Elliott Wave Handbook

Financial Freedom Trading

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General Market Structure

Broad Concept

The Wave Principle was a phenomenon which was discovered by Ralph Nelson Elliott in the 1930s. He analyzed the stock market and noticed, that the **prices trend and behave in recognizable pattern.** In his research he discovered five primary pattern or waves, which link together to form a bigger version of themselves. The **Elliott Wave Theory** was born.

The Elliott Wave Theory is primarily a tool to describe how markets behave. But it can be used **remarkably well** as a forecasting tool, to identify the end of a movement and **predict** where the market will turn.

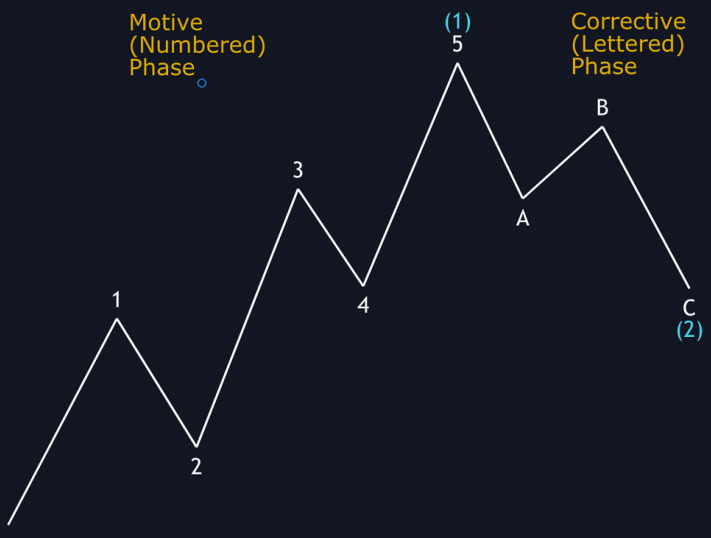
Here at Financial Freedom Trading we use the Elliott Wave Theory as **one building block** of our strategy. In combination with traditional support and resistance, Fibonacci level and Price Action Signals it leads to great confluence and forms an edge in our trading.

On the following pages you will find a comprehensive collection of the **basic and advanced** Elliott Wave elements, guidelines to follow and tips for the practical application.

Complete Market Cycle

First we have to take a look at the Complete Market cycle. It consists of 8 waves, which can be divided into two phases. In this whole book we will only look at the bull market variation, the bear market pattern are the exact opposite.

- Phase 1 consists of five motive waves, which are labelled with numbers.
- Phase 2 consists of three corrective waves (or variations thereof) and are labelled with letters.

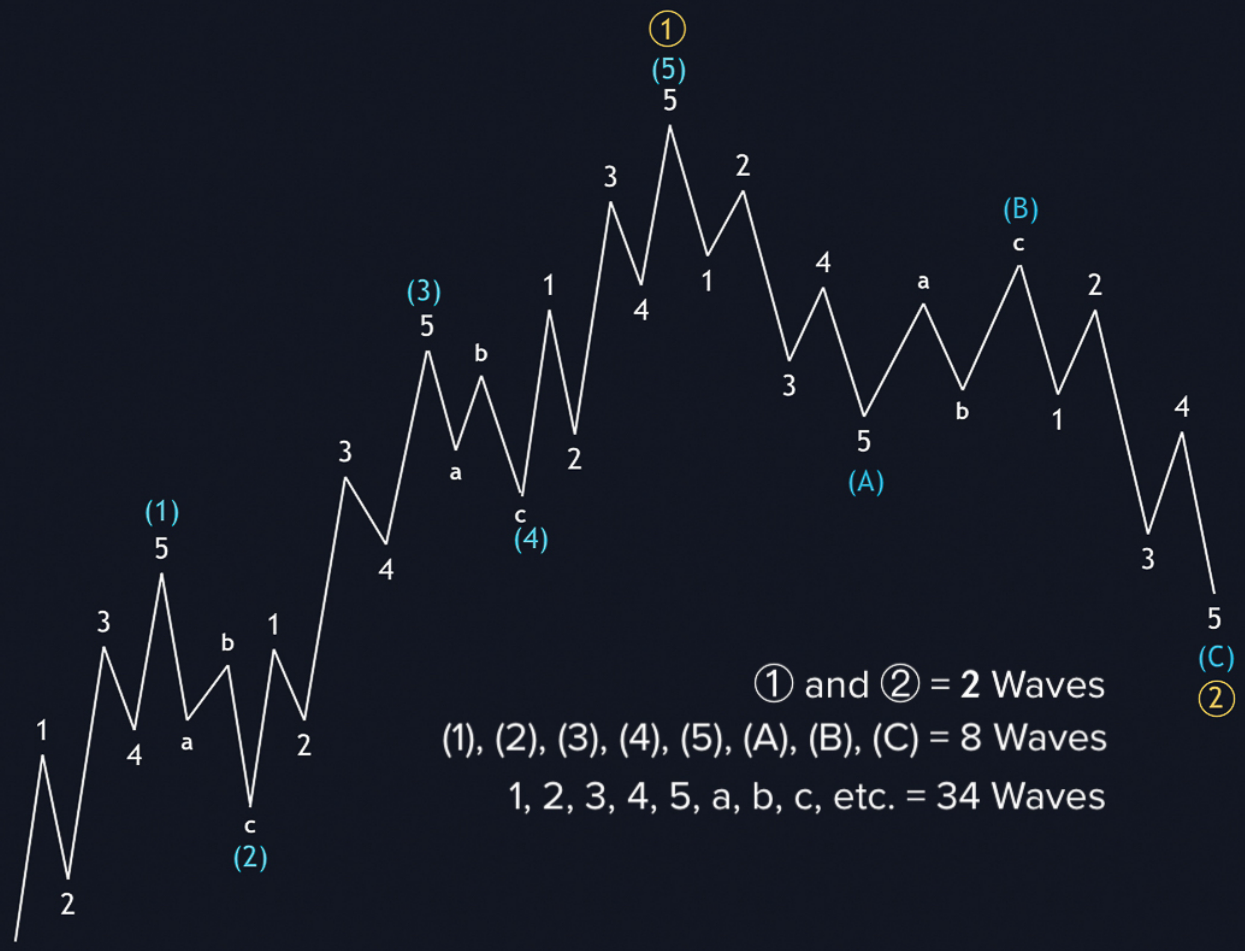


Wave 1/3/5 are directional movements and represent the primary trend. They are separated by wave 2 and 4, which represent countertrend corrections.

The biggest rules to follow about the basic pattern are:

- Wave 2 never goes below the beginning of wave 1
- Wave 3 is never the shortest wave
- Wave 4 never overlaps with Wave 1

Compound Construction



❗ You have to understand how the **timeframes and cycles are interconnected.** ❗

Take a look at the chart above. It contains the chart from the previous page with the waves (1) & (2).
But it is also a bigger, more detailed version of itself.

- One 5-wave pattern represents one part of a 5-waved pattern of a higher degree.
- It also can be subdivided into a 5-waved pattern of smaller degree.

Wave ② can also be subdivided into (A), (B), (C). Wave ② is a corrective wave on primary degree.
Its Wave (A) and (C) are motive waves, as they point of the **trend direction of the correction.**

- A 3-wave movement is a correction of a 5-wave pattern one degree higher.
- Wave (1), (2), (3), (4), (5) can also be subdivided into smaller versions of themselves.

❗ It's crucial to understand, that these wave pattern are compounded in themselves. We could have a nice trend on the 1 or 4-hour chart, which is only a correction of the daily chart.

It is not useful for everyday application to go too deep from a timeframe perspective.
A 5-waved motive pattern should be clearly visible one the 1h, 4h or daily chart.

When trading it's best to look out for a continuation of the primary directional movement, as they are the strongest with high momentum.

Motive Waves

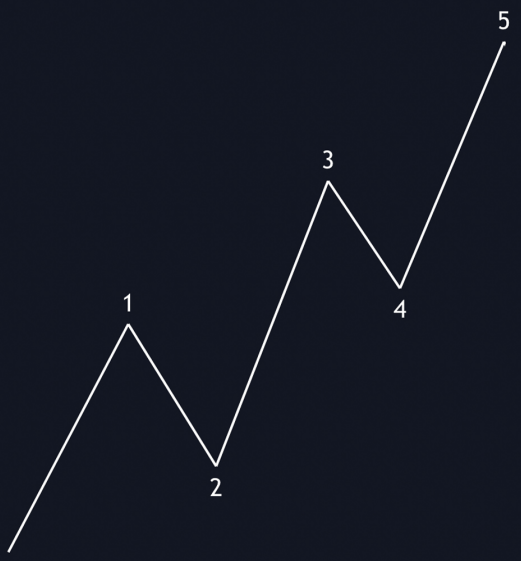
Impulse

Motives waves subdivide into five waves and **always move in the same direction as the trend of one degree higher**. The countertrend wave 2 never moves beyond the beginning of wave 1 and wave 4 moves never beyond the beginning of wave 3.

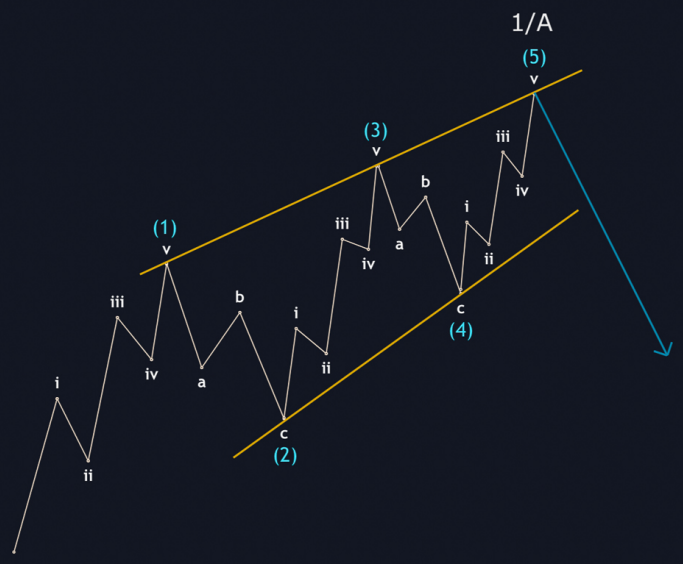
There a 2 types of motive waves:

- The impulse
- The diagonal

The most common one is the impulse.
In an impulse wave 4 **never overlaps** with the high of wave 1. Wave 1/3/5 are themselves motive.
Also wave 3 is **never the shortest** wave and **always an impulse.**



Leading Diagonal



Leading Diagonals is a motive wave, but no impulse as it also has corrective characteristics.
Typically its wave 4 overlaps with the top of wave 1.
It can be the Wave 1 of an Impulse or a Wave A of an A-B-C Correction.
Its structure is either 3-3-3-3-3 or 5-3-5-3-5.

Rules:

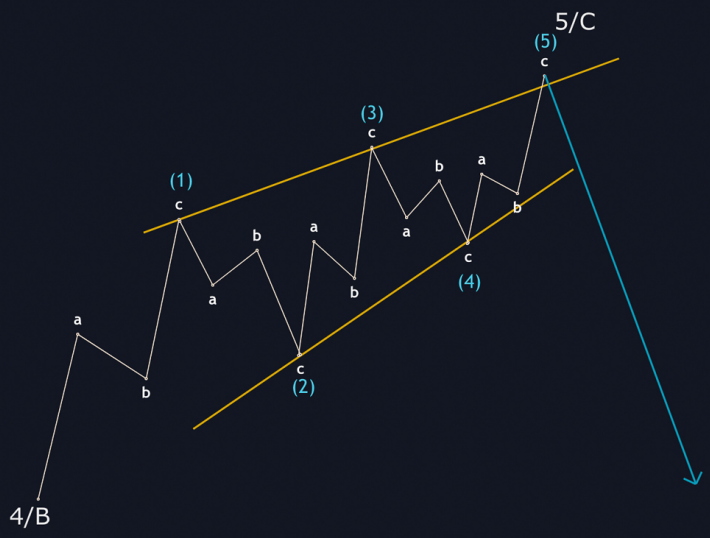
- Wedge shape with parallel or contracting trendlines
- Usually Wave 1 is the longest, Wave 3 must be longer than Wave 5

- Wave 4 overlaps with wave 1 and has a smaller retracement than wave 2
- It is either followed by a wave 2 in a motive wave or by a wave B in an A-B-C correction.

❗ Often the fifth wave of the leading or ending diagonal makes a fake breakout above the trendline.

Ending Diagonal

The Ending Diagonal is a pattern the occurs when the preceding move as Elliott puts it has gone „to far too fast“.
This pattern is mostly found in the fifth wave, at the end of an impulse. It can also happen as a final Wave C in a ABC-Correction.



Rules:

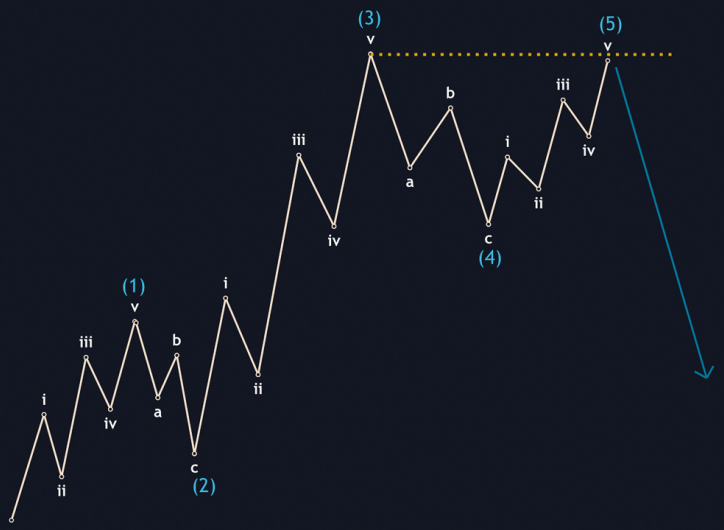
- Wedge shape with contracting trendlines
- Wave 4 overlaps with Wave 1, but does not go beyond the start of wave 2
- Wave 1 is the longest wave and wave 3 can’t be shorter than wave 5
- Structure is normally 3-3-3-3-3, each waves subdivides into a ZigZag a-b-c or w-x-y

It is also accompanied by divergences in RSI or MACD indicator.

❗ Watch out, often the fifth wave of the Ending Diagonal makes a fake breakout above the wedge forming trendlines.

➔ Because Ending Diagonals **only** occur **at the end of a move**, the **following trend change** and new direction of price action leads to great trade opportunities.

Truncation



A truncation is a „failure“ of the fifth wave to move beyond the end of the third wave.

- It can usually be verified by identifying the necessary five subwaves
- In classic technical analysis this wave pattern can also be classified as a common double top.

❗ A truncation usually happens after a really strong extended third wave.

💡 Watch out for the subwaves to identify the pattern early and be one step ahead.

Extension

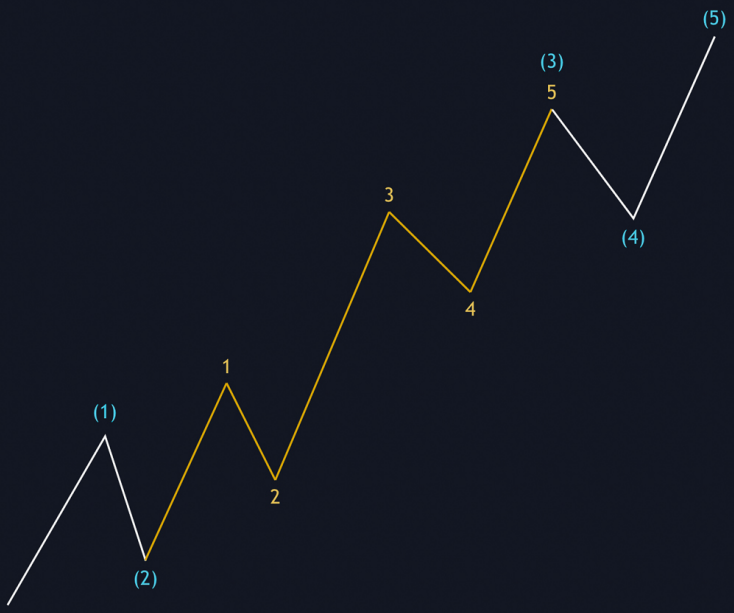
Most impulses contain what Elliott called an extension. An extension is an elongated wave with exaggerated subdivisions.

- The majority of impulses has one extension.
- The most common extension is of wave 3, although wave 1 and 5 are also possible

Have look at the chart on the right:

- Subwave 2 could not be labelled Wave 4, because it overlaps with wave (1)
- Subwave 1 is shorter than wave (1)

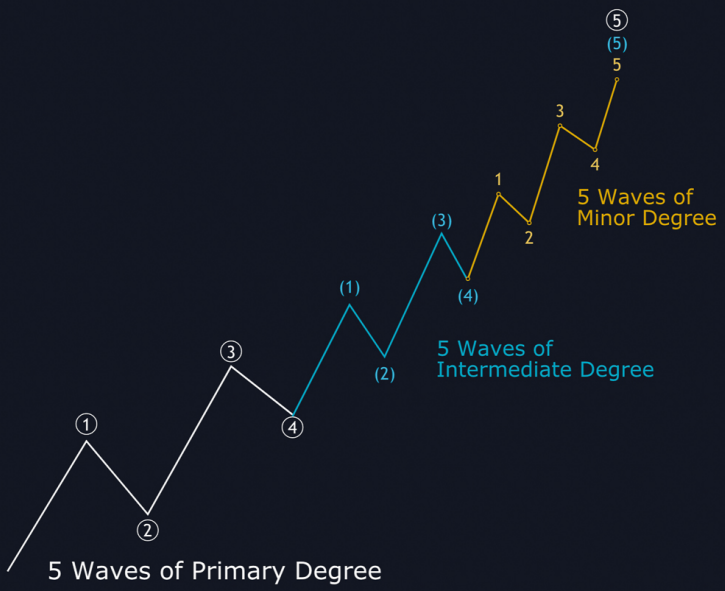
➜ If Subwave 1 is an impulse, than an extended wave 3 is the most likely expectation



❗ If wave 3 is the same size as wave 1, we would expect an extension of wave 5.

❗ Is wave 3 extended, Wave 5 often resemble Wave 1 in time and length.

Fifth Wave Extension of Fifth Wave Extension



An extension may also have an extension within itself. This mostly happens in third of fifth wave.

Normally you would expect a trend change at the point of (1), because five waves took place. But the trend remains intact and new highs are made consistently.

➜ This is where novices get eaten by the market in one huge loss, as extensions tend to go on forever.

❗ As only one Wave can be extended, if wave 3 is the same size as wave 1, we would expect an extension of wave 5.

„The trend is your friend“ - an old saying which is still true in today's market. If most impulses have an extension it is clever to ride the waves until a change of trend is clearly visible.

Corrective Waves

Markets **move against the trend** of one greater degree only with struggle. This can be witnessed in the frequently **messy price action**, as two forces are pulling in each direction. One clear rule for corrections is, that they **never have five waves**. If they do, they are only a motive part of the overall corrective pattern.

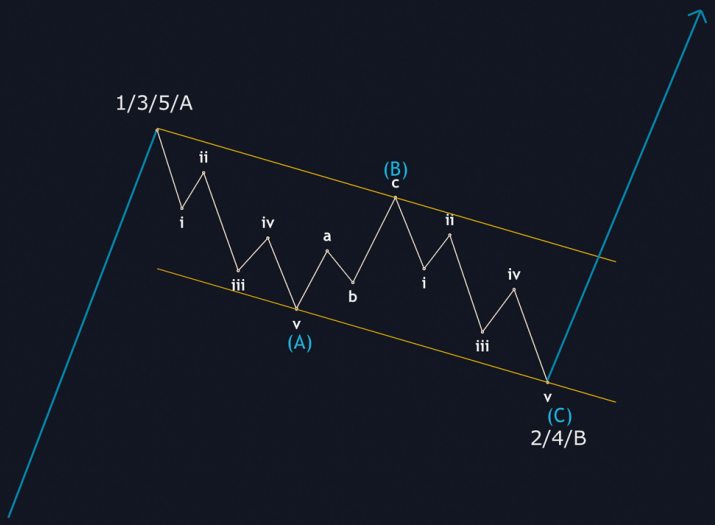
Corrections can be classified into two styles. There are the **sharp** corrections, which move sharply against the major trend. Their angle is rather steep. On the other hand are **sideways** corrections, they don't retrace much in price, but can take a long time to finish.
Apart from the two styles are in general three correction pattern:

- Zig-Zag (5-3-5) (single, double, triple)
- Flat (3-3-5) (regular, expanded, running)
- Triangle (3-3-3-3-3) (contracting, barrier, expanding and running)

Combination of these pattern form either a double three or triple three correction. These prolonged corrections are separated by a wave X.

Zig-Zag Correction

A single Zig-Zag is a simple three-waved corrective movement which is labelled A-B-C.
It's structure is 5-3-5, and top of wave B is noticeable lower than the start of wave A.



Rules:
- Wave A has to be motive or diagonal
- Wave B can only be corrective pattern
- Wave B has to be shorter than Wave A
- Wave C has to be an impulse or ending diagonal

This is the most common corrective pattern in Elliott Wave Theory and is usually a sharp correction.

The length of wave C is between 100%-161,8% of wave A.

Zig-Zag's appear most of the time as a wave 2, but are also very common as a connective wave in more complex corrections like a double or triple three.

Occasionally Zig-Zag corrections will occur two, sometimes even three times in a row. This happens mostly, when the first Zig-Zag did not correct far enough from a price perspective.

❗ If a double Zig-Zag occurs, the single Zig-Zags are separated by a three-waved reactionary move, which is labelled Wave X and is always corrective.

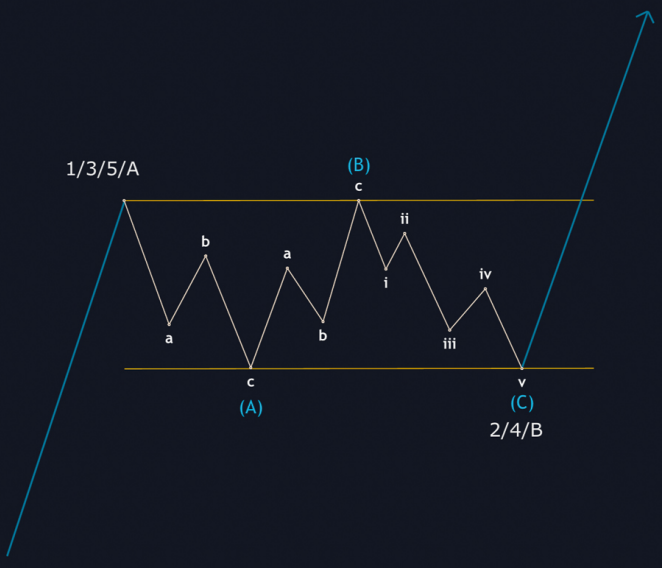
💡 Zig-Zag corrections often fit into a parallel channel which is drawn between the highs of wave A & B to determine the end of wave C.

Flat Correction

The Flat correction is the second most common pattern and always has a 3-3-5 structure.
As wave A is not five-waved and powerful, the retracement of wave B is rather strong.

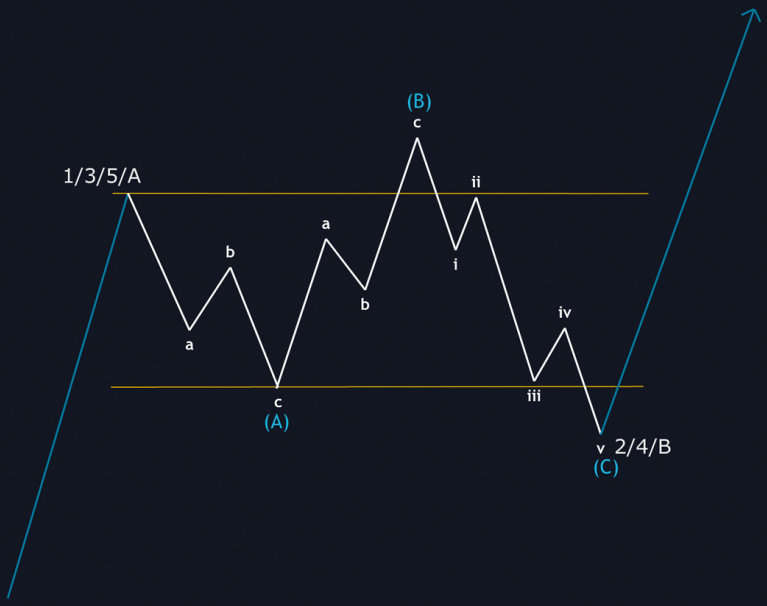
Rules:

- Classic sideways movement, Wave A and Wave B are corrective.
- Wave C is impulsive, but does not go much below Wave A.
- Most of the time Wave B/C go some pips above or below of Wave A (just to trick people into believing a breakout occurs).
- Although it is called the Regular Flat Correction, it is not the most common one.



❗ Watch for overall market structure to avoid overtrading in corrections.

Expanded Flat



The Expanded Flat is the most common one under the flat corrections.

- Corrective wave pattern with an extended wave B, which reaches higher than the start of wave A.
- Wave B marks a fake breakout above the last high.
- Wave C is also extended and goes deeper than wave A.
- Structure of the correction is 3-3-5.

Rules:

- Wave B ends higher than the beginning of wave A
- Wave C is an impulse or ending diagonal and ends lower than the low of wave A

❗ Wave B/C over and over again catch traders on the wrong side, as fake breakouts take place just before the market turns.

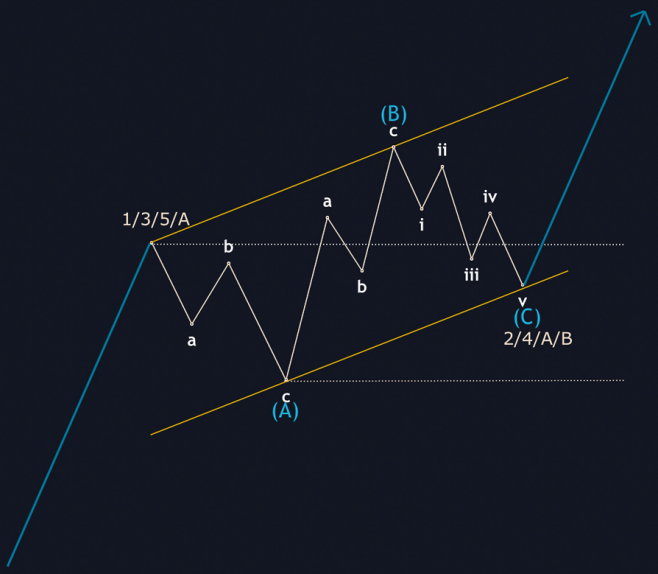
Running Flat

The last of the flat corrections is the running variation. It is the least common one, but has the same 3-3-5 structure.

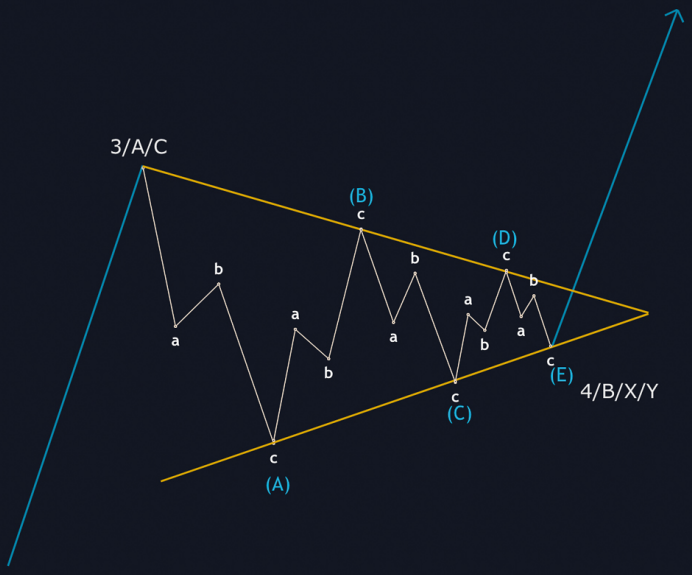
Rules:

- Wave B ends high above the beginning of wave A
- Wave C ends higher than the end of wave A
- Usually wave C is the same length as wave A.

➜ This kind of correction happen in really strong and fast markets. The fast and high push of wave B and the short wave C are signs of a strong primary trend.
A parallel channel regularly marks the low of wave C.



Contracting Triangle



Triangles represent a balance of the buying and selling force in the market. They contain five overlapping waves with a 3-3-3-3-3 structure.

The contracting triangle represents the most frequently appearing.

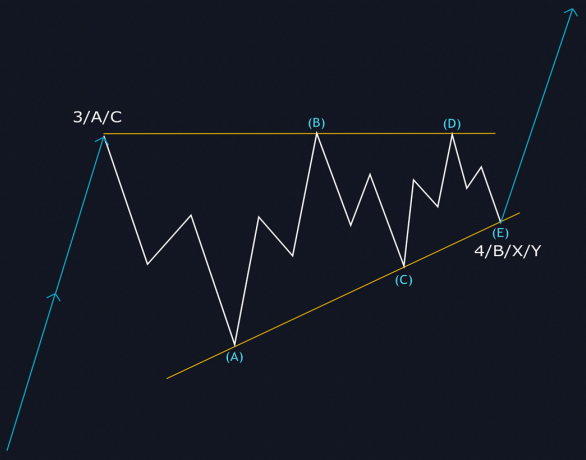
Rules:

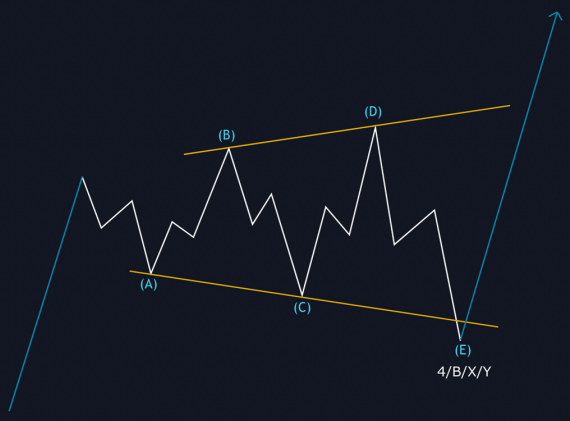
- Triangles have 5 Waves: A-B-C-D-E
- All of the waves are corrective
- Upper line is declining, lower line is rising
- Wave E frequently overshoots the trendline and can also be a triangle

- Triangles only occur as a Wave 4/B/X/Y
- Never as a Wave 2/A

❗ Triangles represent a continuation pattern for the dominant trend.

Barrier & Expanded Triangle



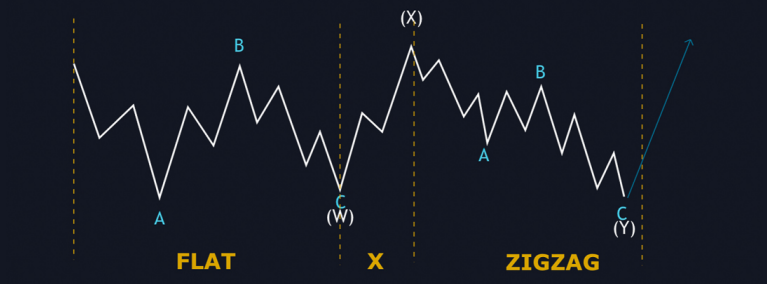


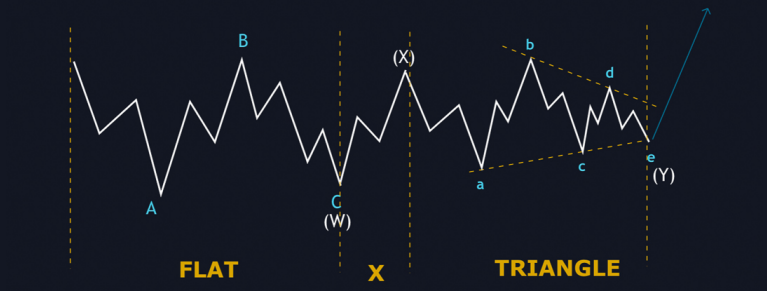
The other two variations are the **barrier** and **expanded triangle**. They have the same characteristics as the contracting triangle except their overall shape.

Usually **triangles occur prior to the final push in the trend one degree higher**. This final push is either a wave 5 in an impulse or wave C in A-B-C correction. Often it travels the distance of the widest part of the triangle.

They also occur in more complex corrections like the double or triple three, which are discussed in the next chapter.

Double Three

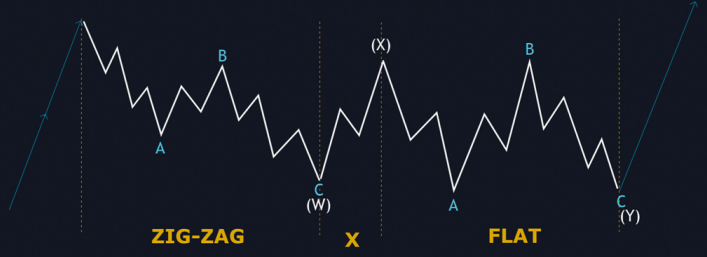




Rules:

- Zig-Zags and triangles only happen once in these combination.
- Triangles only appear as Wave Y.
- The difference to a double Zig-Zag correction apart from the elements, is the horizontal orientation. A Zig-Zag corrects sharper and more against the major trend.

➜ It is possible that two flats are appearing, but a flat followed by a triangle is a more common example. As the single corrections tend to alternate in form.

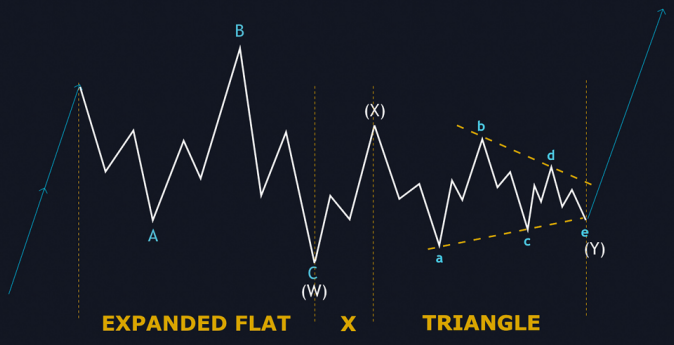


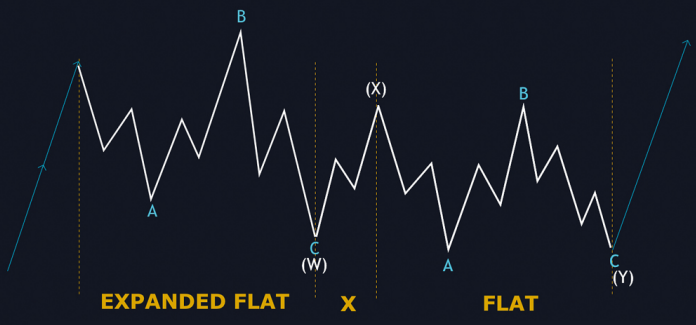
Apart from the normal and short corrections, exist the more complex variations like the double or triple three.

These pattern are **combination of single simple correction pattern** like the zig-zag, the flat or triangle variation.

These single corrections are linked by a connecting „X“ Wave, which can take any corrective form, but is usually a zig-zag.

Characteristic for complex corrections is the sideways movement.





The count for a double three is W-X-Y.

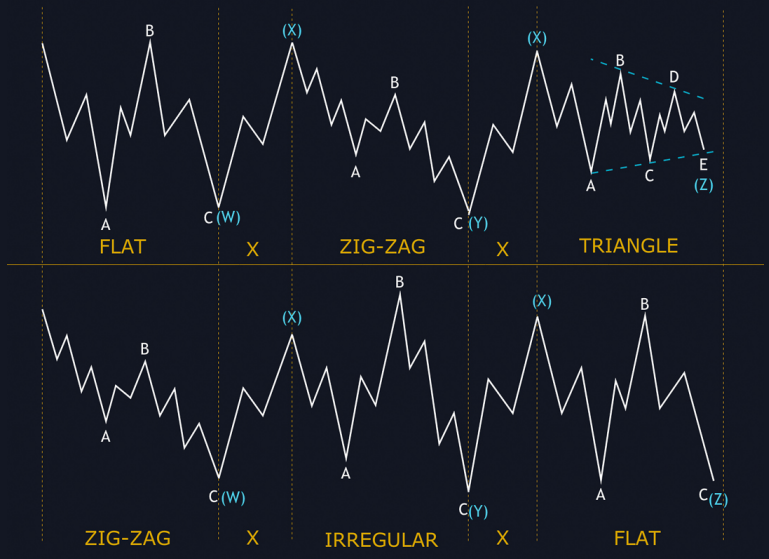
Double three’s are common in the more shallow wave 4.

❗ The purpose of double or triple threes is to expand the duration of the correction.

❗ Watch out for a triangle or a final wave C to catch the continuation of the primary trend.

The pattern displayed show only some possible variation the double three can take due to reasons for clarity.

Triple Three



Next to the double three exist the even more complex or elongated corrections the triple three.

The **triple three correction is very similar to the double three**, it is just even more extended.

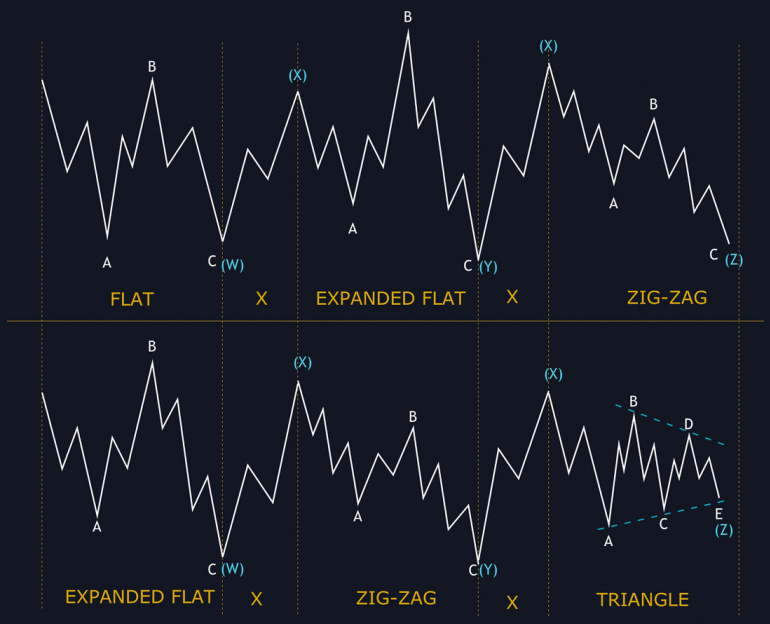
The overall count is W-X-Y-X-Z, so the three simple corrections are separated by two X waves.

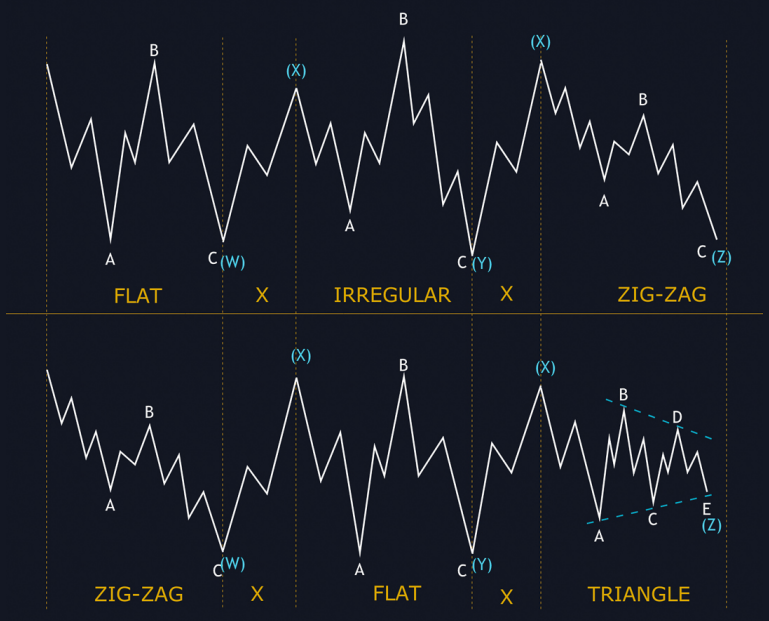
Similar to the double three, these X waves are normally zig-zags, but can take any form.

A triangle is only valid as wave Z and therefore represent the end of the correction.

As with the double three, the variation displayed only show some possible forms.

In general the three simple corrective pattern can take any shape (Flat, zig-zag, triangle), but usually show alternation between themselves.





A final notice about corrections:

Most traders loose money in these long sideways corrections as the market does not present a clear trend.

It is usually full of **false breakouts** and **messy price action**. The experience shows, that most of the time it is the best decision to stay out of the market **until a clear entry signal** is given.
In some cases a clear ranging market (especially on higher timeframe) can be traded, but this is only for experienced traders.

Guidelines of Wave Formation

The Elliott Wave pattern are conducted by rules, which can not be broken to classify one pattern. The two most widely know are, that wave 3 can't be the shortest wave, and wave 4 can't overlap with wave 1.

Apart from the rules to classify the movements in the market, exist guidelines for identifying the correct count. These guidelines can best be interpreted as a help to determine what is the most probable thing to happen. But they are no rules, and therefore the possible must always be kept in mind.

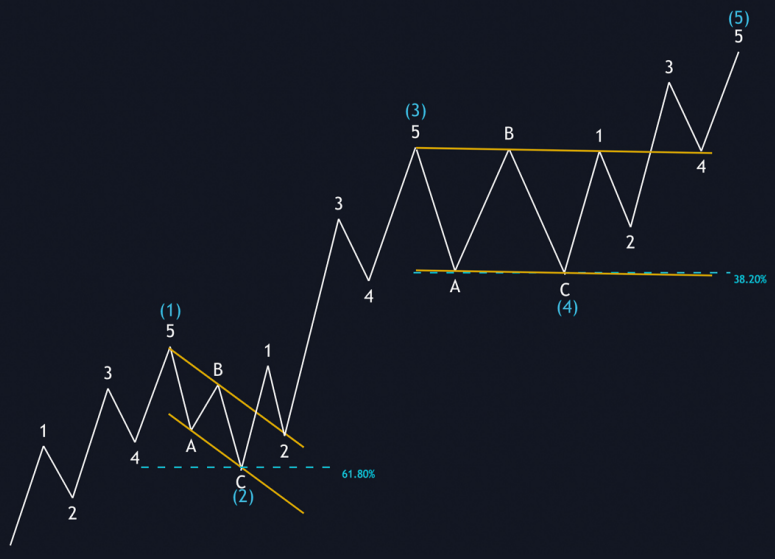
In this chapter you will find additional concepts to make analysis easier and develop the right look.
Apart from the guidelines already described at the individual wave pattern, you will learn about alternation, channeling, wave personality etc.

Alternation

When talking about guidelines, the **concept of alternation** has to be discussed.
It basically states, that when analyzing the markets, the most common pattern to expect next, is one, that **differs from the previous related pattern**.

To illustrate this concept, take a look at the chart to the right. It shows a complete impulse with five waves.

- Wave 2 corrects rather sharp against the major trend und deep to the 61,8% Fibonacci level.
- Wave 4 on the other hand is more of a sideways correction and only corrects to the 38,2% Fibonacci level.



Usually **wave 2** is a zig-zag which **corrects much of the price movement** and **wave 4** is either a flat, triangle, double or triple three correction whose purpose lies in the **extension of duration**.

Alternation within Corrective Waves

Not only does alternation take place between different waves, but also within the waves themselves.

Have a look at the two corrections shown. They are both (A)-(B)-(C) pattern, but differ in development.

In the first variation wave (A) is made of a ABC Flat correction, which is followed by a ABC Zig-Zag correction forming wave (B).

The second variation represents the exact opposite. In both cases the second component of the correction (Wave (B)), varies from the first component.

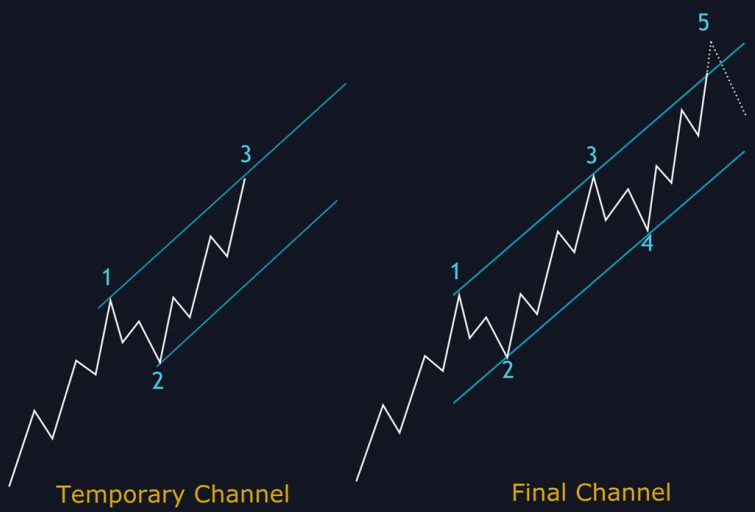
➜ Both corrections finish with a classic wave (C), which is a five-wave countertrend movement.

Channeling

As Elliott stated, a parallel channel often occurs in the impulsive phase of the market cycle and marks the lower and upper boundaries of the impulse.

- For the initial channel we need three reference points
- We can draw a channel when Wave 3 has finished.

➜ Draw a line between the high points of Wave 1 and Wave 3 and make a parallel line touching the base of Wave 2



Temporary Channel

Final Channel

➜ The extension of this parallel line will determine the most likely ending point of Wave 4

❗ The final Wave 5 of the impulsive move has a target projection at the upper channel boundary.

💡 Wave 5 frequently forms a „throw-over“ which is a fake breakout above the channel line.

Wave Personality

The **price movements are the collective reflection of the beliefs of all market participants.** They represent mass psychology and the underlining dynamics from pessimism to optimism and back again.

Wave 1 is sometimes hard to spot, as the previous opposite trend is still intact. It also does not have clear price action, looks choppy and the waves are overlapping, forming wedges/diagonals.

Wave 2 retraces a lot of the price movement made in wave 1. Most of the market participants still speculate on the previous trend to continue and do not notice the ongoing trend change.

Wave 3 is usually the biggest move. It represents the finished trend change, as wave 2 made a higher low followed by a higher high in wave 3. Also it is frequently extended, moving with strong momentum without any major corrections to new highs.

Wave 4 can generally be predicted easily, as they tend to alternate to wave 2 and take more time to finish. Most of the time it is a complex sideways movement, tricking traders into false signals.

Wave 5 represents the final push in the direction of the dominant trend. Usually wave 5 comes with lower volume and often shows a clear divergence in indicators like the RSI, MACD etc.

Wave A can unfold in either three or five wave structure. It represents the exhaustion in the market and is regularly not clearly visible as a lot of traders just think it is a normal pullback of the dominant trend.

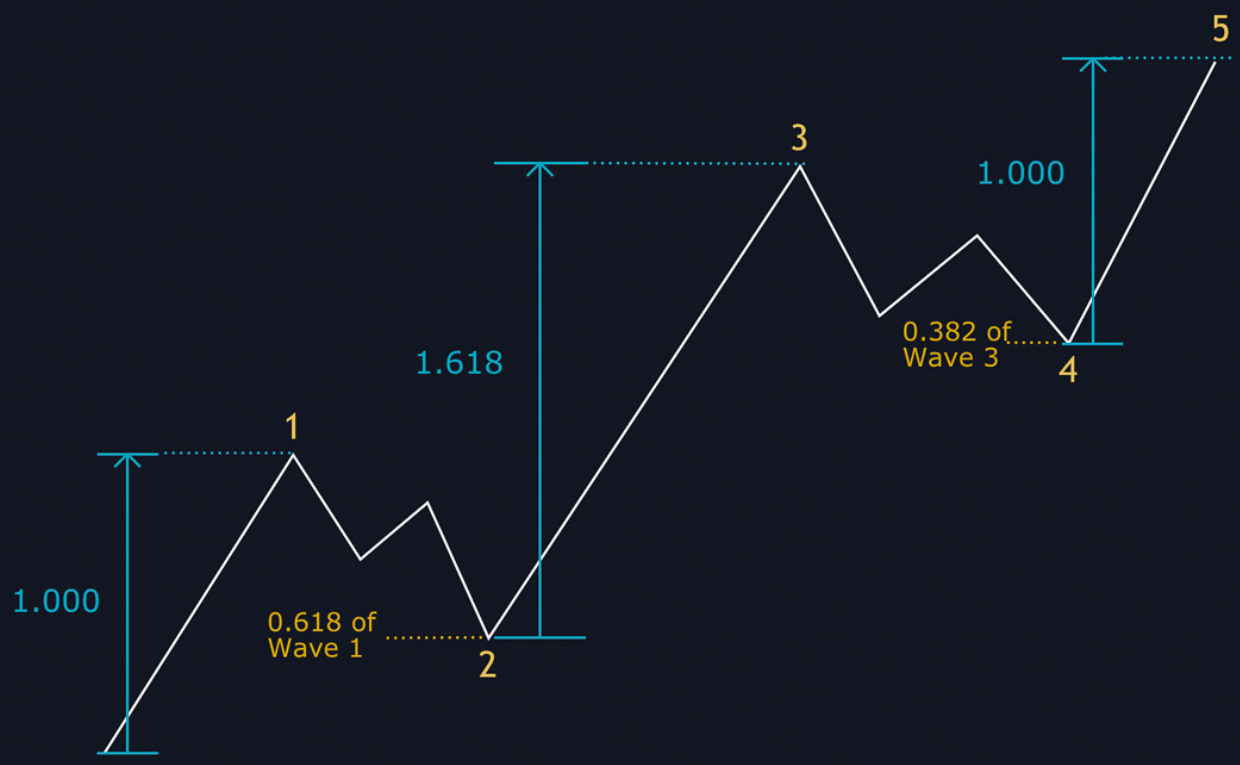
Wave B is can take many shapes and are known for being a „bull-trap“. The can either retrace much lower than wave A or they shoot back up fast, sometimes even above the last high, catching traders on the wrong side as a fake breakout occurs. They always have there subwaves and in classical technical analysis represent the right shoulder in Head-Shoulder formation.

Wave C is impulsive and has five waves against the dominant trend. Continually it has the length of wave A, but an extension to the 161,8% or even greater is possible, making them fast and devastating moves. It frequently catches traders on the wrong side of the market.

Fibonacci & Ratio Analysis

When talking about Elliott waves, the **proportional relationship between waves** has to be considered. The concept of the fibonacci numbers, which could be discussed in a book of its own, can often be applied with exceptional accuracy.

In the following chapter we will take a look at the overall market structure, the retracement levels, motive wave multiples and how to correctly apply the ratio analysis.



The practical application of Fibonacci level and Elliott waves can be divided into two groups.

- Retracements - identify probable targets for a corrective wave
- Extensions - identify probable targets for the next impulsive wave

The Retracement measures how far the correction retraces the previous wave.

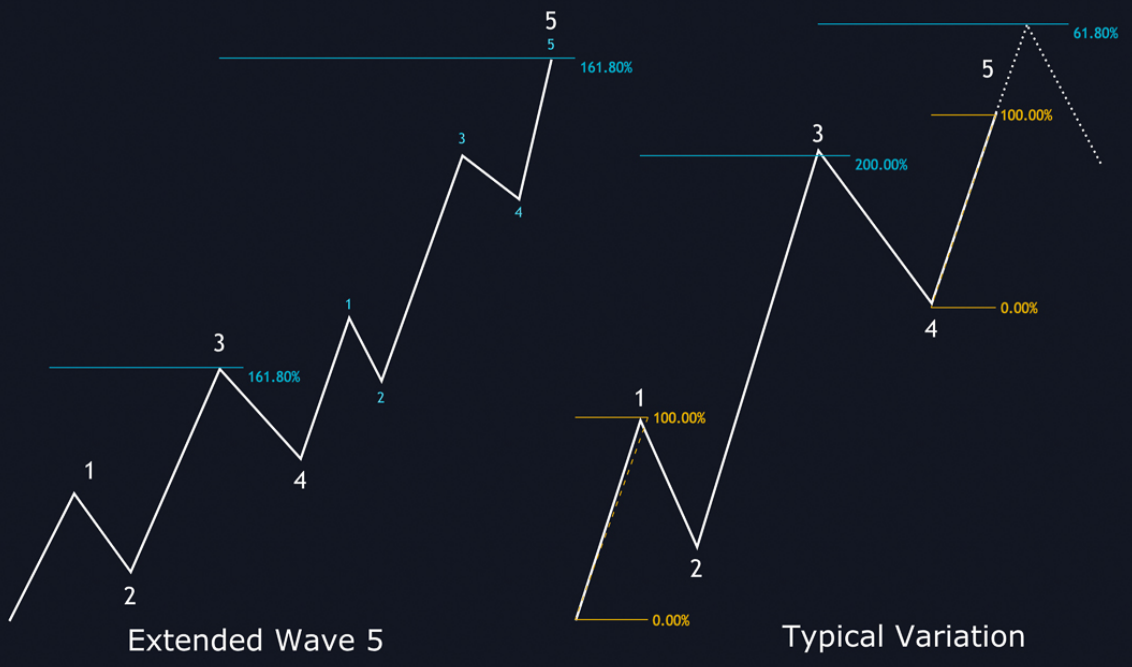
Sharp corrections like a Zig-Zag as wave 2, wave B in a larger Zig-Zag, or a wave X correct time and again to the 50%-61,8% level of the previous wave. If wave 1 is a leading diagonal it can even go travel to the 78,6% level.

Sideways corrections like a flat variation, double or triple three often correct only to the 23,6 / 38,2% retracement. These shallow corrections regularly occur as a wave 4.

❗ In general wave 2 corrects deeply (e.g. 61,8%), while wave 4 is shallow and only reaches the 38,2%.

❗ IF daily price action candlestick signals occur, most of the time a retest and entry at 50% level is possible.

Motive Wave Multiples



Apart from identifying a possible target for a retracement, it is very useful to **determine a target for the next impulse.**

One way is to apply the Extension of the previous wave. To determine the extension you have to measure the initial wave (e.g. Wave 1), and attach the multiples at the low of wave 2.

This can be seen at the diagram above.

- On the left, wave 3 is 161,8% of wave 1 which was laid at the low of wave 2.
- On the left, wave 5 is 161,8% of the length wave 1 to wave 3, attached to the low of wave 4.

  ➜ Such a great extension of wave 5 only happens, if wave 5 is extended.

On the right is far more typical variation of an impulse:

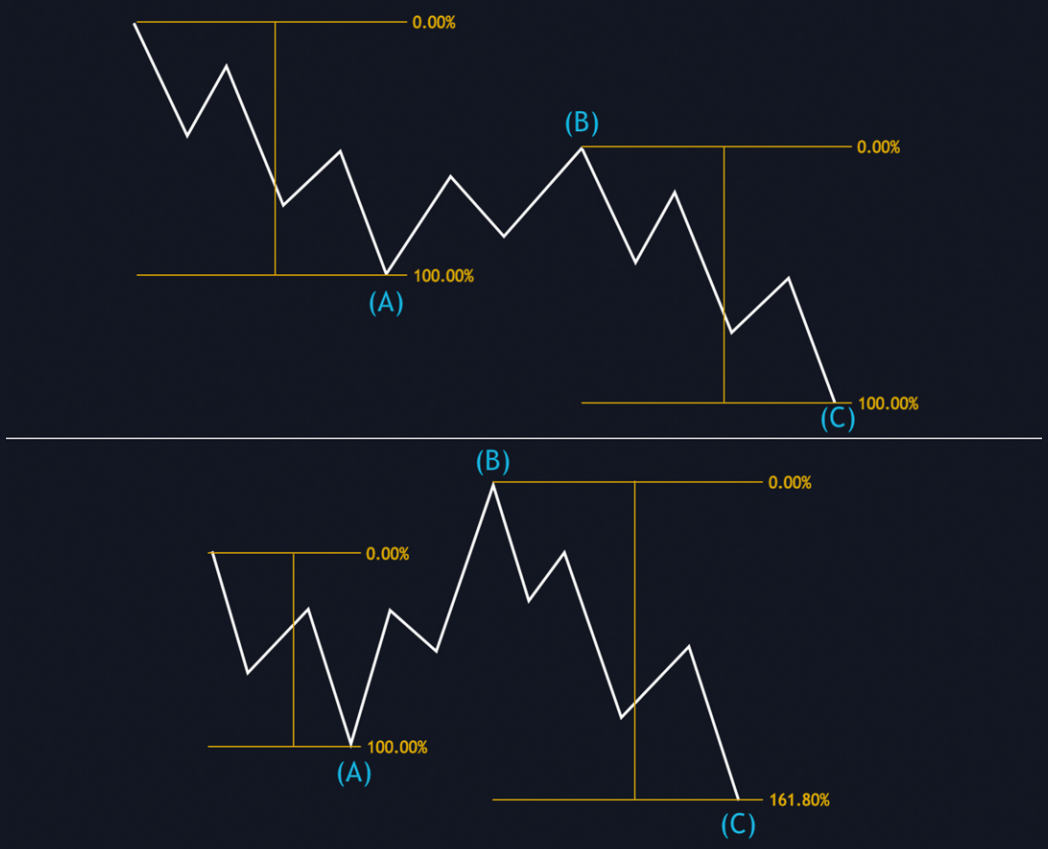
- Wave 3 is 200% of wave 1, also attached to the low of wave 2.
- Wave 5 can be measured in different ways.
  - Wave 5 = Wave 1 (100% of wave 1 attached to low of wave 4)
  - Wave 5 = 61,8% extension of wave 1 to wave 3, attached to low of wave 4)

Motive Wave Multiples:

- **Wave 1** - No target, initial wave
- **Wave 3**
  - 161,8-261,8% extension of wave 1
  - In rare cases over 261,8% extension of wave 1. (Extended wave within extended wave)
- **Wave 5**
  - 100% of wave 1
  - 100% of wave 3
  - 61,8% of wave 1-3
  - etc.

Always keep the overall right look in mind. Wave 3 is the most likely wave to be extended.
If so, wave 1 and 5 are probable to be similar in size and time. If wave 1 and 3 look very similar in size, wave 5 most definitely will be extended. Always close some of your position at potential targets.

Corrective Wave Multiples



The multiples of waves can also be **applied to corrections**. In a Zig-Zag **Wave C repeatedly equals Wave A** in length. But other ratios like 161,8% or 61,8% do also occur. This ratio does also apply to the first and the second zig-zag in a double zig-zag correction.
A regular flat correction, has Waves A/B/C which are quite equal. On the other hand, the extended flat correction has different ratios applied. In this case wave C often represents the 161,8% extension of wave A.

As you can see the **waves are connected** through a relationship in their ratio of magnitude and time. But not only the degree of waves or timeframe you currently analyze, **all degrees are operating at the same time.** Therefore have level with multiple Fibonacci relationships, more importance than a single relationship.

BUT the concept of measuring the waves should always **be the second part when analyzing the markets.** Do not expect to correctly measure a target for a wave, if the overall count is not valid and rules were broken. The fibonacci numbers are complementary applied to the Elliott Wave theory.

Always be flexible in your approach and preserve capital if you are in doubt. Watch for clear pattern and execute only if your edge appears in the market.

Summary

Dear Trader,

thanks for taking the time and reading my compendium about Elliott Waves. I hope you find some notable insights in this guide.

In my own trading journey I discovered and adapted the Elliott waves, as I was stunned about the accuracy this methodology applies to the markets. The waves represent one building block and are combined with powerful price action trading to make my edge even greater.

You have to understand, that a methodology, may it be Elliott waves or something completely different, is just one part of your successful trading.

A far greater element in becoming a successful trader, is **the mindset** you must obtain. You could have the best strategies available, if you do not master the voice inside your head and the emotions which come up while trading, it won't be easy to reach mastery. I encourage you to take this journey serious and take responsibility for your actions.

If you are openminded, disciplined and patient you can master the craft. Journal your trades, reflect your thoughts and actions and you can reach your own financial freedom.

May your journey into trading be prosperous,

Phil

Founder of Financial Freedom Trading

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