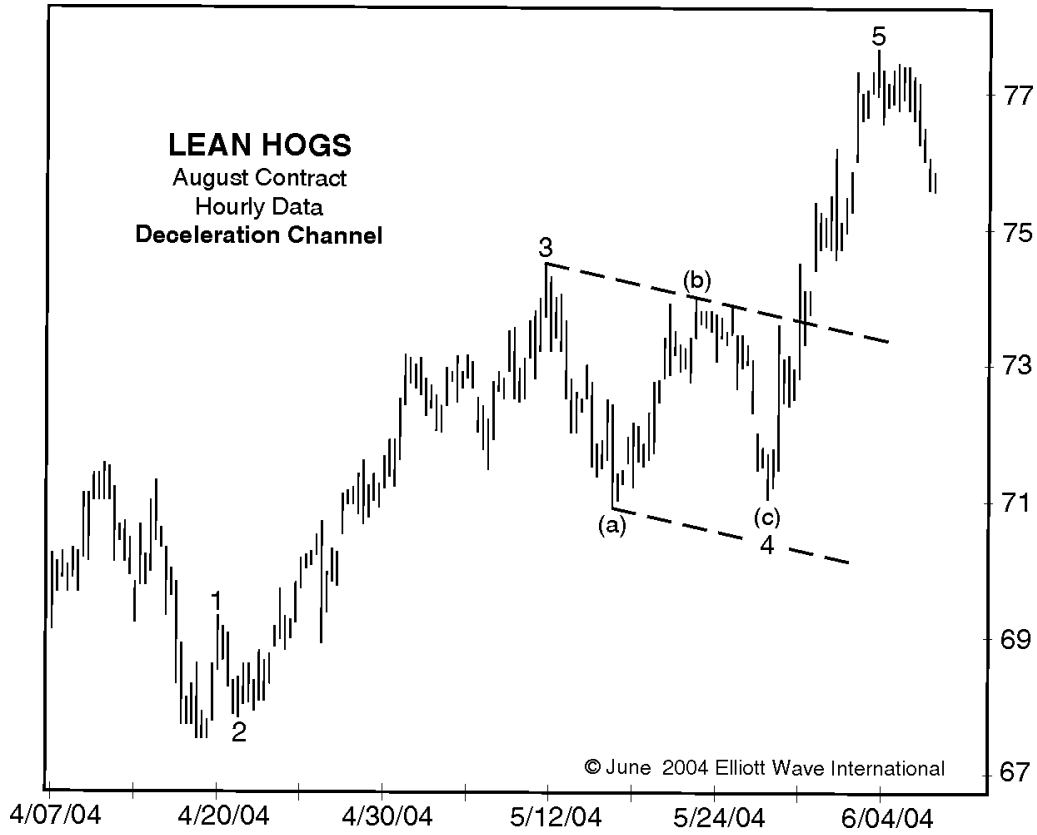


Figure 7-22



Figure 7-23

VIII. How Historical Extremes Act Like Price Boundaries

In October 2003, I taught a seminar called, “How to Spot Trades in Commodities with Elliott Wave Analysis.” The traders who were my students focused on opportunities in three markets: Coffee, Feeder Cattle and Live Cattle. At the time, I was bullish Coffee – but I was bearish on Feeder Cattle and Live Cattle. All three positions turned out to be correct.

No, I didn’t get a tip from a psychic on TV, and no, I don’t stare into crystal balls when I’m bored. So how did I know that Mad Cow disease would hit the U.S. and in turn, crush cattle prices? Of course, I didn’t. I didn’t need to. A basic understanding of how commodity markets trade and a little chart analysis served me better than the news or that other stuff ever could have.

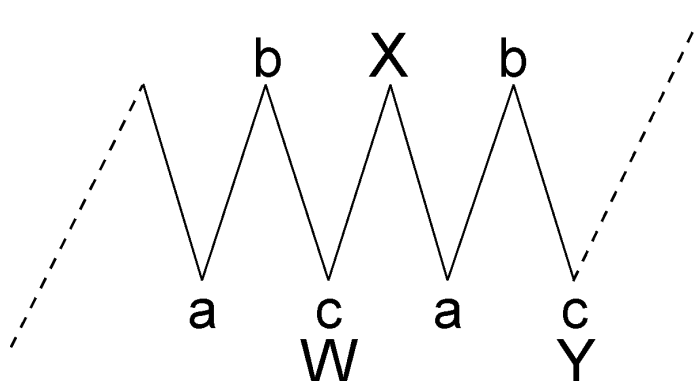


Figure 8-1

Let’s face it — commodities and equities are very different. A bushel of Corn doesn’t pay dividends, and an early freeze in Florida won’t spark a rally in shares of Microsoft. Changes in investor psychology show up differently in commodity prices than they do in stock indexes.

Figure 8-1 illustrates how commodities tend to trade between historical extremes. Cotton (Figure 8-2), for example, has traded between 100.00 and 30.00 since the early 1970s. And each time prices have reached the upper end of that range, a sizeable selloff has followed. The reverse is true whenever prices have dropped down to 30.00 – a rally has followed.

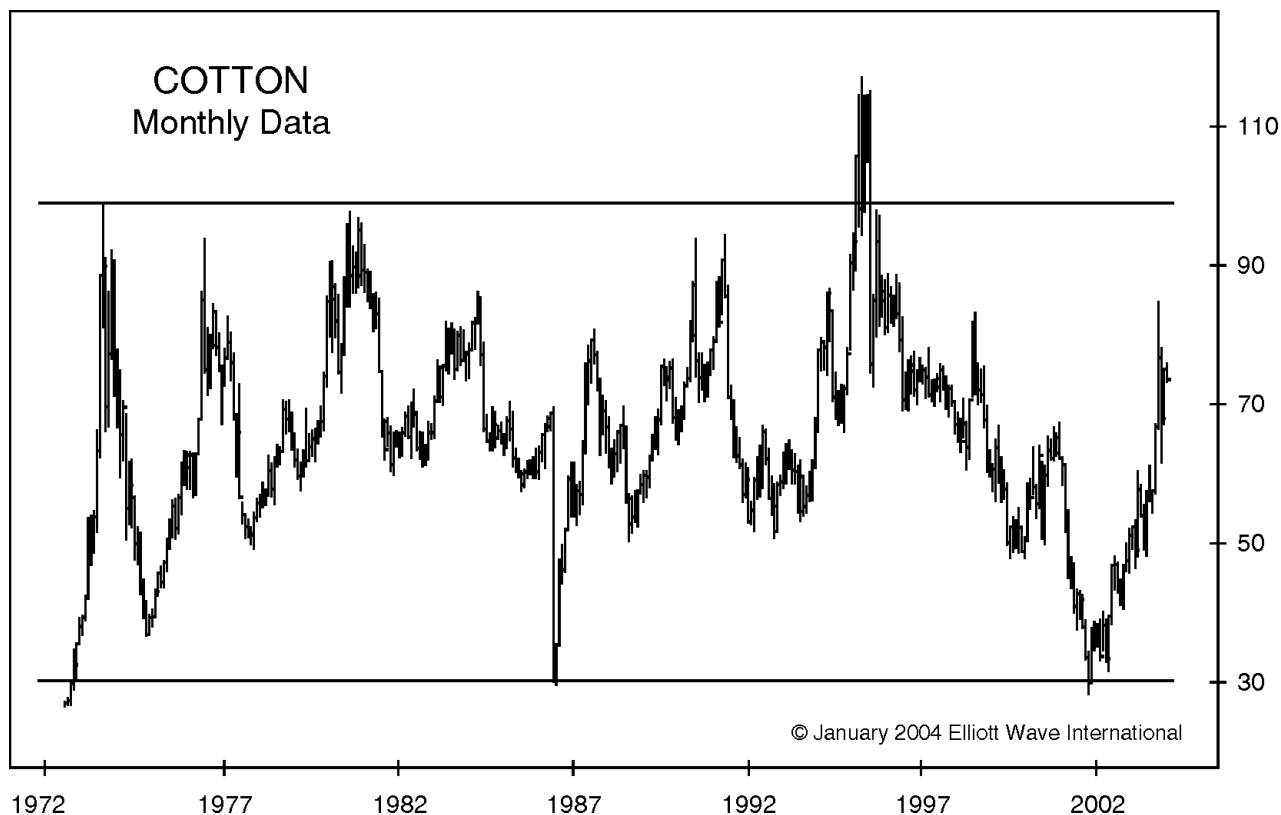


Figure 8-2

VIII. How Historical Extremes Act Like Price Boundaries

Regardless of the timeframe, highs and lows represent psychological hurdles. Of course, the larger the timeframe, the more significant the hurdle – and the more likely it is that a reaction will come on a test of a historical extreme.

Now, note on the monthly chart of Feeder Cattle (Figure 8-3) that a ceiling of 90.00-95.00 has been in effect since the mid-1970s. It was no magical feat to figure out that a move beyond this area was unsustainable. Similarly, Live Cattle (Figure 8-4) has traditionally met resistance between 80.00-85.00. Even back in October, it wasn't a stretch to expect declines in these markets, because each prior break of these ranges resolved that way.

Two opportunities I didn't mention at that seminar were in Oats and Orange Juice (Figures 8-5 and 8-6). Basis the monthly chart, Oats showed solid support at 120.00-100.00. Every time prices have traded this low, a rally has developed soon after. And O.J. has maintained support at 75.00-65.00 since the 1980s. Basis the monthly chart, the recent low in Orange Juice was 60.05. Did this guarantee that prices were ready to rally? If only it were that simple.

What this chart did tell us was that the next move worth trading was likely to be a move up. In other words, a five-wave advance on the daily or weekly chart following such a test should carry a bit more importance in your analysis than it normally would.

[January 2004]

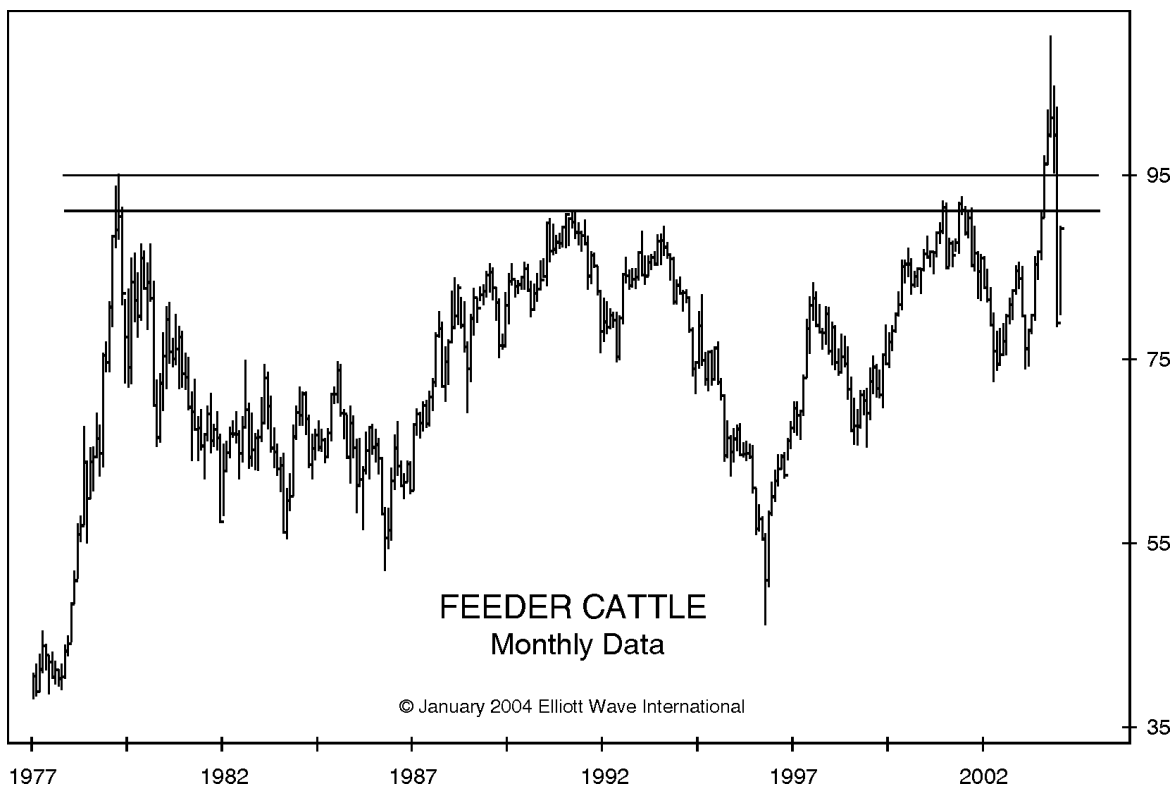


Figure 8-3

VIII. How Historical Extremes Act Like Price Boundaries

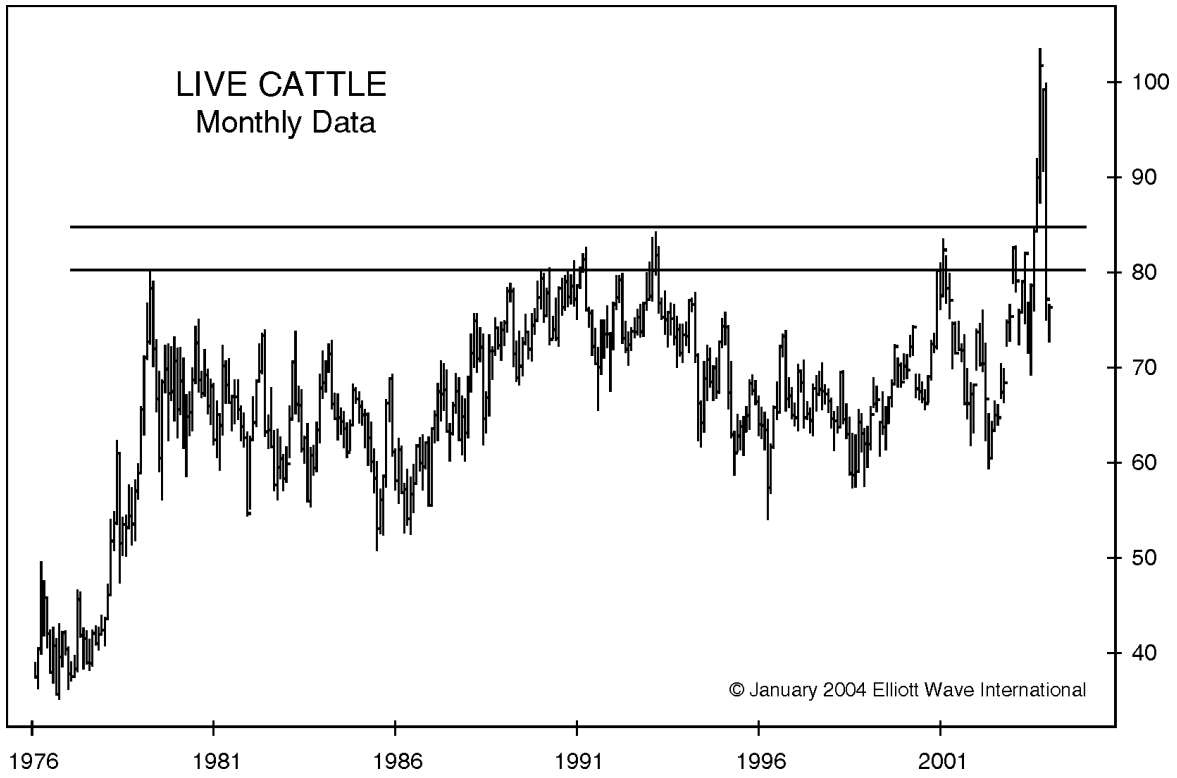


Figure 8-4

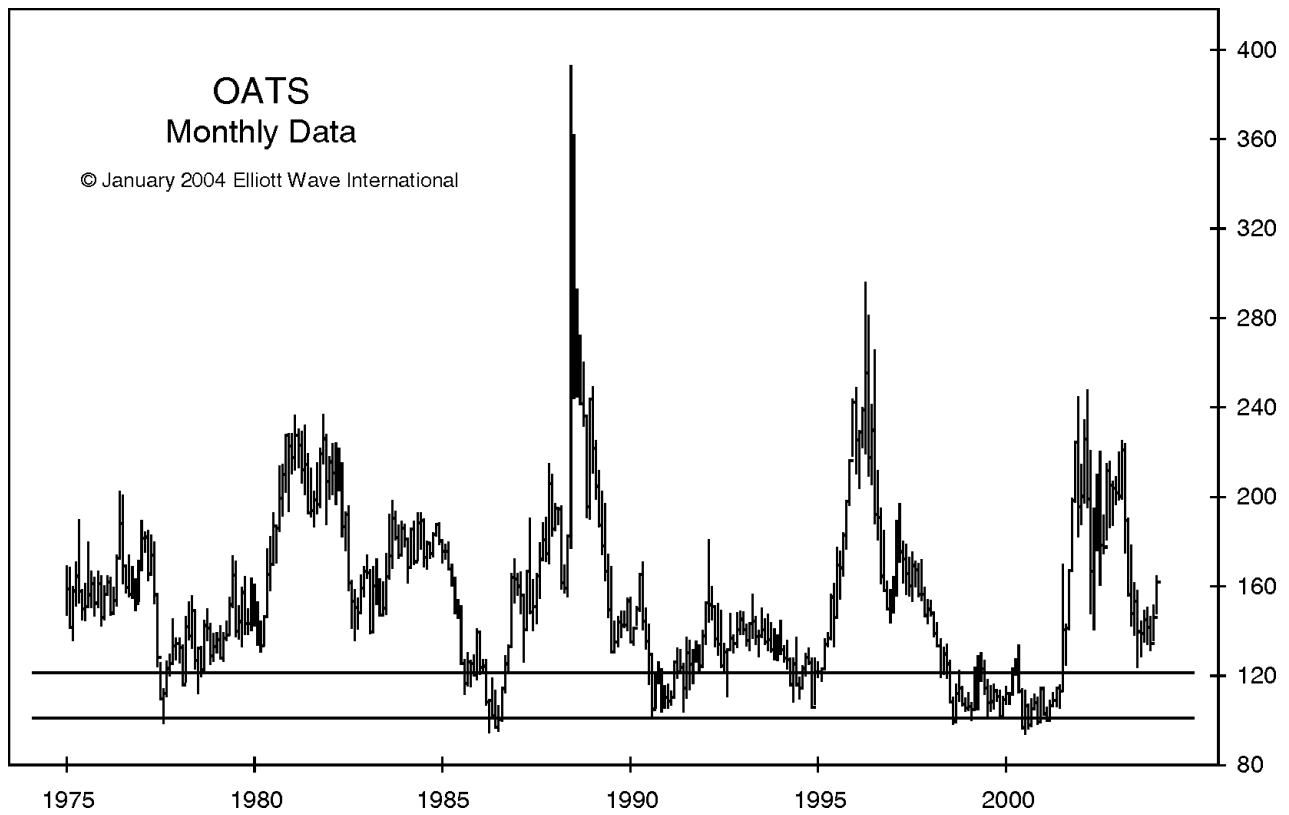


Figure 8-5

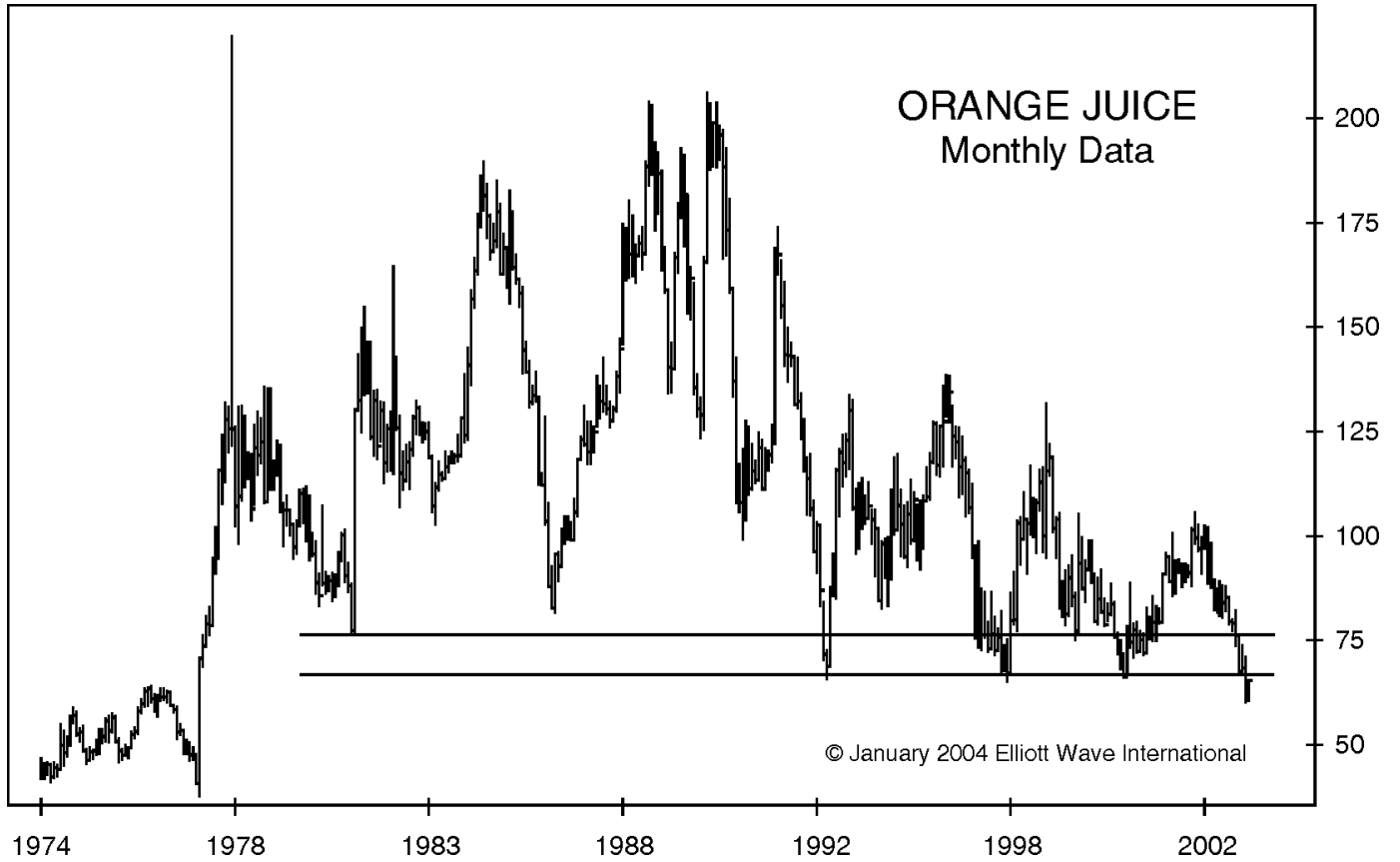


Figure 8-6

IX. How To Interpret Failed New Highs and Lows

It pays to identify where previous highs and lows occur. Often a failed new high or low will result in a tradable move. A failed new high or low happens when prices attempt to achieve a new price extreme and fail. By “fail,” I mean that prices don’t follow through or continue the immediate trend. In traditional technical analysis, failed new highs and lows are referred to as double tops or bottoms. In Elliott Wave analysis, a number of wave patterns account for this price action, particularly flat or expanded flat corrections. Sometimes, prices will match a previous high or low and then reverse. Other times, prices will push a few ticks beyond a previous high or low and change direction.

For example, the rally in March Cotton (Figure 9-1) to 51.80 was an attempt to register a new high above the November 2 peak of 51.30 and the July 2 peak of 51.70. This move is considered to be a “failed new high,” because the move up did not continue in the following days. In fact, during the month after the new high on November 15 at 51.80, Cotton traded sideways to lower.

In this instance, there were two previous extremes that were being tested – 51.30 and 51.70. The July peak of 51.70 is more significant than the November 2 high of 51.30, because it is a higher price and is more significant in terms of time. We can also determine the importance of a previous extreme by the move that follows. In Cotton, the July high of 51.70 essentially turned prices down for three months, retracing more than half of the May advance.

The October low of 44.80 is considered to be a failed new low (basis the low that occurred on September 16 at 45.35). So the failure of prices to follow through immediately, once this new extreme was made, introduced a significant reversal in both price and trend.

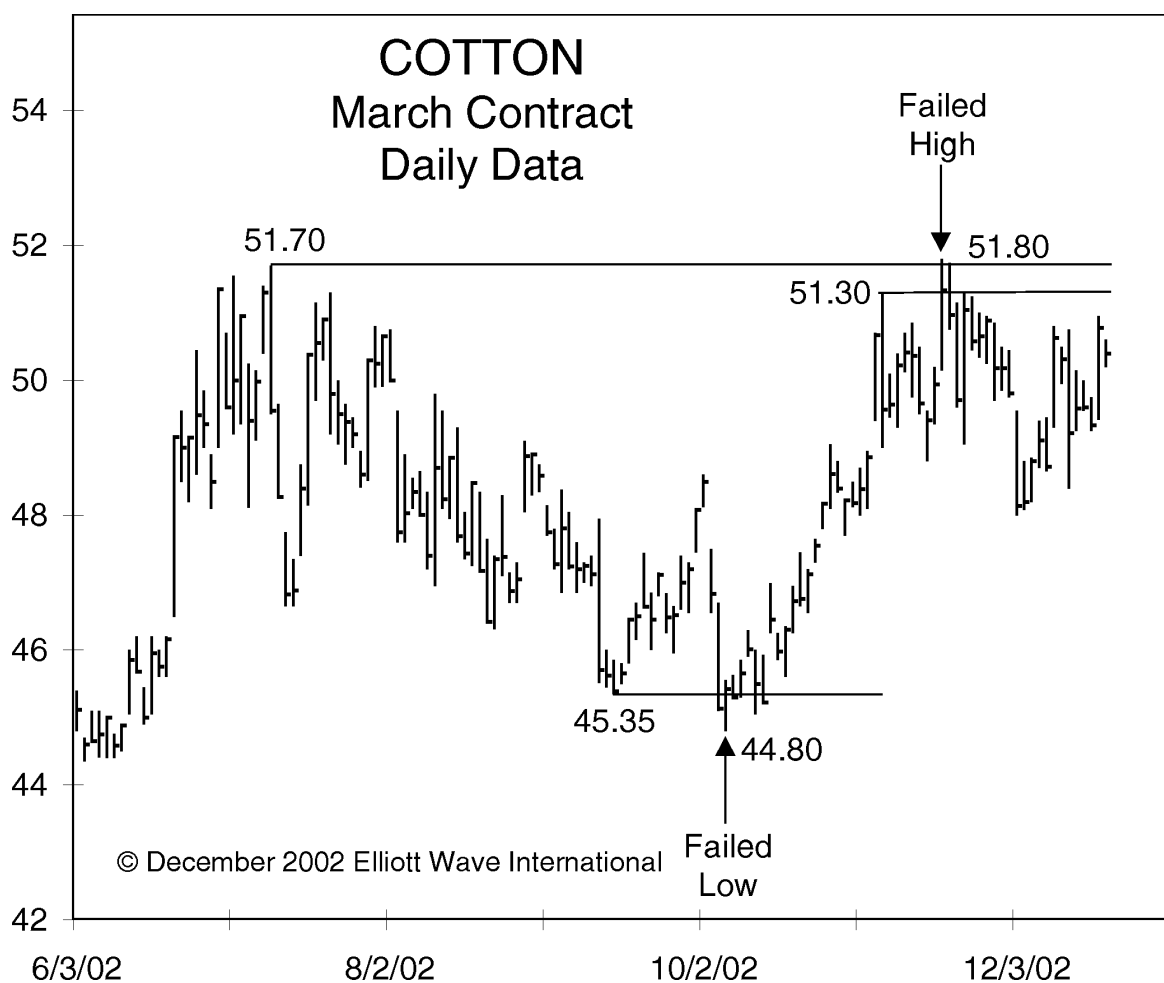


Figure 9-1

There are three failed new extremes in March 2003 Coffee (Figure 9-2): the August low vs. the July low, the October 25 high vs. the October 15 high, and the December peak vs. the November peak. In each instance, sizable moves in the opposite direction began the day following the new extreme.

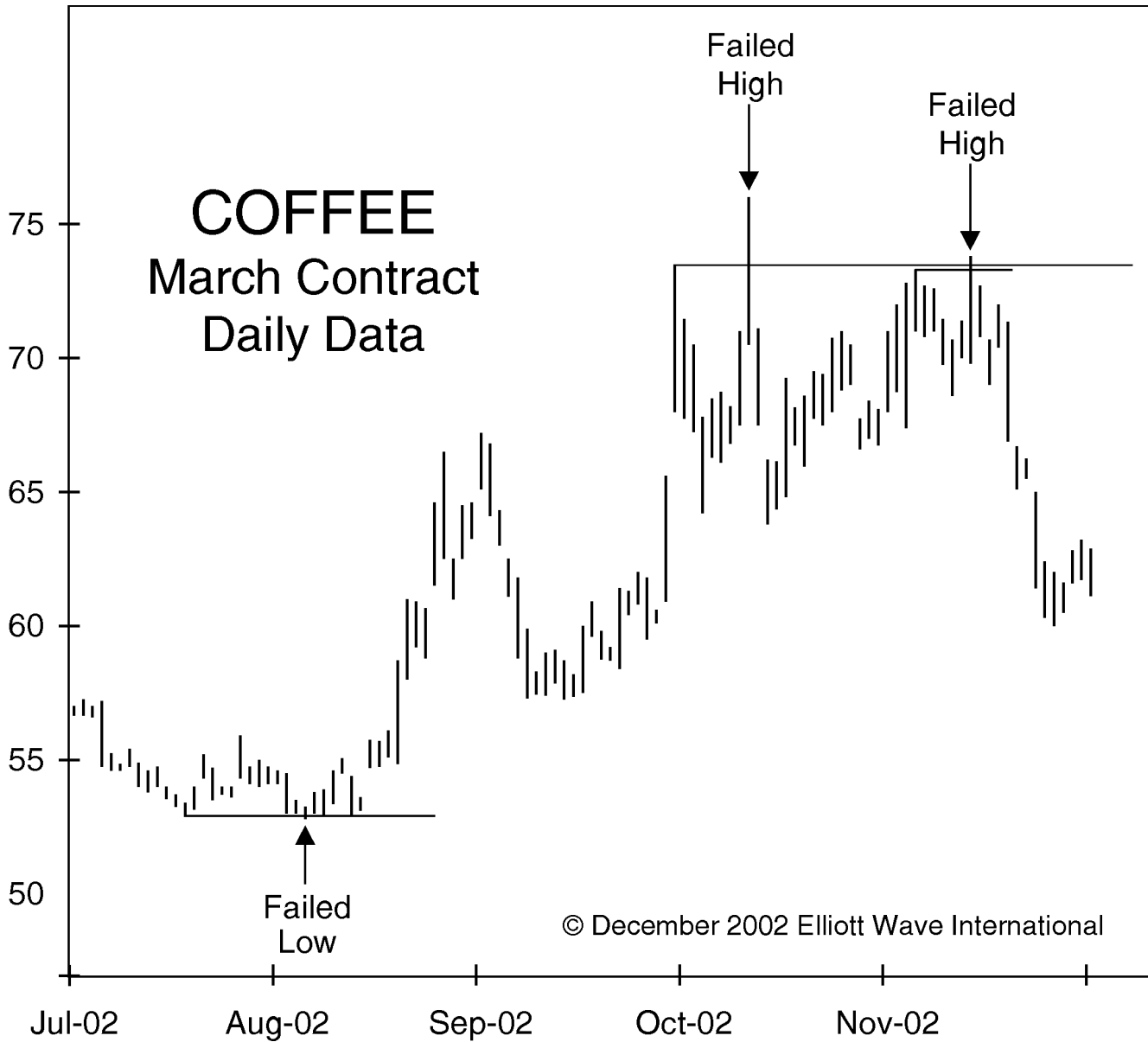


Figure 9-2

Also, this pattern is not market- or time-dependent. It happens often in all markets and time frames. The weekly chart of Pork Bellies (Figure 9-3) shows that a failed new high occurred in 2001, and a failed new low occurred in 2002. Both times, significant multi-month moves ensued.

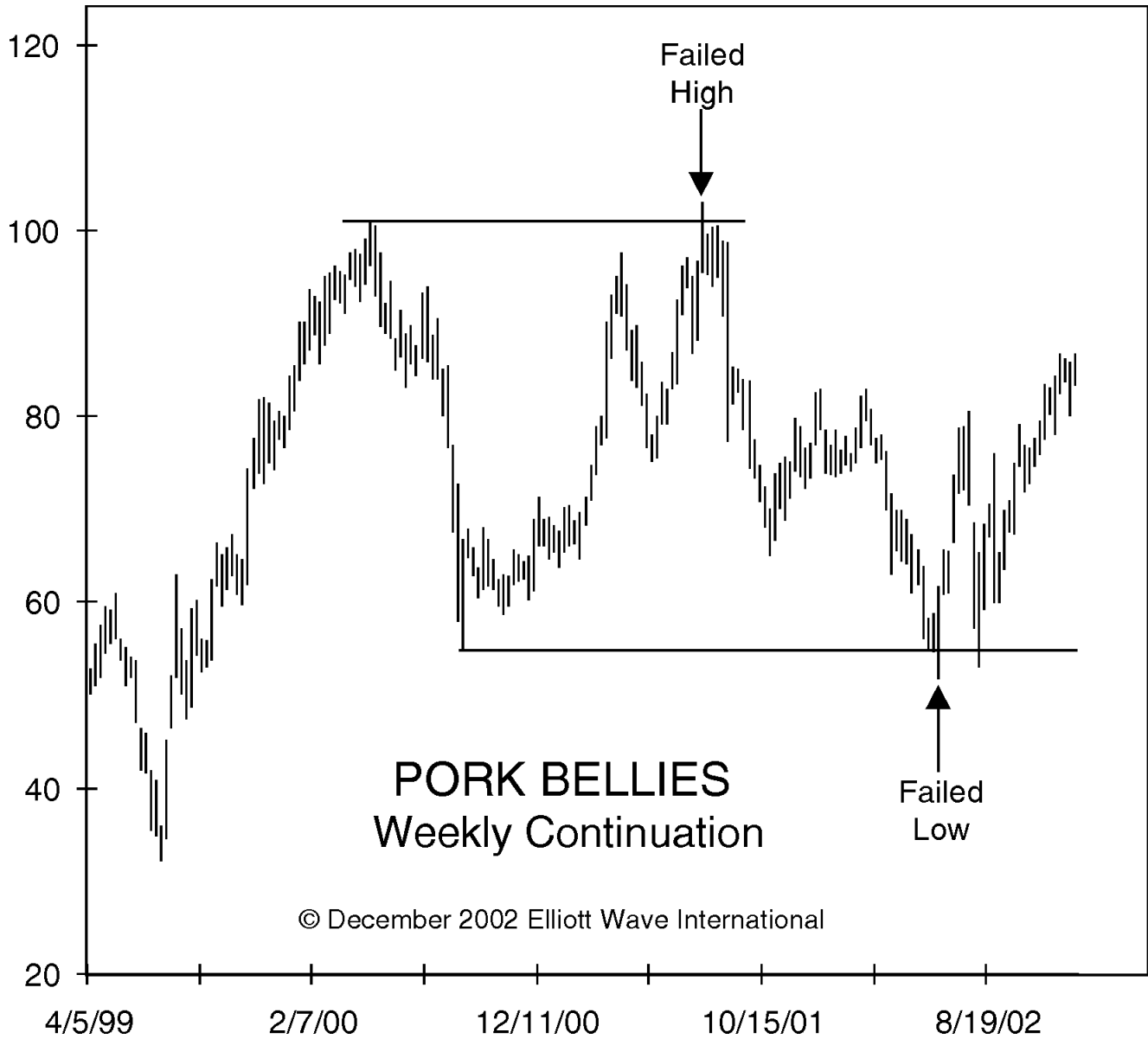


Figure 9-3

Failed new highs occurred three separate times in two days (December 12 and 13) on the 5-minute chart of the E-mini S&P 500 futures (Figure 9-4). Each time the market tried to register a new high above a previous extreme and failed, a sharp selloff resulted. On December 13, prices came close to a new high and failed, leading to decline into the close. Also note the failed new low.

[December 2002]

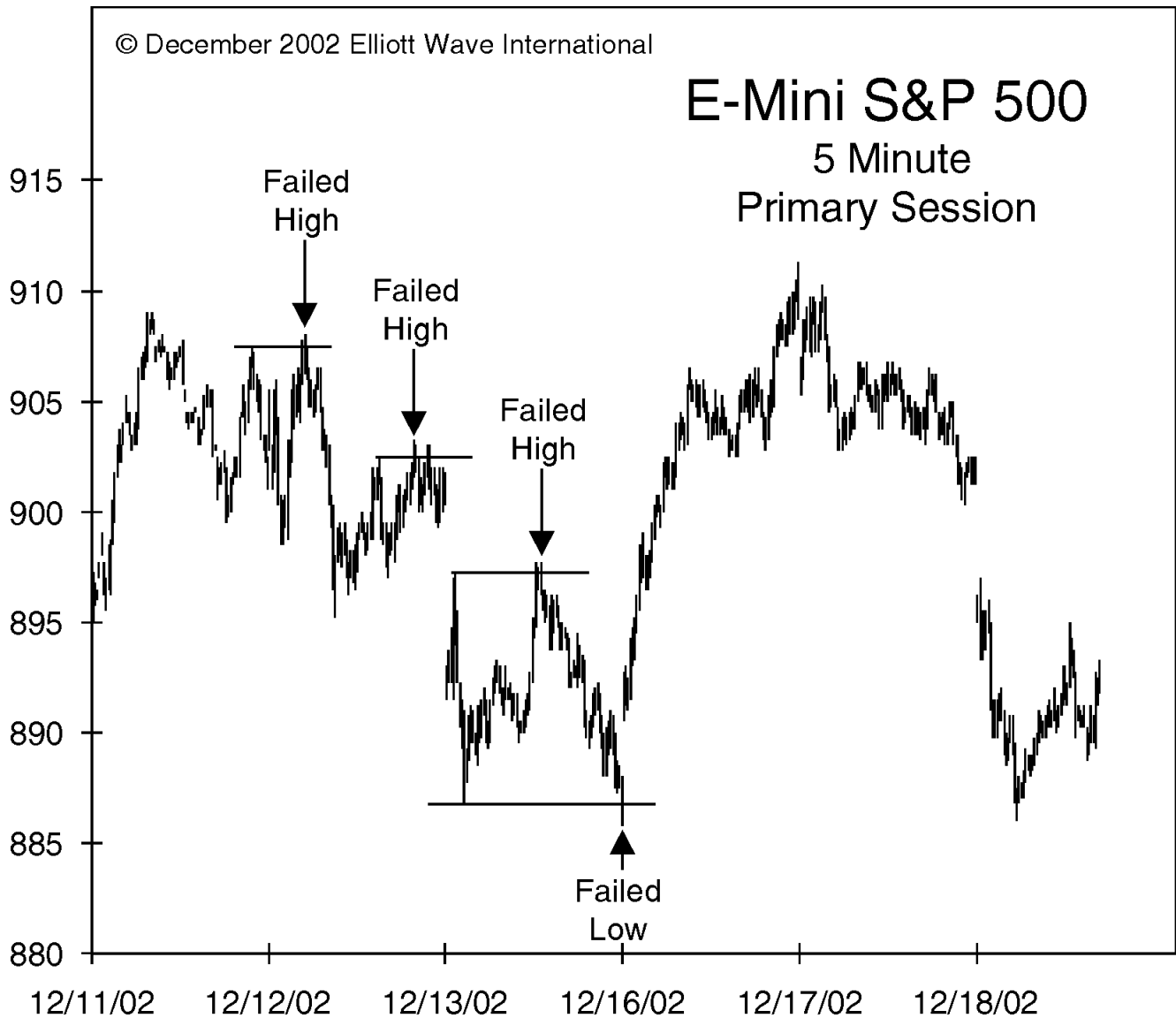


Figure 9-4

X. How “Gaps” Attract and Then Repel Prices

Traditionally, a gap occurs when the current bar’s range fails to include the previous bar’s range. In recent years though, the definition of a gap has been expanded to include instances when the current bar’s range fails to include the previous bar’s close.

The three most common gaps are breakaway, continuation and exhaustion. Breakaway gaps appear at the beginning of a trend. In Elliott terms, this gap most likely comes in wave one of three. Continuation gaps come within the middle of a trend and often mark periods of extreme acceleration in price. Continuation gaps are common in wave three of three. Exhaustion gaps come in the latter stages of a trend, denoting maturity. Exhaustion gaps occur in the wave five of three position as well as wave three of five or five of five.

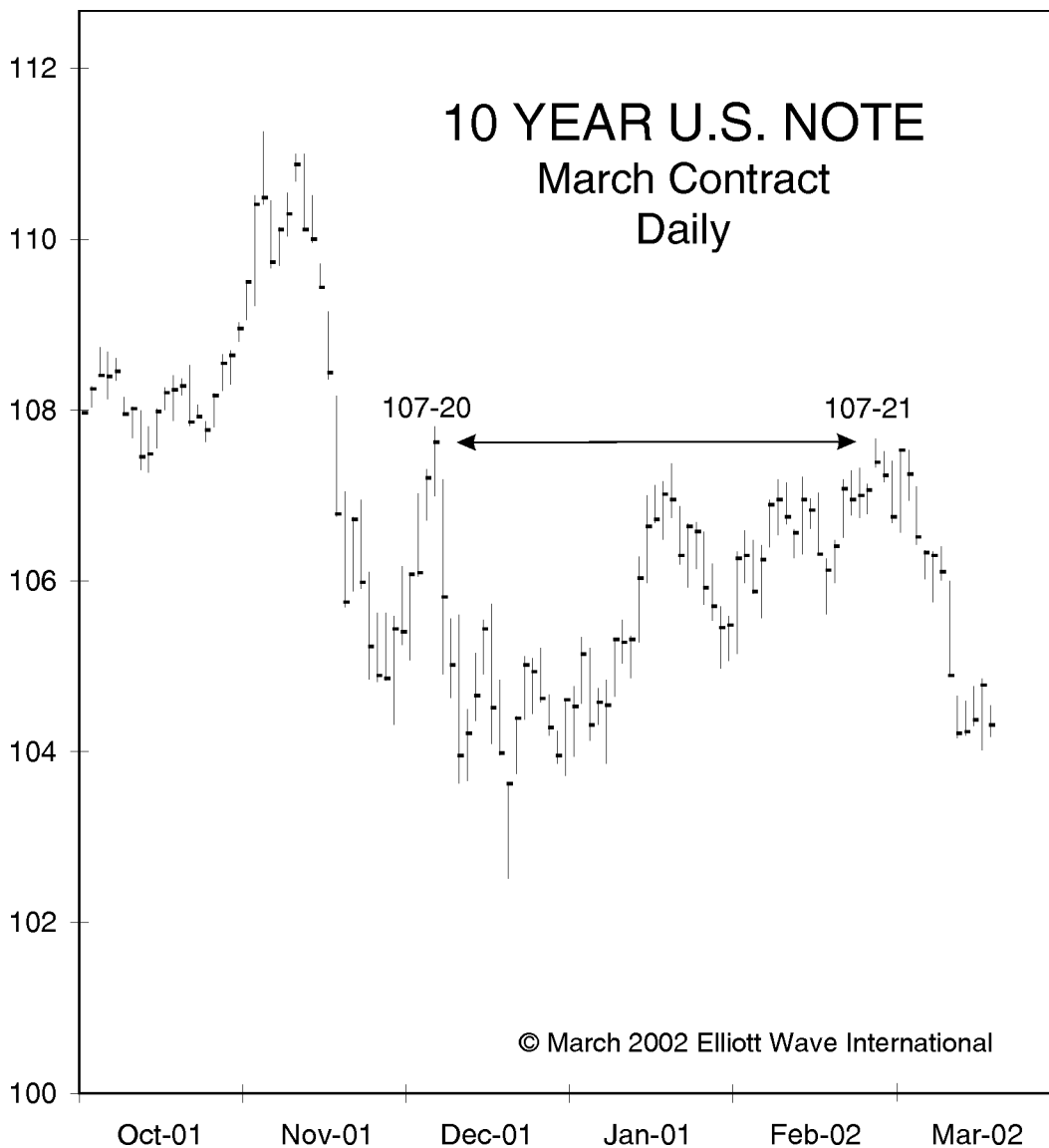


Figure 10-1

X. How “Gaps” Attract and Then Repel Prices

I don't just want to reiterate what is commonly known about gaps, I also want to demonstrate the uncanny way that they can serve as price support and resistance. Sometimes the closing of a gap (when price action exceeds the close of the bar preceding the gap), appears to be as automatic as a magnet first attracting then repelling flakes of iron.

The first example is the March 2002 10-Year Note (Figure 10-1). In the February 2002 issue of *Monthly Futures Junctions*, we said, “It would not surprise us to see the Tens push to just above the 107-20 level and roll over.” As you can see from the chart of March 10-Year Notes, prices rallied to 107-21 and did in fact roll over. This push up closed the December 4, 2000, gap at 107-20. Again, like a magnet, it appears that the 107-20 level was the objective of the December 17, 2001, advance all along.

The daily cash chart of the NASDAQ 100 (Figure 10-2) provides another example of this strong and reliable tendency. On October 31, 2001, the NASDAQ left behind a gap at 1342.26. Prices then rallied to a high of 1734.58 before correcting the September 2001 advance. As you can see, on February 22, this level was tested, resulting in the subsequent advance.

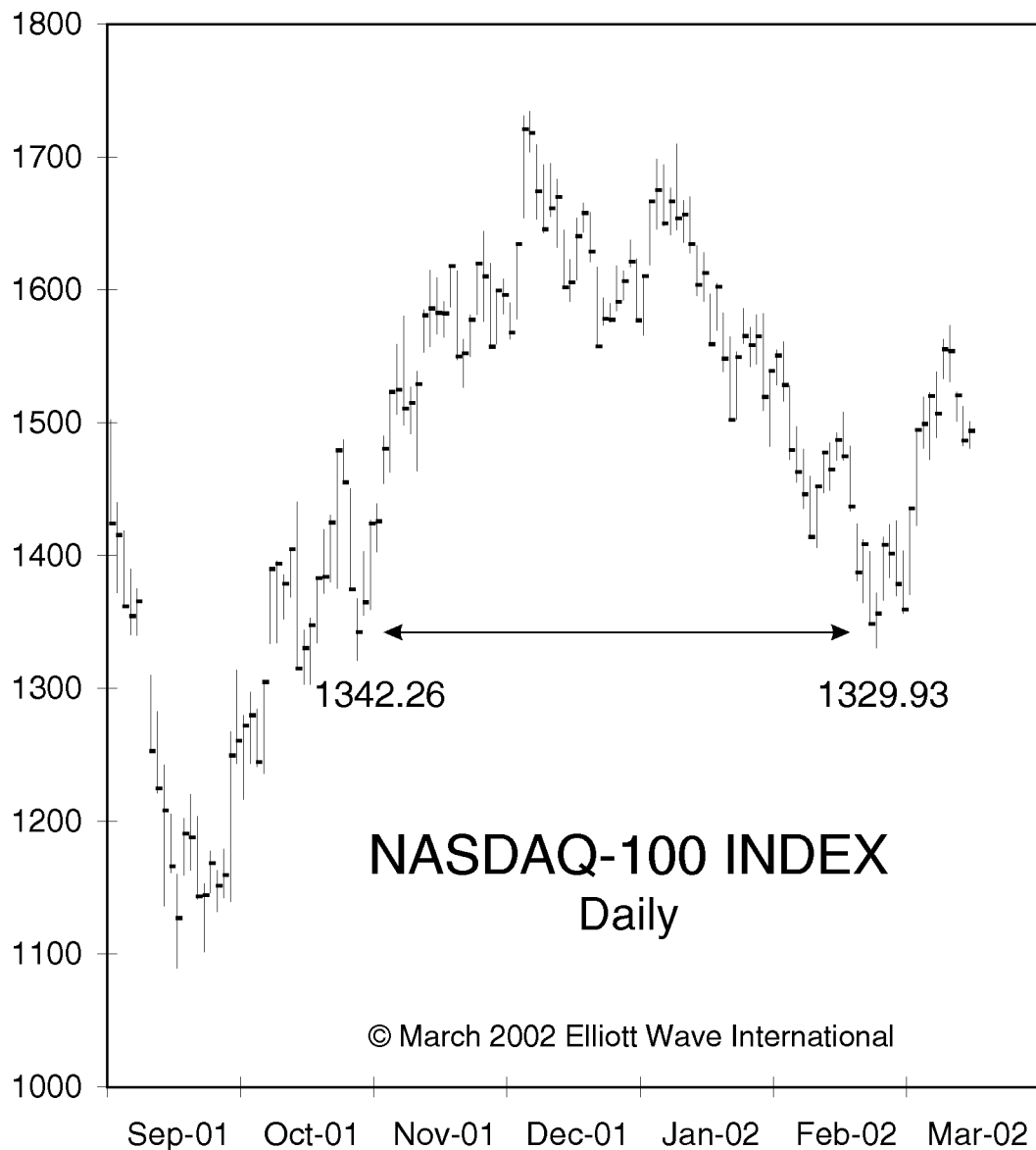


Figure 10-2

May 2002 Silver (Figure 10-3) supplies our final example of a gap first attracting and then repelling prices. To close the gap that appeared on January 8, prices had to exceed that day's close at 463.9. The daily chart of May Silver shows that the March high was 464.0.

[March 2002]

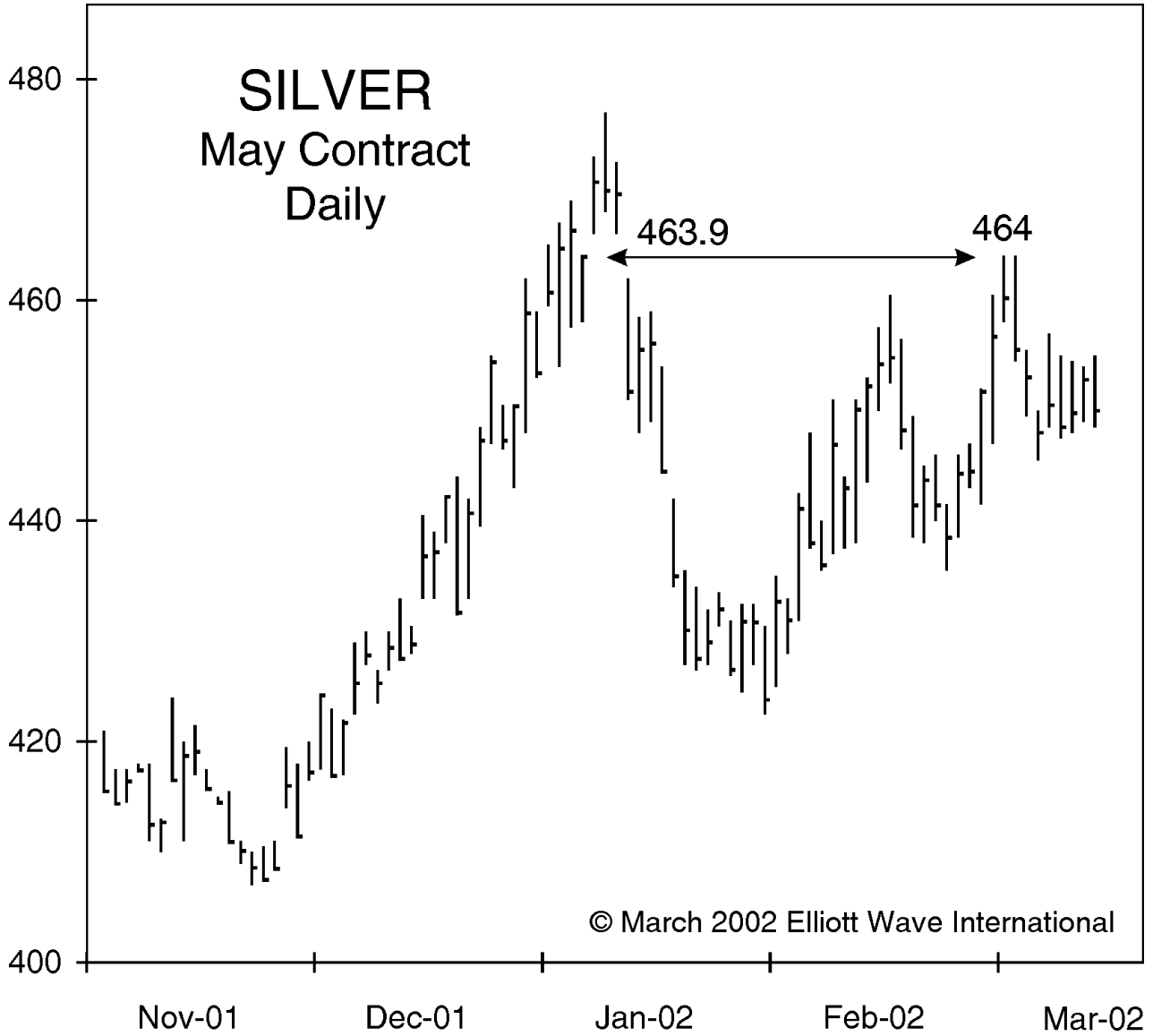


Figure 10-3

XI. How To Identify “Firsts” as Support or Resistance

Everyone can remember an important first — a first kiss, a first car or a first trade.

Financial markets also seem to remember their respective firsts. Often, the high or low of the week will occur within the first few hours of Monday trading. Similarly, the high or low of the month will often occur within the first few trading days of that month. Even annually, the high or low of the year will often develop within the first few weeks of trading in January. I have also found the price ranges made by these bars tend to act as significant support or resistance levels for price action later in the week, month or year.

- In Figures 11-1, 11-2, 11-3 and 11-4, (Coffee, Soybeans, Cotton and Orange Juice), you can see many examples of the first or second hourly bar of the week being the high or low of that week. You’ll also see examples of how the range of these bars acts as support or resistance for midweek bounces or pullbacks.
- Figures 11-5, 11-6, 11-7 and 11-8 (Coffee, Sugar, Soybeans and Lean Hogs) show how the first few trading days of each month often include the high or low of that month. The range of these bars provided support or resistance for midmonth bounces or pullbacks, similar to the 60-minute charts.
- Figure 11-9 (Cocoa) and Figure 11-10 (Orange Juice) have fewer examples than the 60-minute and daily charts. Nevertheless, I still find that the first few weeks of trading in January often set a market’s tone for the rest of the year.

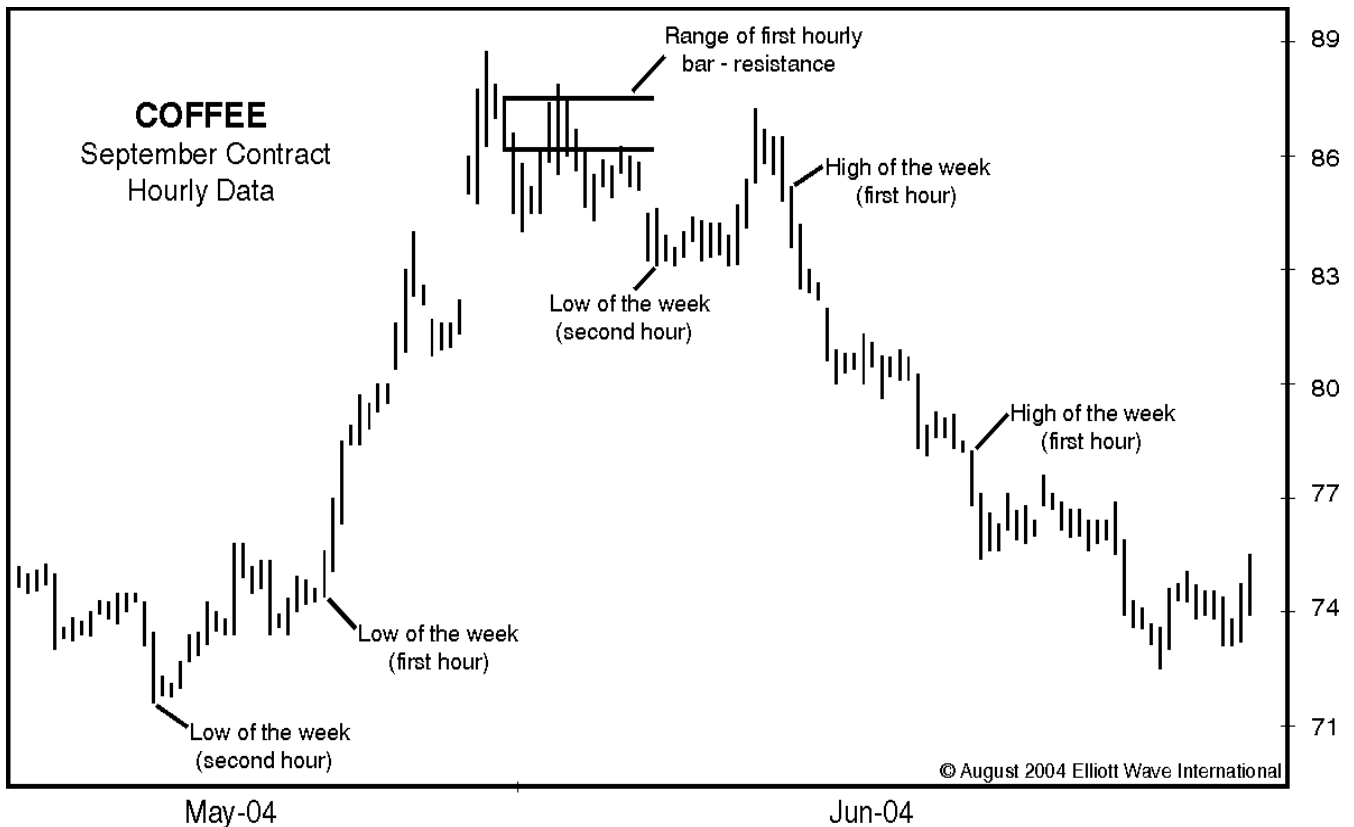


Figure 11-1

XI. How To Identify “Firsts” as Support or Resistance

As with all my analytical tools and techniques, this rule of “firsts” has stood the test of time. I wouldn’t use it unless I had found that it works on any time frame and any market with a high degree of reliability. As you can see in Figure 11-11 (Microsoft), the same tendency of prices to register the high or low of the week within the first few hours of trading Monday is apparent.

Figure 11-12 (Swiss Franc) shows an excellent example of this price characteristic as well. As Steve Briese of Insider Capital Group (editor of *Bullish Review* and *Market Revolutions*) states: “Currencies usually make an extreme reading for the year — either low or high — within the first two weeks of each year.” If you don’t recognize the name, Steve Briese is probably the world’s foremost expert on interpreting Commitment of Traders Report data.

How is this technique of “firsts” useful to you as a trader? It is helpful in identifying the direction prices will move, in addition to significant support and resistance levels. As an Elliottician, it helps me time the end of impulse moves or corrections. If you would like to learn more about this technique, I highly recommend the book, *The Logical Trader*, by Mark Fisher. Mark has done extensive research into this technique and has incorporated it into a very successful trading methodology.

[August 2004]

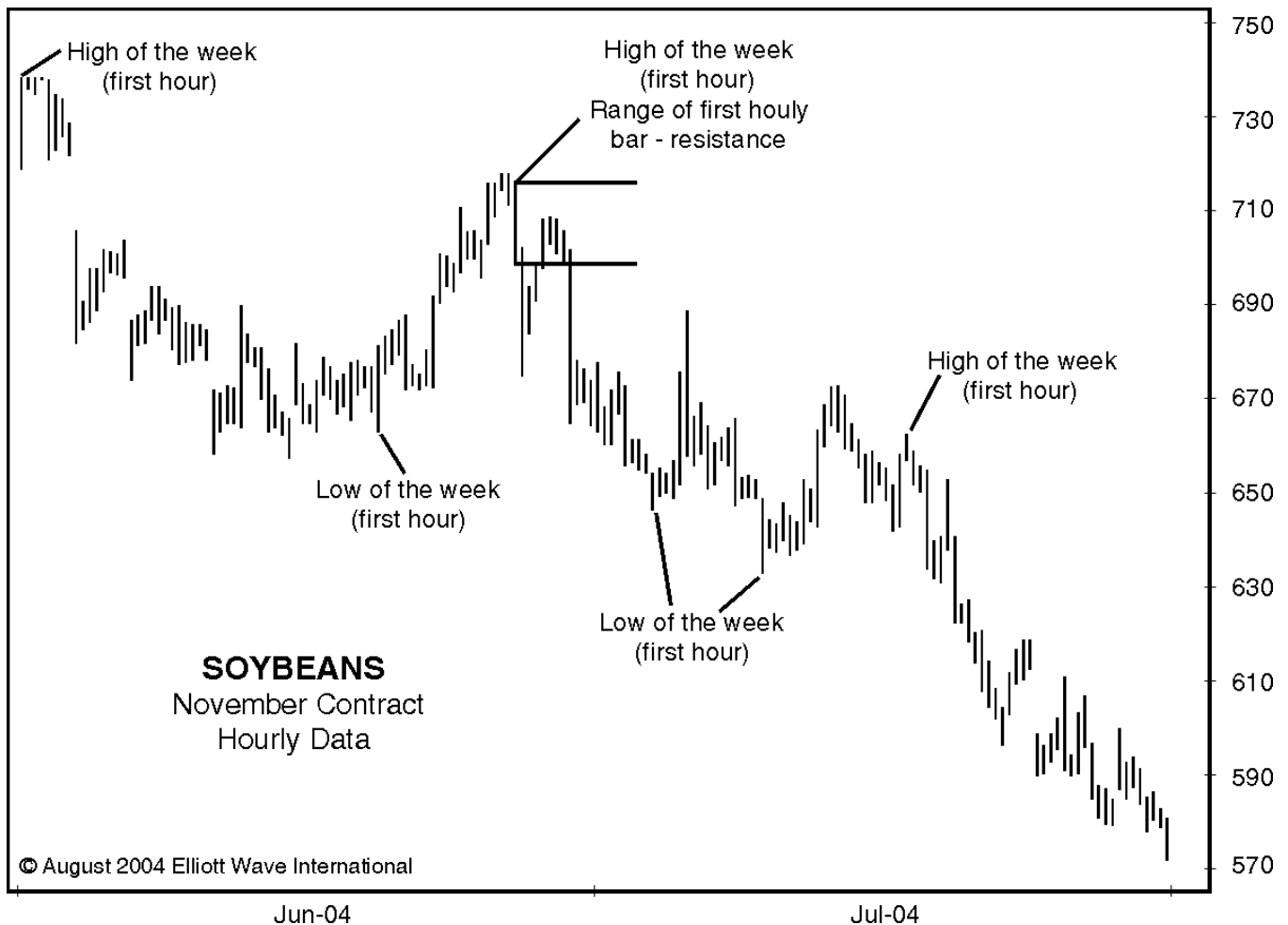


Figure 11-2

XI. How To Identify "Firsts" as Support or Resistance

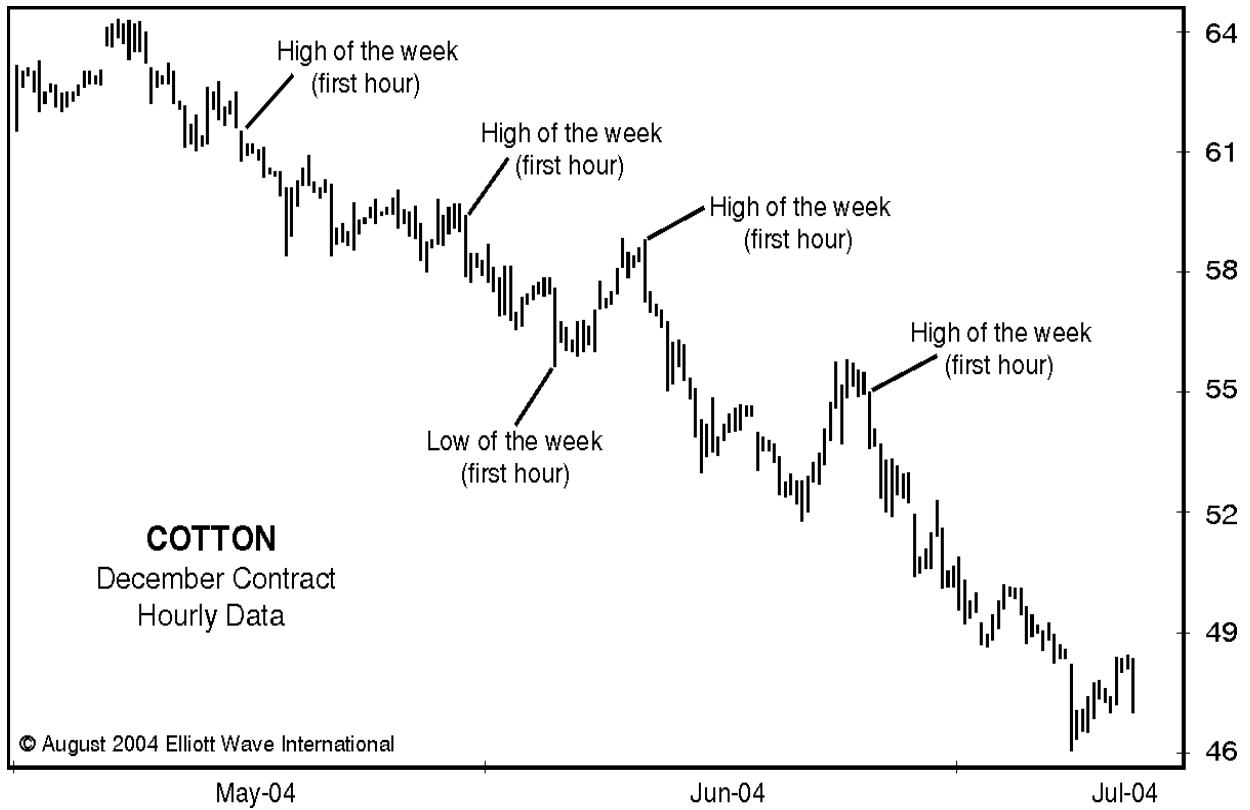


Figure 11-3

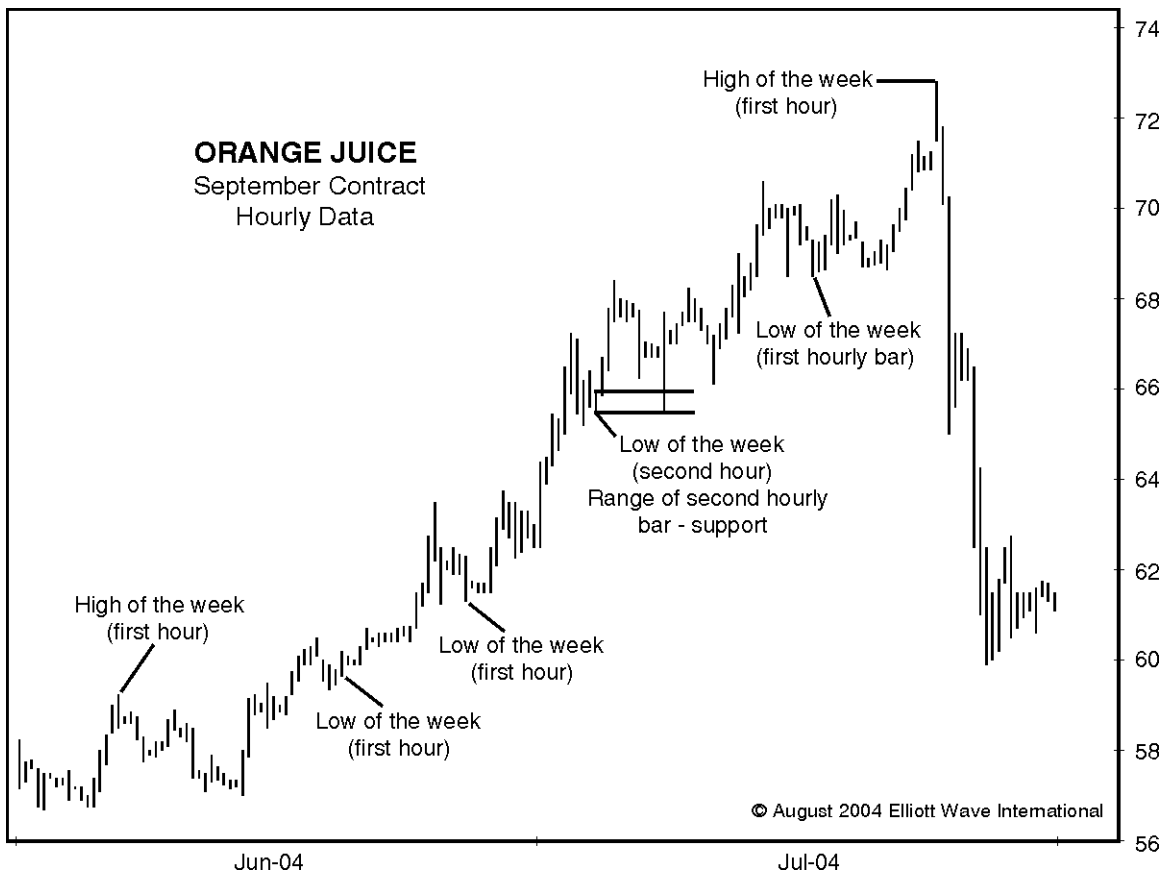


Figure 11-4

XI. How To Identify "Firsts" as Support or Resistance

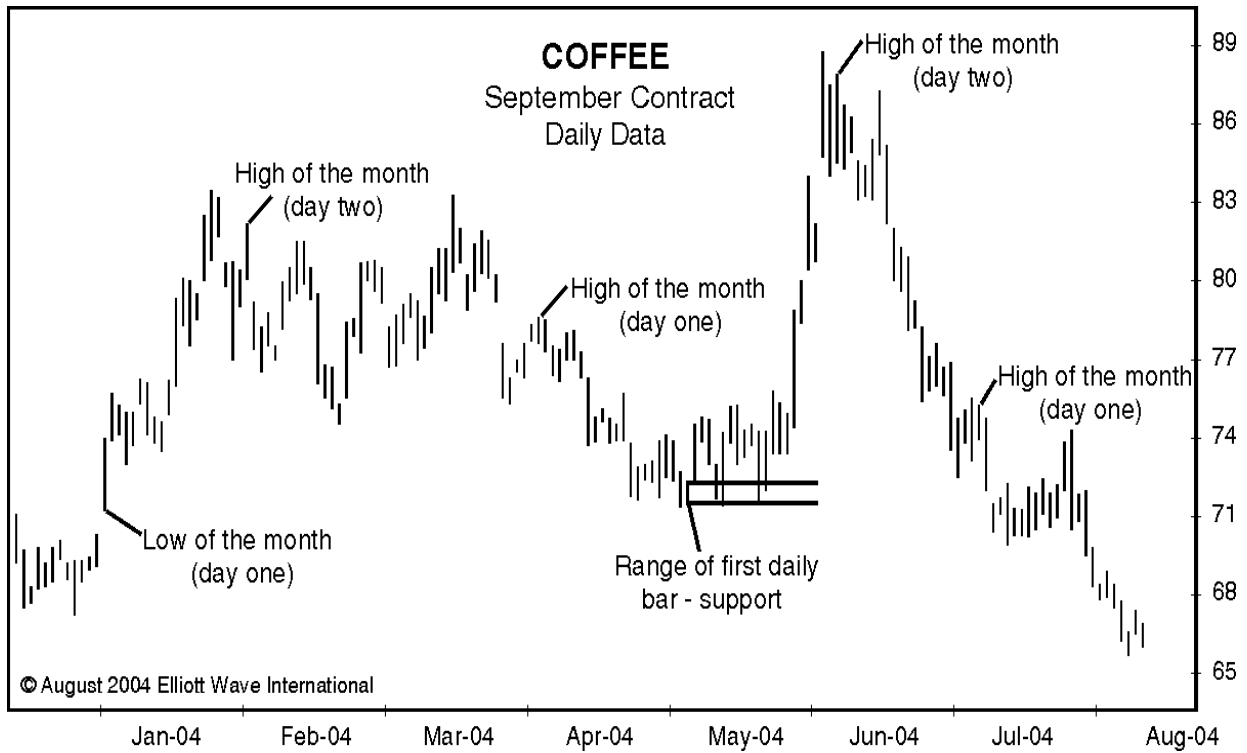


Figure 11-5

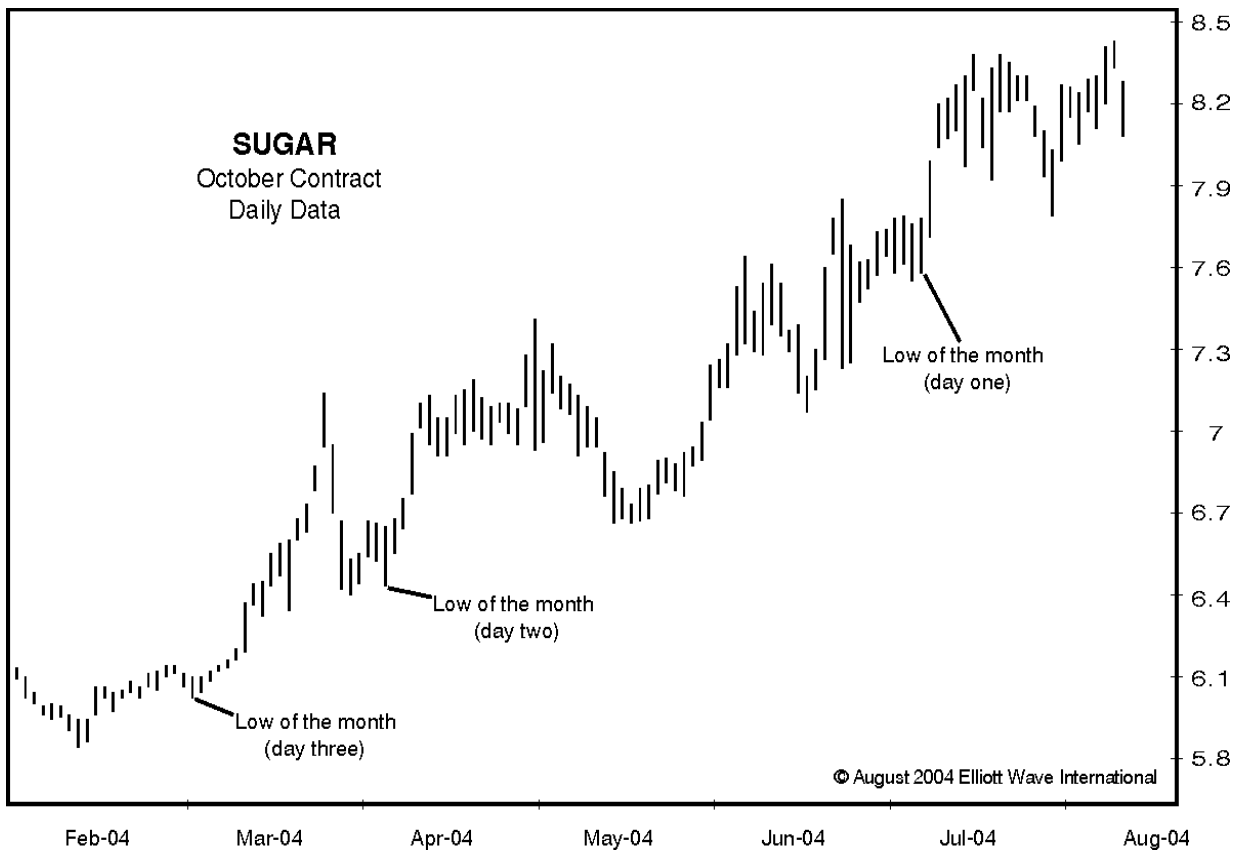


Figure 11-6

XI. How To Identify "Firsts" as Support or Resistance

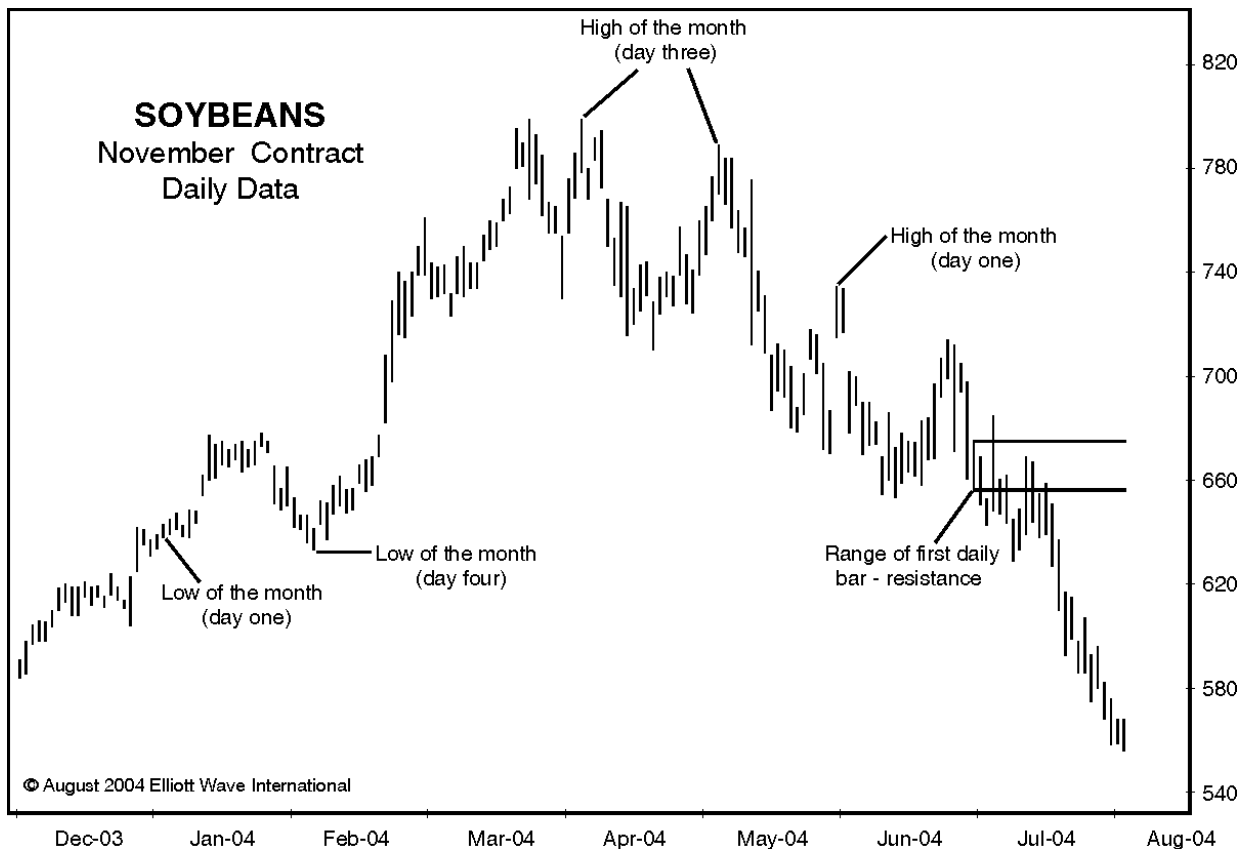


Figure 11-7

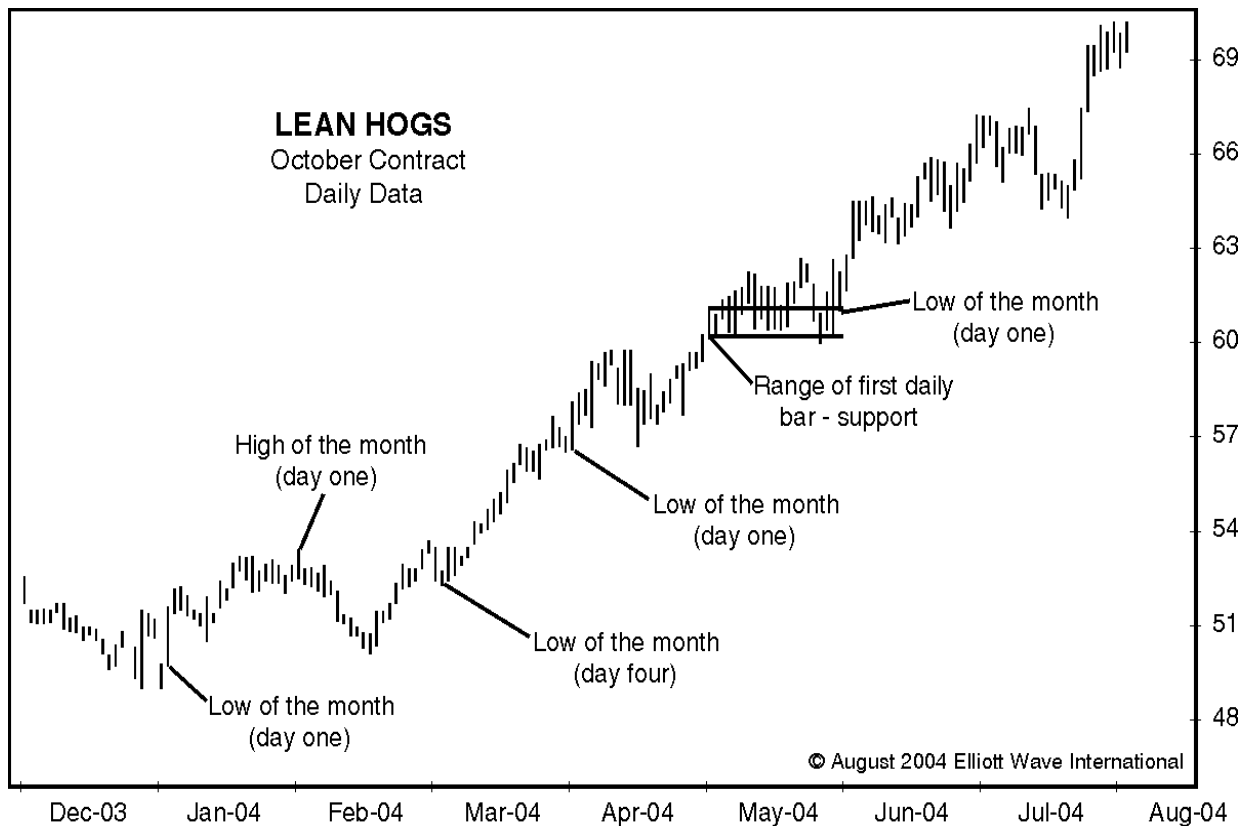


Figure 11-8

XI. How To Identify "Firsts" as Support or Resistance

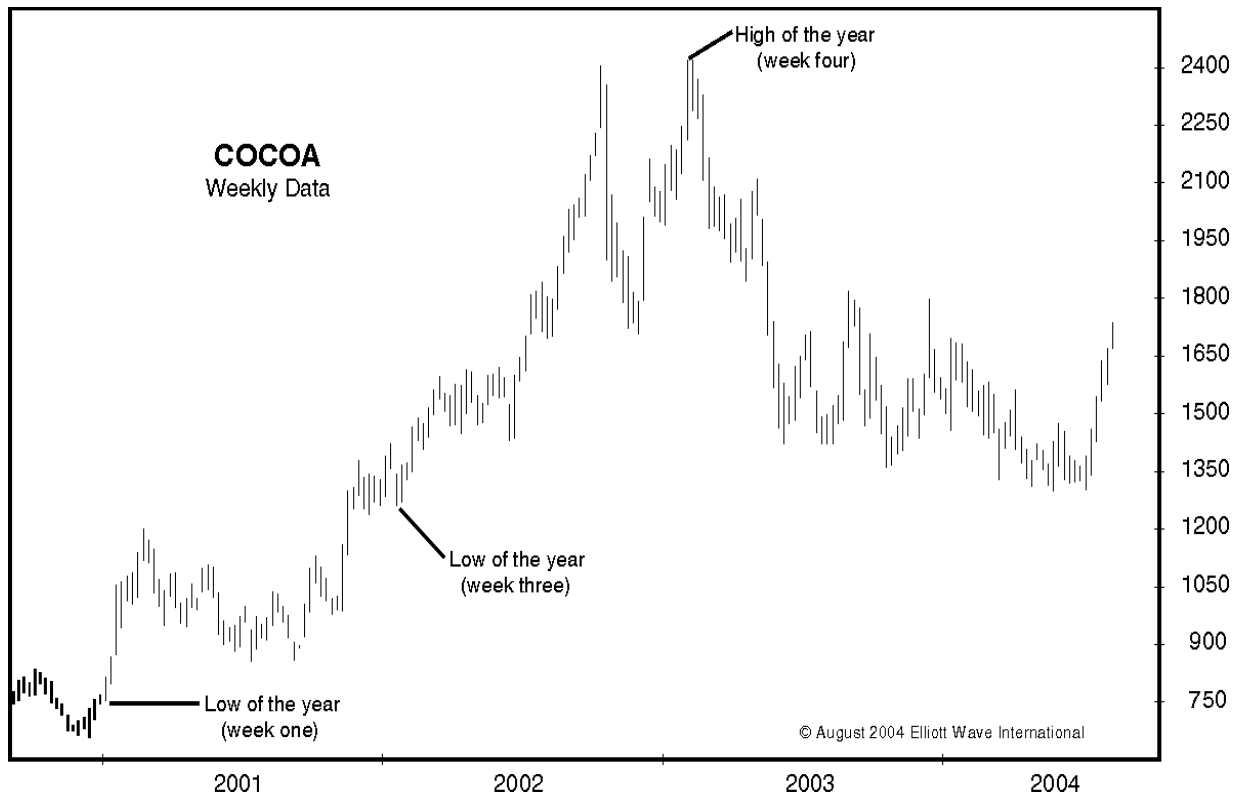


Figure 11-9

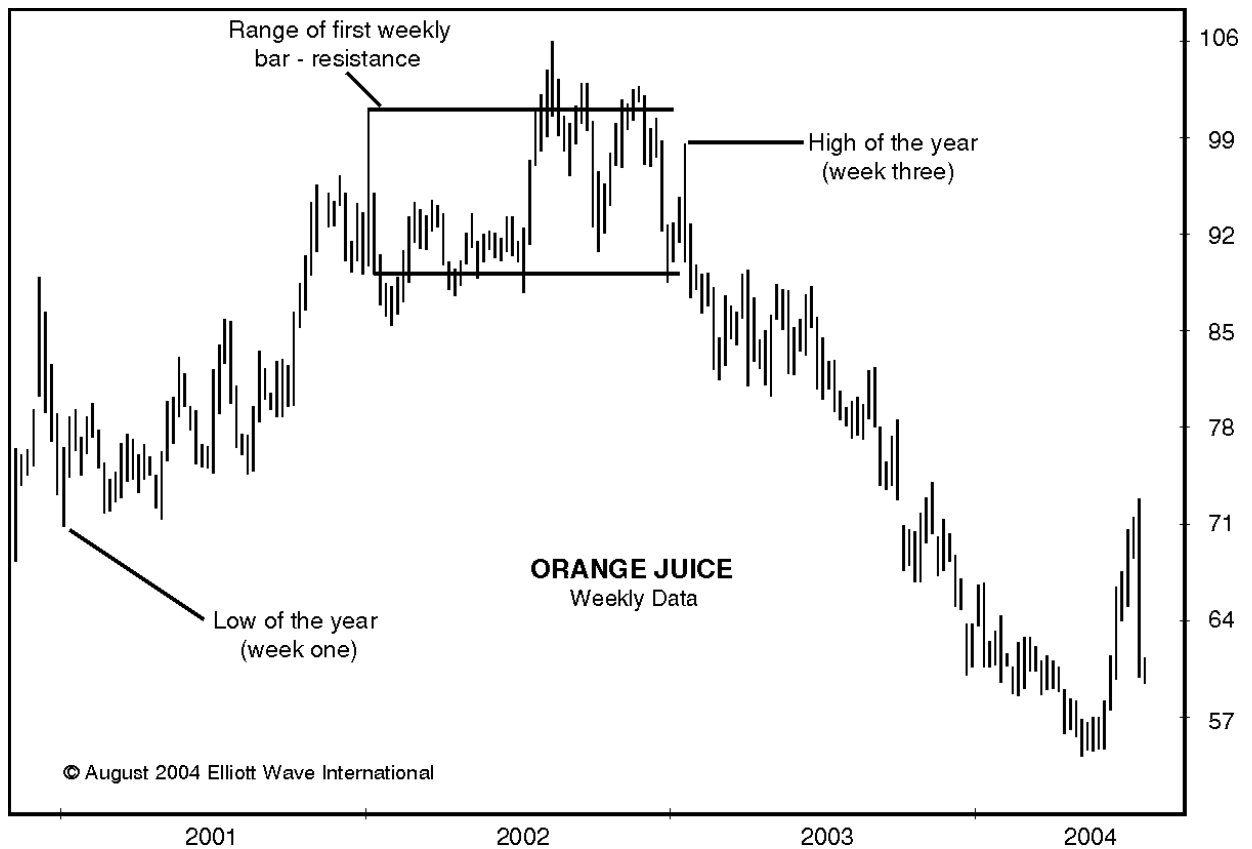


Figure 11-10

XI. How To Identify "Firsts" as Support or Resistance

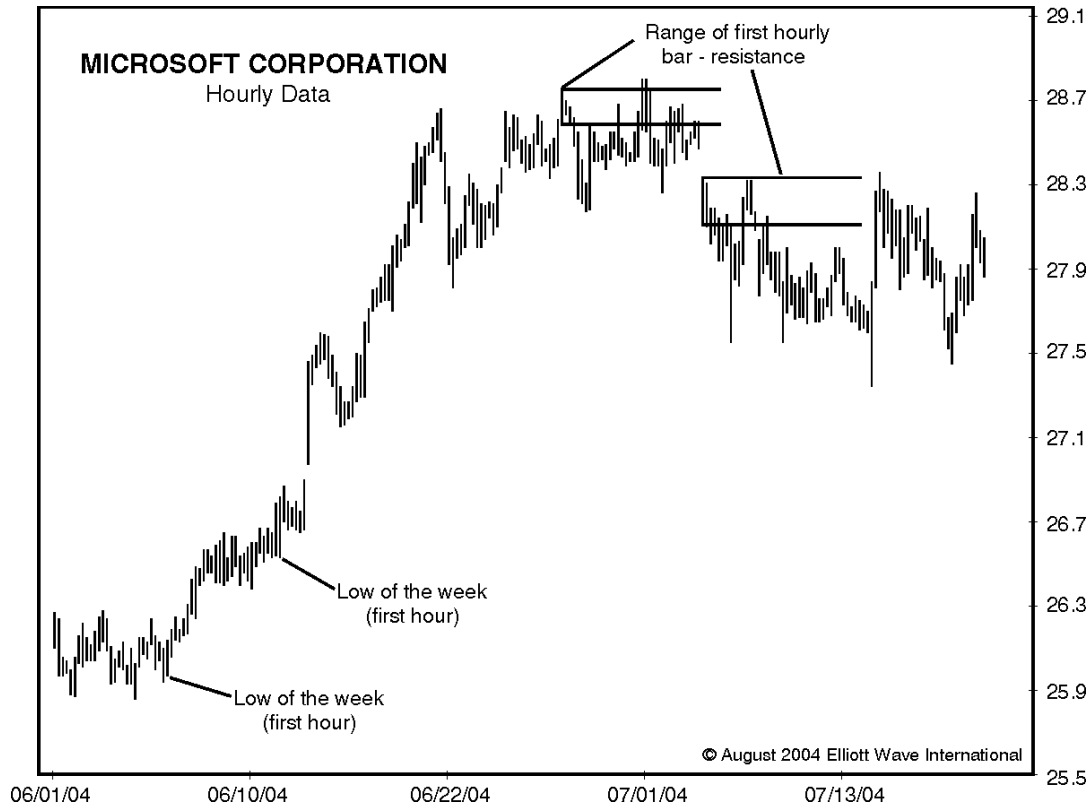


Figure 11-11

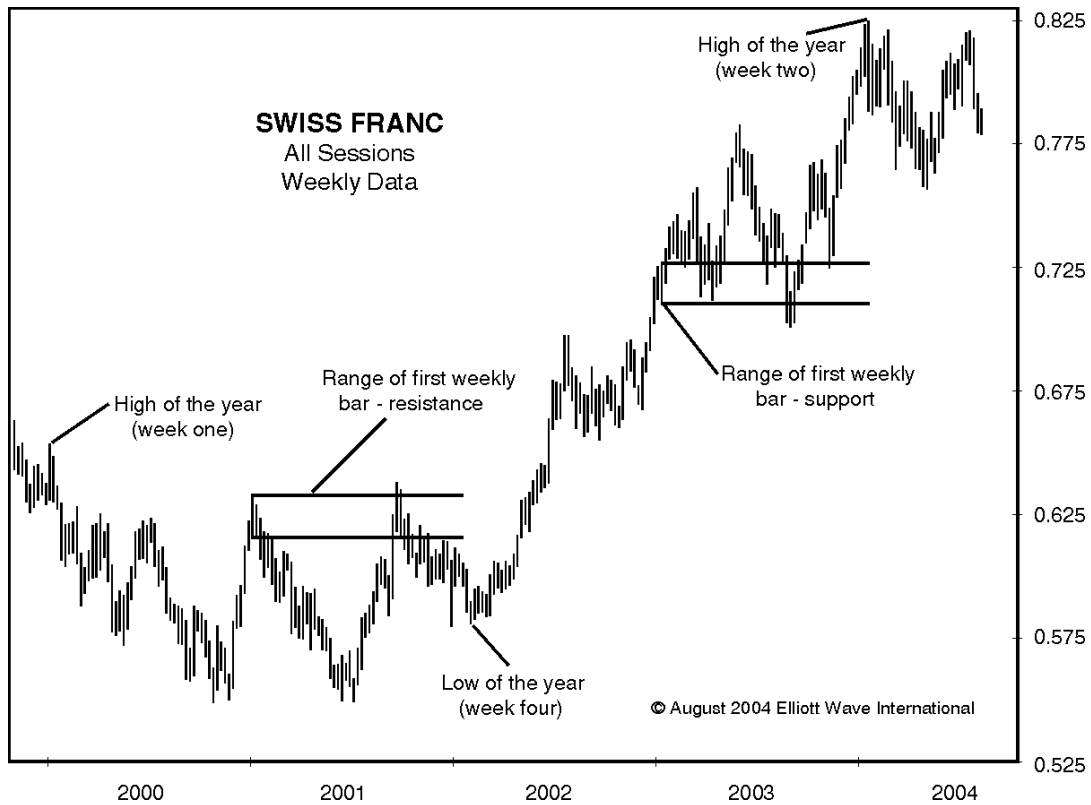


Figure 11-12

Appendix A:

How Jeffrey Kennedy's Techniques Work Outside the Futures Market

Monthly Futures Junctures strives to identify exciting opportunities in the futures markets, using the Elliott Wave Principle. At times, additional techniques are employed to augment our analysis. Once you've reviewed each of the preceding lessons, you should have a better idea of how these different techniques can complement one another to support a confident forecast.

We have chosen to reprint this Trader's Classroom, from June 2002, to demonstrate the equally relevant application of these techniques in markets other than futures.

TYCO. Were There Any Clues?

Here's an excellent example of how technical analysis can provide clues to the movement of a particular stock. As a refresher, remember that: Fibonacci analysis is an integral part of the Wave Principle when determining retracements and targets. Typical Fibonacci retracement ratios are .382, .500 and .618. Conversely, common Fibonacci projections include 1.618, 2.618 and 4.236.

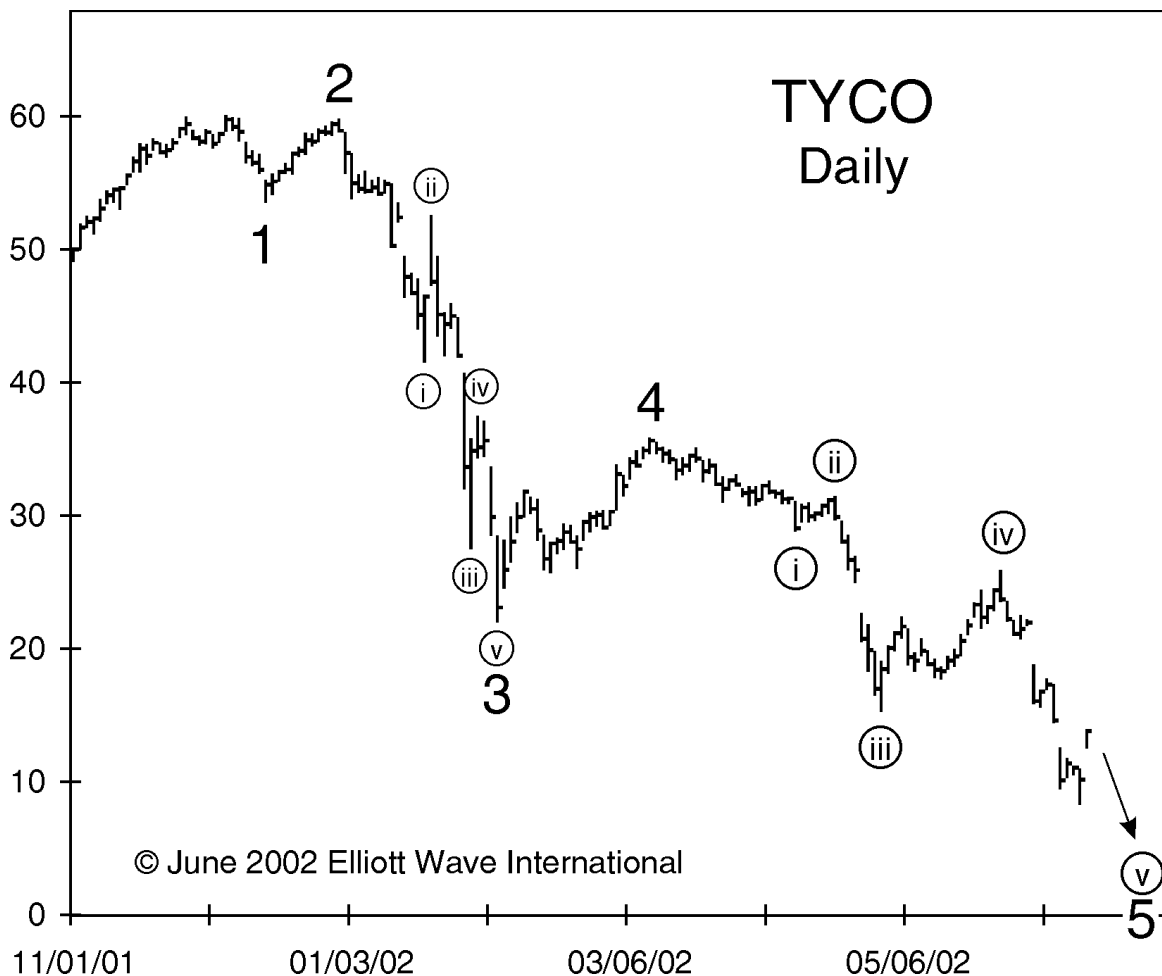


Figure A-1

- Also, in our lesson on Gaps, we noted that gaps often attract and then repel prices, almost like a magnet does.
- In addition to the basic tenants of the Elliott Wave Principle, Fibonacci analysis combined with gap identification are powerful tools in identifying key reversal and objective areas – which brings us to Tyco (TYC), the company that crashed spectacularly in January 2002.

As you can see in Figure A-1, the Elliott wave interpretation of Tyco is straightforward. Wave 3 and (iii) are both sharp, typical of third waves. Wave 4 and (iv) are clearly three-wave moves, indicating that the February and April 2002 advances were countertrend.

The chart in Figure A-2 is exciting. Note that 36.44 is the .382 retracement of wave 3. The nearby dashed line at 35.63 represents a gap that opened on February 1. Thus, significant Fibonacci and structural resistance stood at 35.63/36.44. On March 11, Tyco registered a 35.83 high and ended the day at 35.62.

A similar situation occurred in Tyco on May 24. Fibonacci analysis and gap identification pinpointed resistance at 25.26/25.90. As you can see in Figure A-2, Tyco rallied to a high of 25.90, moderately above the .618 retracement of wave (iii) at 25.26, and precisely closed the gap that opened on April 24 at 25.90.

Were there any clues that Tyco was headed lower? Yes! Tyco rallied in three waves from the February low into significant Fibonacci and structural resistance at 35.63/36.44 and, in the following days, registered a series of lower highs and lower lows. On May 24, Tyco reversed sharply from similarly significant resistance at 25.26 - 25.90 and closed near the lows of the day on both May 28 and May 29.

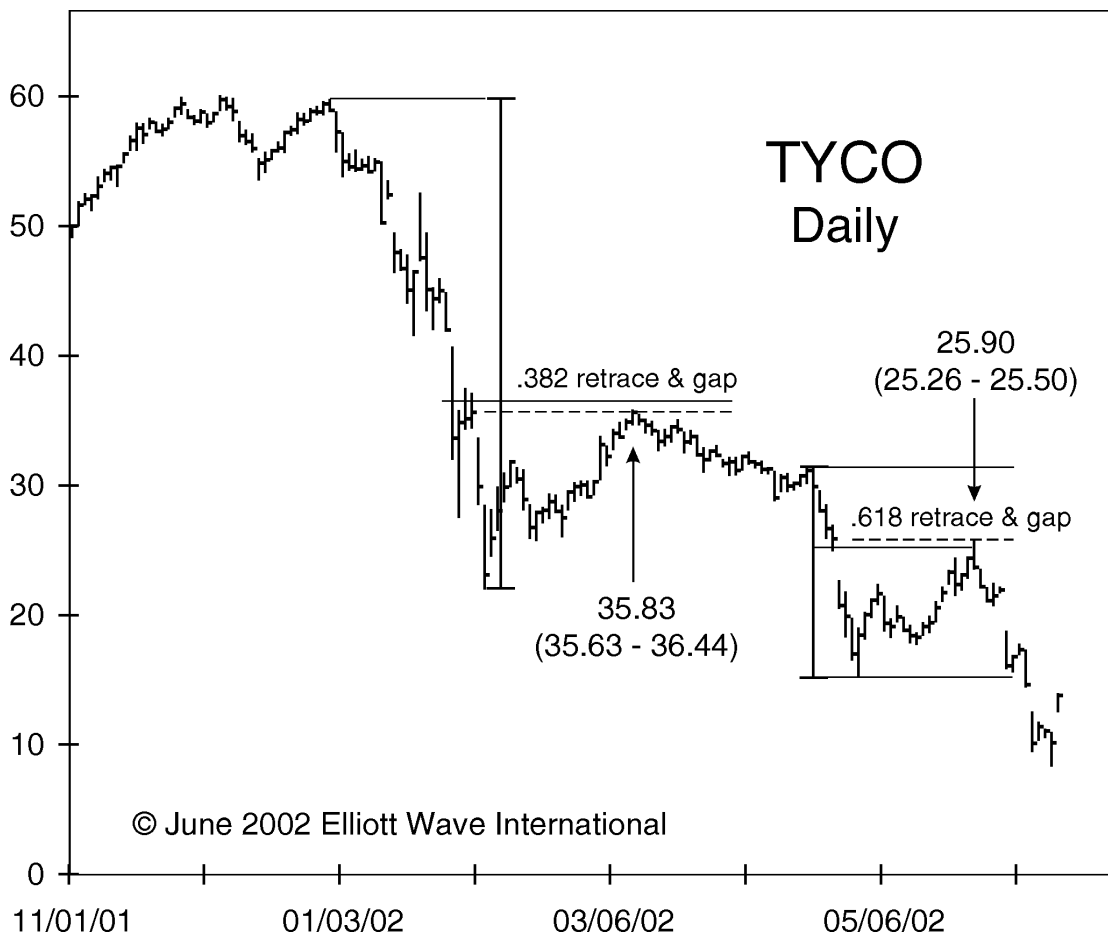


Figure A-2

Appendix B: A Capsule Summary of the Wave Principle

The Wave Principle is Ralph Nelson Elliott's discovery that social, or crowd, behavior trends and reverses in recognizable patterns. Using stock market data as his main research tool, Elliott isolated thirteen patterns of movement, or "waves," that recur in market price data. He named, defined and illustrated those patterns. He then described how these structures link together to form larger versions of those same patterns, how those in turn link to form identical patterns of the next larger size, and so on. In a nutshell, then, the Wave Principle is a catalog of price patterns and an explanation of where these forms are likely to occur in the overall path of market development.

Pattern Analysis

Until a few years ago, the idea that market movements are patterned was highly controversial, but recent scientific discoveries have established that pattern formation is a fundamental characteristic of complex systems, which include financial markets. Some such systems undergo "punctuated growth," that is, periods of growth alternating with phases of non-growth or decline, building fractally into similar patterns of increasing size. This is precisely the type of pattern identified in market movements by R.N. Elliott some sixty years ago.

The basic pattern Elliott described consists of impulsive waves (denoted by numbers) and corrective waves (denoted by letters). An impulsive wave is composed of five subwaves and moves in the same direction as the trend of the next larger size. A corrective wave is composed of three subwaves and moves against the trend of the next larger size. As Figure 1 shows, these basic patterns link to form five- and three-wave structures of increasingly larger size (larger "degree" in Elliott terminology).

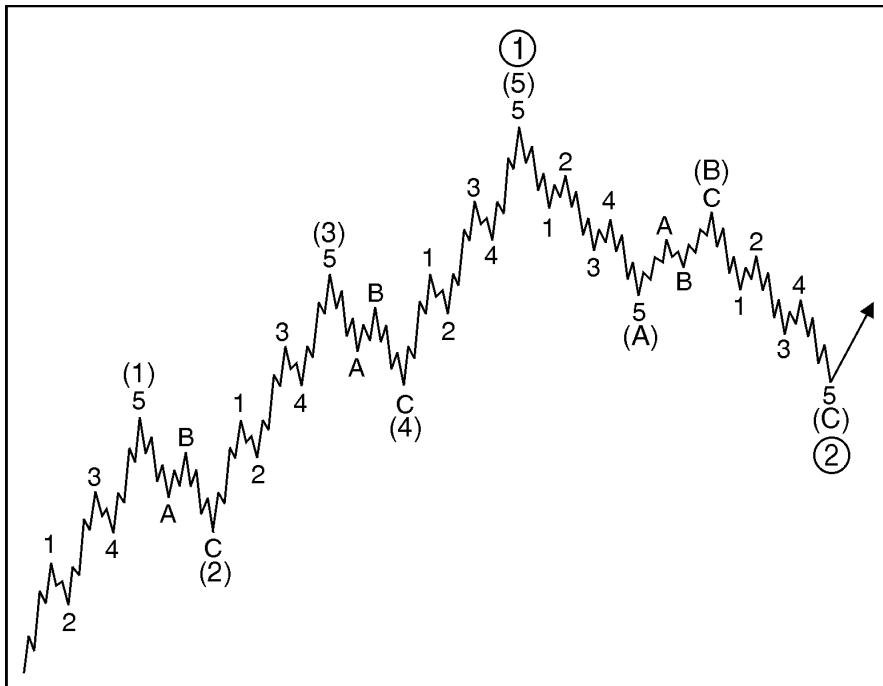


Figure B-1

In Figure B-1, the first small sequence is an impulsive wave ending at the peak labeled 1. This pattern signals that the movement of one larger degree is also upward. It also signals the start of a three-wave corrective sequence, labeled wave 2.

Waves 3, 4 and 5 complete a larger impulsive sequence, labeled wave (1). Exactly as with wave 1, the impulsive structure of wave (1) tells us that the movement at the next larger degree is upward and signals the start of a three-wave corrective downtrend of the same degree as wave (1). This correction, wave (2), is followed by waves (3), (4) and (5) to complete an impulsive sequence of the next larger degree, labeled wave 1. Once again, a three-wave correction of the same degree occurs, labeled wave 2. Note that at each "wave one" peak, the implications are the same regardless of the size of the

wave. Waves come in degrees, the smaller being the building blocks of the larger. Here are the accepted notations for labeling Elliott Wave patterns at every degree of trend (see Figure B-2):

Wave Degree	5s With the Trend					3s Against the Trend		
Grand Supercycle	Ⓘ	Ⓜ	Ⓜ	Ⓜ	Ⓜ	ⓐ	ⓑ	ⓒ
Supercycle	(I)	(II)	(III)	(IV)	(V)	(a)	(b)	(c)
Cycle	I	II	III	IV	V	a	b	c
Primary	①	②	③	④	⑤	Ⓐ	Ⓑ	Ⓒ
Intermediate	(1)	(2)	(3)	(4)	(5)	(A)	(B)	(C)
Minor	1	2	3	4	5	A	B	C
Minute	⓪	⓪	⓪	⓪	⓪	ⓐ	ⓑ	ⓒ
Minuette	(i)	(ii)	(iii)	(iv)	(v)	(a)	(b)	(c)
Subminuette	i	ii	iii	iv	v	a	b	c

Figure B-2

Within a corrective wave, waves A and C may be smaller-degree impulsive waves, consisting of five subwaves. This is because they move in the same direction as the next larger trend, i.e., waves (2) and (4) in the illustration. Wave B, however, is always a corrective wave, consisting of three subwaves, because it moves against the larger downtrend. Within impulsive waves, one of the odd-numbered waves (usually wave three) is typically longer than the other two. Most impulsive waves unfold between parallel lines except for fifth waves, which occasionally unfold between converging lines in a form called a “diagonal triangle.” Variations in corrective patterns involve repetitions of the three-wave theme, creating more complex structures that are named with such terms as “zigzag,” “flat,” “triangle” and “double three.” Waves two and four typically “alternate” in that they take different forms.

Each type of market pattern has a name and a geometry that is specific and exclusive under certain rules and guidelines, yet variable enough in other aspects to allow for a limited diversity within patterns of the same type. If indeed markets are patterned, and if those patterns have a recognizable geometry, then regardless of the variations allowed, certain relationships in extent and duration are likely to recur. In fact, real world experience shows that they do. The most common and therefore reliable wave relationships are discussed in *Elliott Wave Principle*, by A.J. Frost and Robert Prechter.

Applying the Wave Principle

The practical goal of any analytical method is to identify market lows suitable for buying (or covering shorts), and market highs suitable for selling (or selling short). The Elliott Wave Principle is especially well suited to these functions. Nevertheless, the Wave Principle does not provide certainty about any one market outcome; rather, it provides an objective means of assessing the relative probabilities of possible future paths for the market. At any time, two or more valid wave interpretations are usually acceptable by the rules of the Wave Principle. The rules are highly specific and keep the number of valid alternatives to a minimum. Among the valid alternatives, the analyst will generally regard as preferred the interpretation that satisfies the largest number of guidelines and will accord top alternate status to the interpretation satisfying the next largest number of guidelines, and so on.

Alternate interpretations are extremely important. They are not “bad” or rejected wave interpretations. Rather, they are valid interpretations that are accorded a lower probability than the preferred count. They are an essential aspect of investing with the Wave Principle, because in the event that the market fails to follow the preferred scenario, the top alternate count becomes the investor’s backup plan.

Fibonacci Relationships

One of Elliott's most significant discoveries is that because markets unfold in sequences of five and three waves, the number of waves that exist in the stock market's patterns reflects the Fibonacci sequence of numbers (1, 1, 2, 3, 5, 8, 13, 21, 34, etc.), an additive sequence that nature employs in many processes of growth and decay, expansion and contraction, progress and regress. Because this sequence is governed by the ratio, it appears throughout the price and time structure of the stock market, apparently governing its progress.

What the Wave Principle says, then, is that mankind's progress (of which the stock market is a popularly determined valuation) does not occur in a straight line, does not occur randomly, and does not occur cyclically. Rather, progress takes place in a "three steps forward, two steps back" fashion, a form that nature prefers. As a corollary, the Wave Principle reveals that periods of setback in fact are a requisite for social (and perhaps even individual) progress.

Implications

A long-term forecast for the stock market provides insight into the potential changes in social psychology and even the occurrence of resulting events. Since the Wave Principle reflects social mood change, it has not been surprising to discover, with preliminary data, that the trends of popular culture that also reflect mood change move in concert with the ebb and flow of aggregate stock prices. Popular tastes in entertainment, self-expression and political representation all reflect changing social moods and appear to be in harmony with the trends revealed more precisely by stock market data. At one-sided extremes of mood expression, changes in cultural trends can be anticipated.

On a philosophical level, the Wave Principle suggests that the nature of mankind has within it the seeds of social change. As an example simply stated, prosperity ultimately breeds reactionism, while adversity eventually breeds a desire to achieve and succeed. The social mood is always in flux at all degrees of trend, moving toward one of two polar opposites in every conceivable area, from a preference for heroic symbols to a preference for anti-heroes, from joy and love of life to cynicism, from a desire to build and produce to a desire to destroy. Most important to individuals, portfolio managers and investment corporations is that the Wave Principle indicates in advance the relative magnitude of the next period of social progress or regress.

Living in harmony with those trends can make the difference between success and failure in financial affairs. As the Easterners say, "Follow the Way." As the Westerners say, "Don't fight the tape." In order to heed these nuggets of advice, however, it is necessary to know what is the Way, and which way the tape. There is no better method for answering that question than the Wave Principle.

To obtain a full understanding of the Wave Principle including the terms and patterns, please read *Elliott Wave Principle* by A.J. Frost and Robert Prechter, or take the free *Comprehensive Course on the Wave Principle* on the Elliott Wave International website at www.elliottwave.com.

GLOSSARY

Alternation (guideline of) - If wave two is a sharp correction, wave four will usually be a sideways correction, and vice versa.

Apex - Intersection of the two boundary lines of a contracting triangle.

Corrective Wave - A three-wave pattern, or combination of three wave patterns, that moves in the opposite direction of the trend of one larger degree.

Diagonal Triangle (Ending) - A wedge-shaped pattern containing overlap that occurs only in fifth or C waves. Subdivides 3-3-3-3-3.

Diagonal Triangle (Leading) - A wedge-shaped pattern containing overlap that occurs only in first or A waves. Subdivides 5-3-5-3-5.

Double Three - Combination of two simple sideways corrective patterns, labeled W and Y, separated by a corrective wave labeled X.

Double Zigzag - Combination of two zigzags, labeled W and Y, separated by a corrective wave labeled X.

Equality (guideline of) - In a five-wave sequence, when wave three is the longest, waves five and one tend to be equal in price length.

Expanded Flat - Flat correction in which wave B enters new price territory relative to the preceding impulse wave.

Failure - See Truncated Fifth.

Flat - Sideways correction labeled A-B-C. Subdivides 3-3-5.

Impulse Wave - A five-wave pattern that subdivides 5-3-5-3-5 and contains no overlap.

Impulsive Wave - A five-wave pattern that makes progress, i.e., any impulse or diagonal triangle.

Irregular Flat - See Expanded Flat.

One-two, one-two - The initial development in a five-wave pattern, just prior to acceleration at the center of wave three.

Overlap - The entrance by wave four into the price territory of wave one. Not permitted in impulse waves.

Previous Fourth Wave - The fourth wave within the preceding impulse wave of the same degree. Corrective patterns typically terminate in this area.

Sharp Correction - Any corrective pattern that does not contain a price extreme meeting or exceeding that of the ending level of the prior impulse wave; alternates with sideways correction.

Sideways Correction - Any corrective pattern that contains a price extreme meeting or exceeding that of the prior impulse wave; alternates with sharp correction.

Third of a Third - Powerful middle section within an impulse wave.

Thrust - Impulsive wave following completion of a triangle.

Triangle (contracting, ascending or descending) - Corrective pattern, subdividing 3-3-3-3-3 and labeled A-B-C-D-E. Occurs as a fourth, B, X (in sharp correction only) or Y wave. Trendlines converge as pattern progresses.

Triangle (expanding) - Same as other triangles, but trendlines diverge as pattern progresses.

Triple Three - Combination of three simple sideways corrective patterns labeled W, Y and Z, each separated by a corrective wave labeled X.

Triple Zigzag - Combination of three zigzags, labeled W, Y and Z, each separated by a corrective wave labeled X.

Truncated Fifth - The fifth wave in an impulsive pattern that fails to exceed the price extreme of the third wave.

Zigzag - Sharp correction, labeled A-B-C. Subdivides 5-3-5.