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 Junctures*, 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 Junctures*. 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 Junctures*. 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 Junctures*.

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,



Jeffrey Kennedy

Elliott Wave International

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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.

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 then 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]

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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.

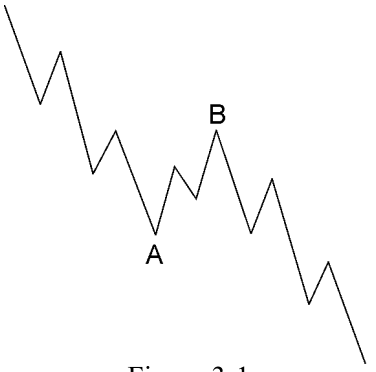


Figure 3-1

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.

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.

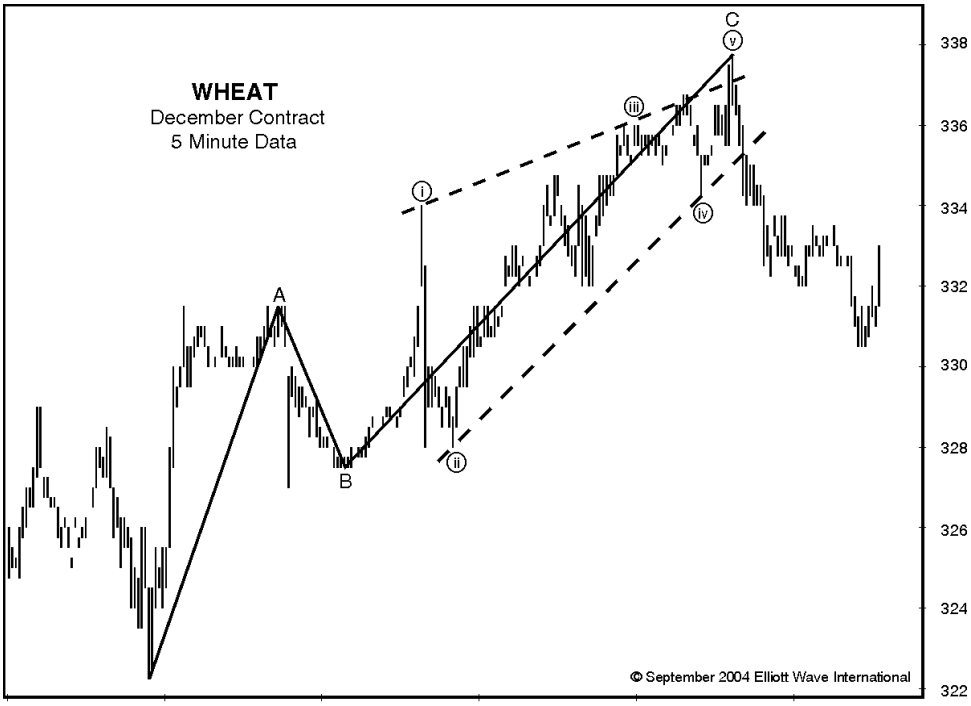


Figure 3-2

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.

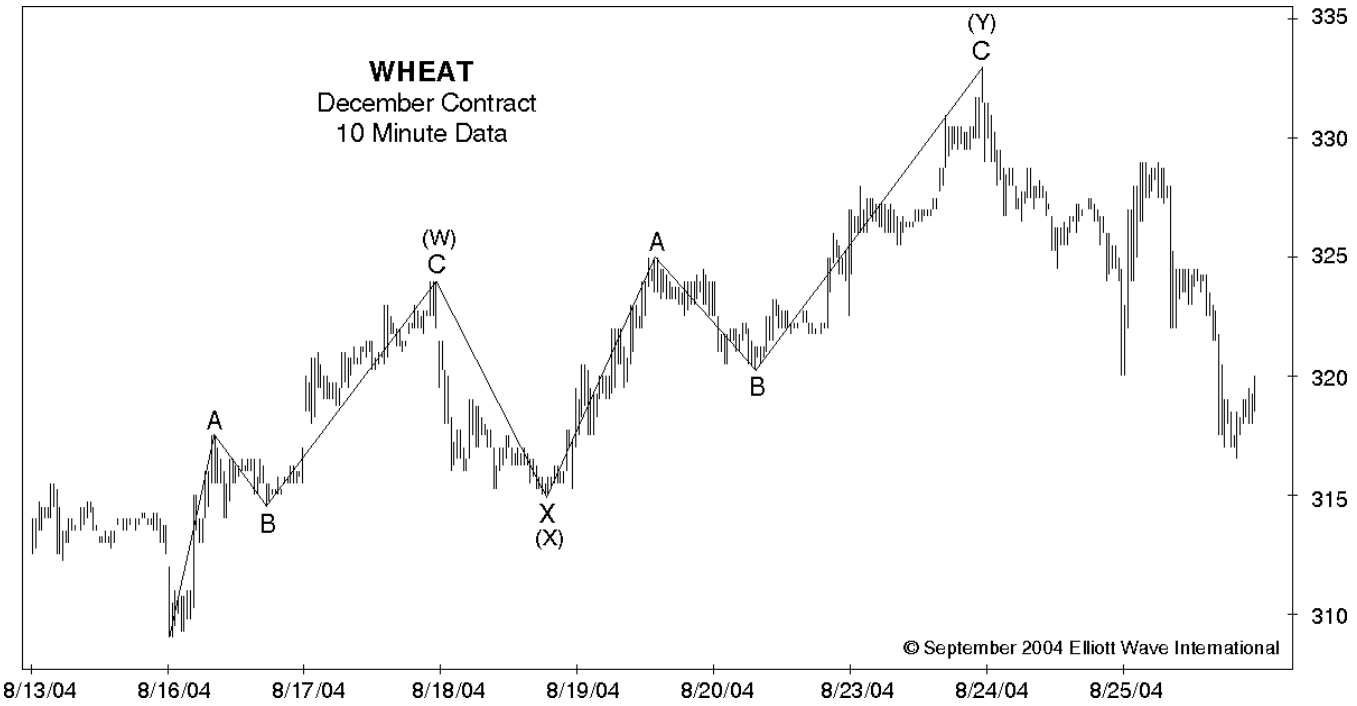


Figure 3-3

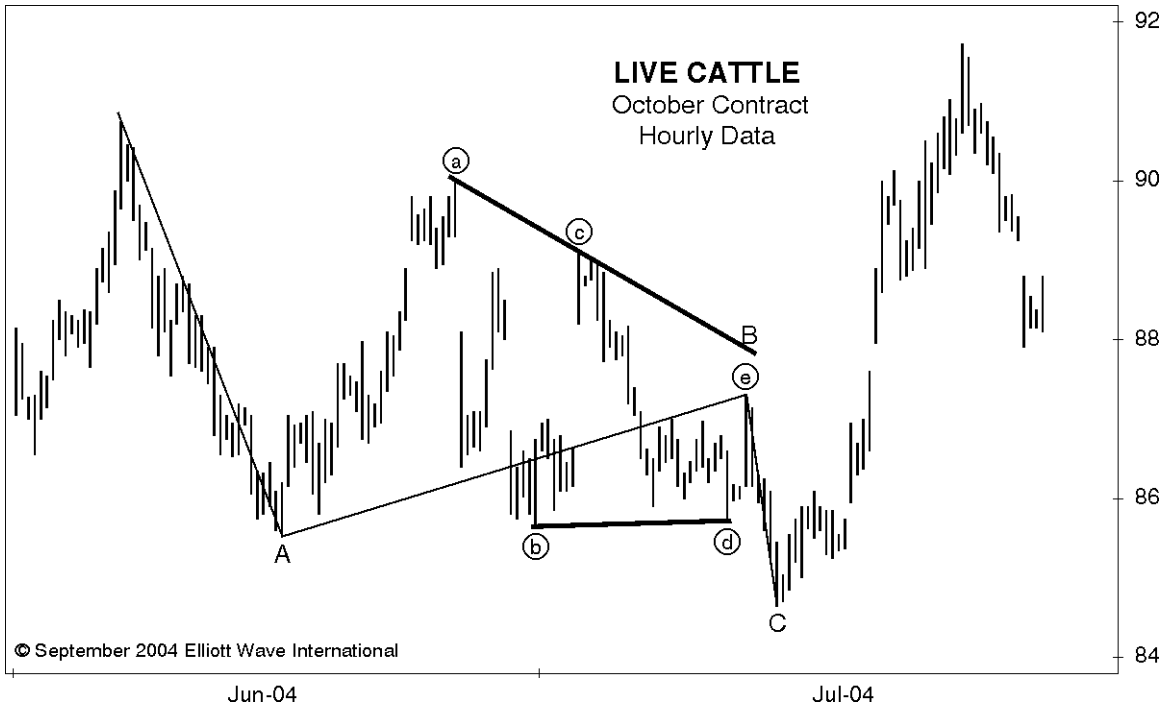
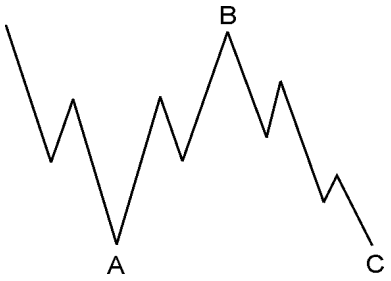


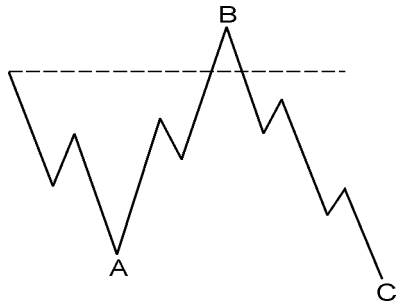
Figure 3-4

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.

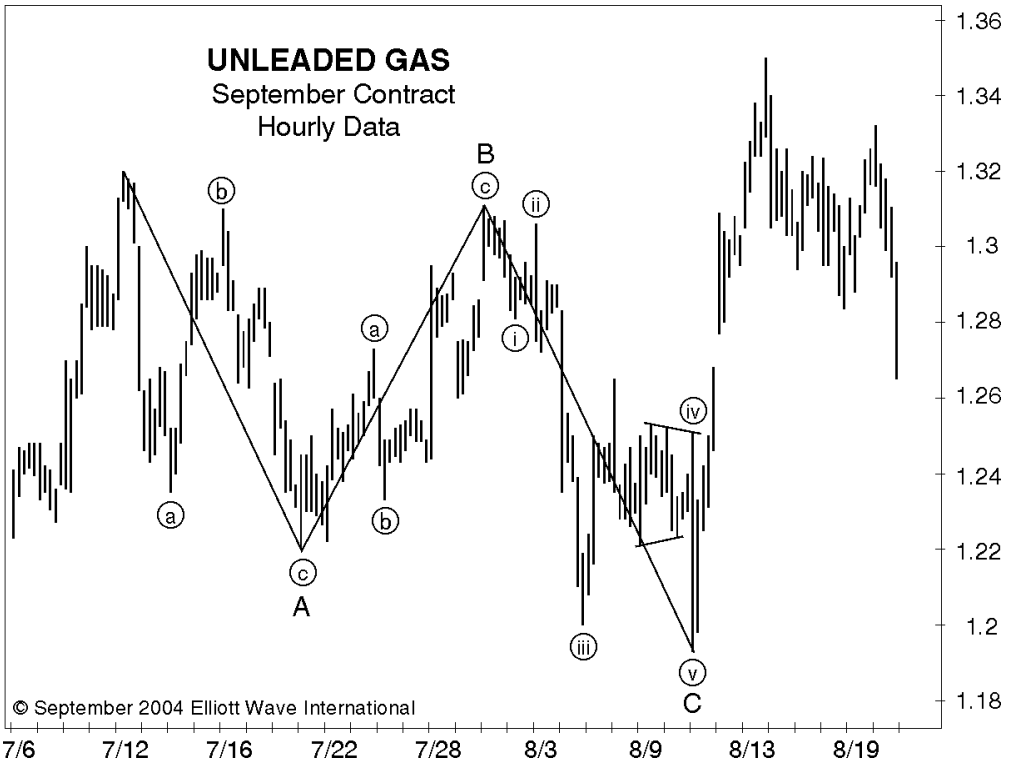


Figure 3-7

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.

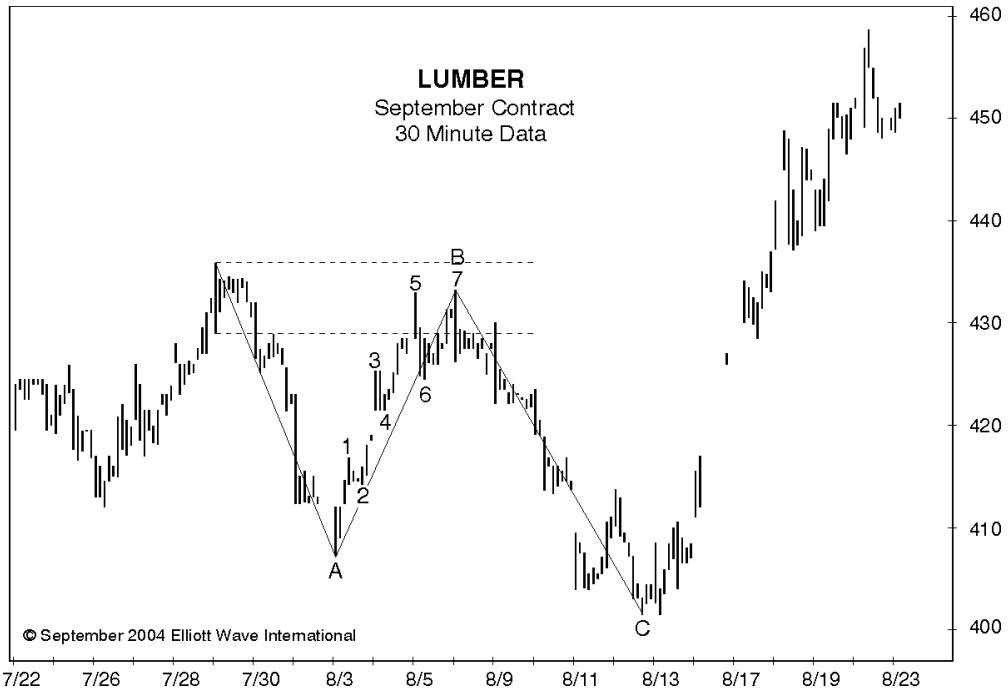


Figure 3-8

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.

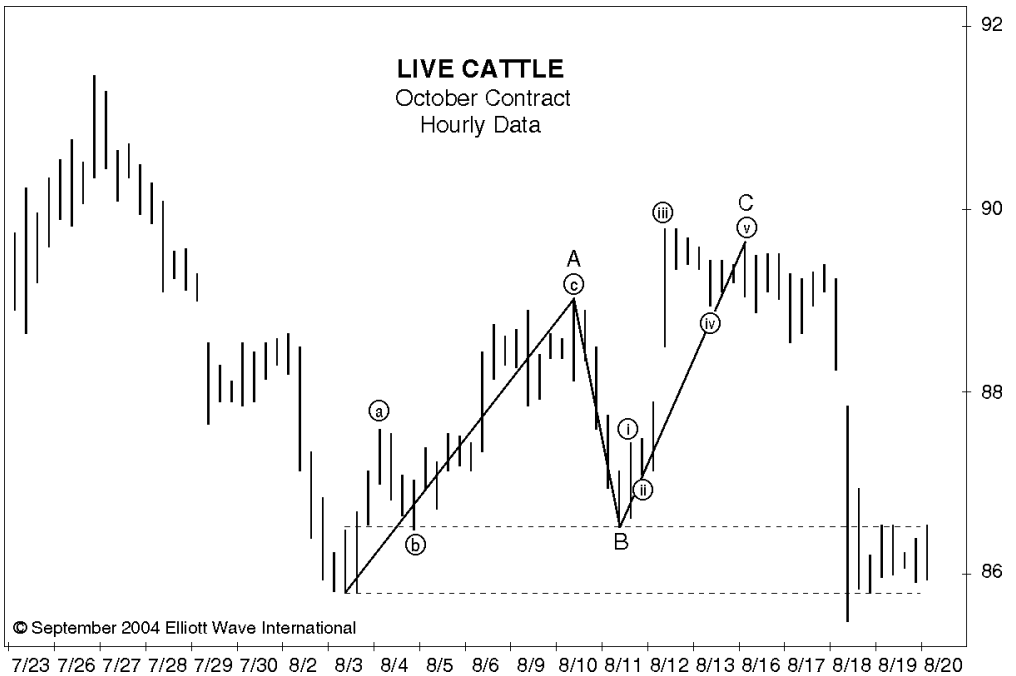


Figure 3-9

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.

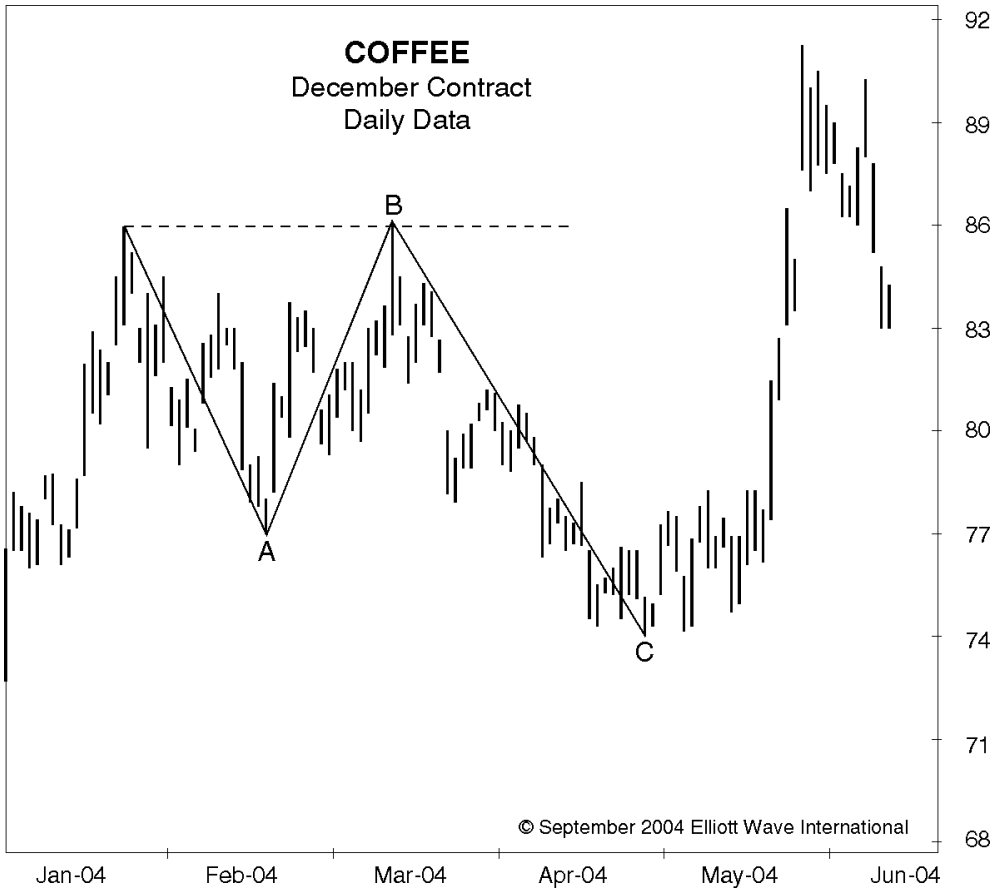


Figure 3-10

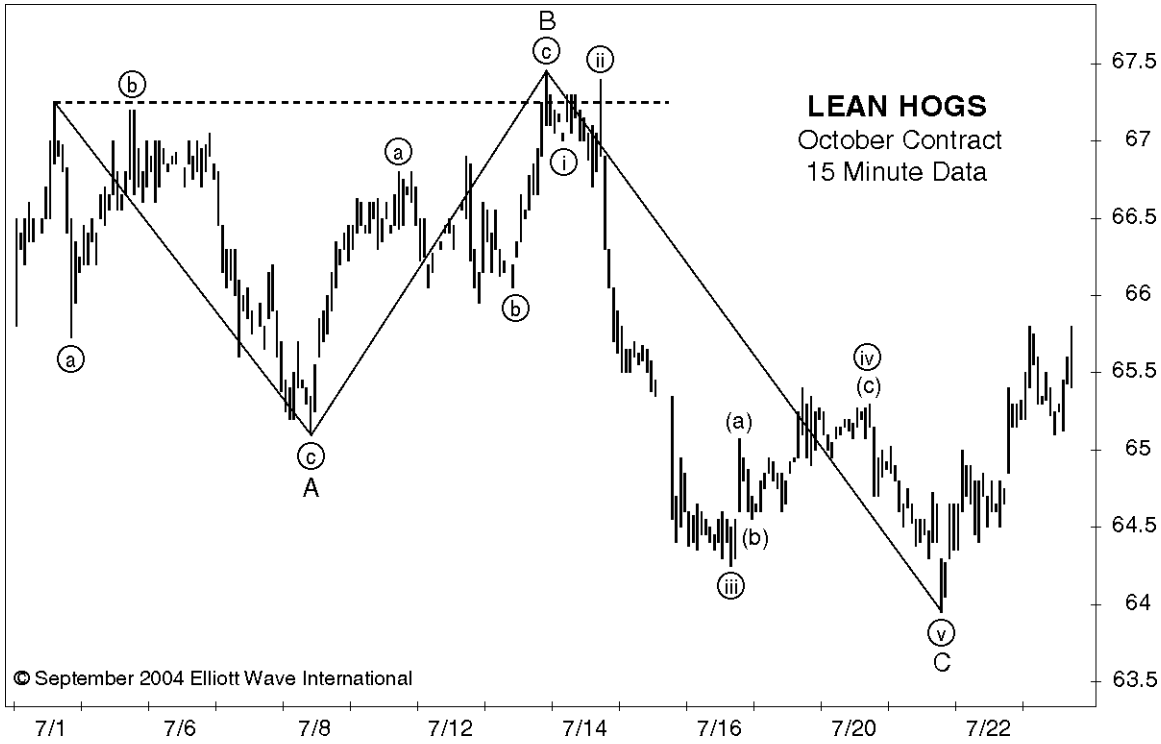


Figure 3-11



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.

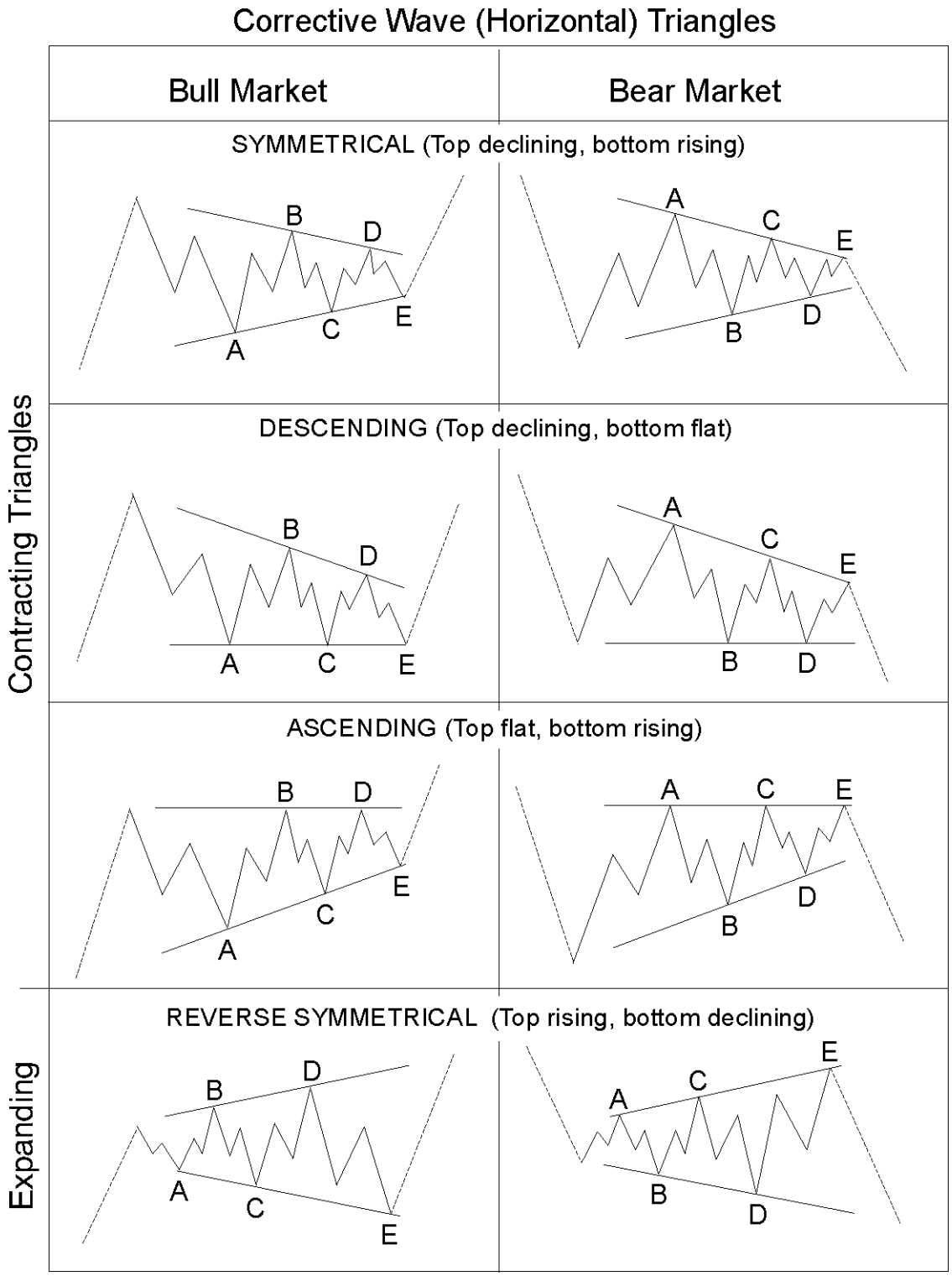

Corrective Wave (Horizontal) Triangles
Bull Market
Bear Market
Contracting Triangles
Expanding
SYMMETRICAL (Top declining, bottom rising)
DESCENDING (Top declining, bottom flat)
ASCENDING (Top flat, bottom rising)
REVERSE SYMMETRICAL (Top rising, bottom declining)
A
B
C
D
E

Figure 3-13

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.

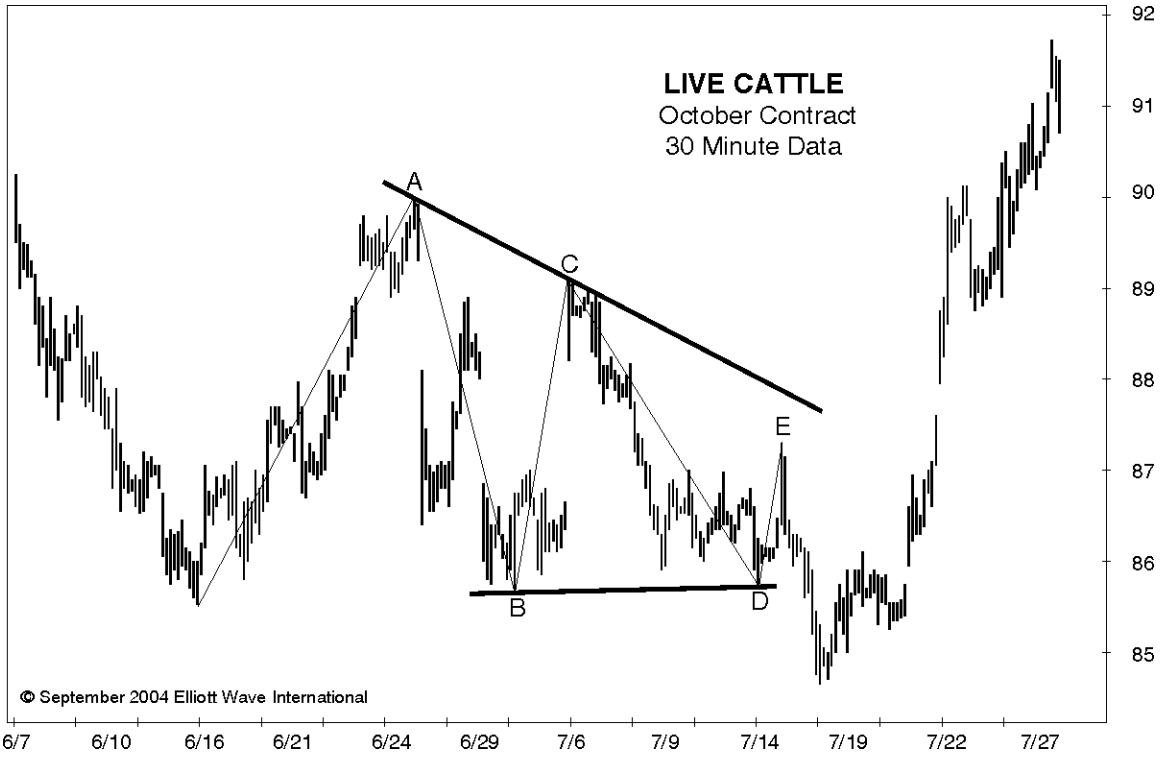


Figure 3-14

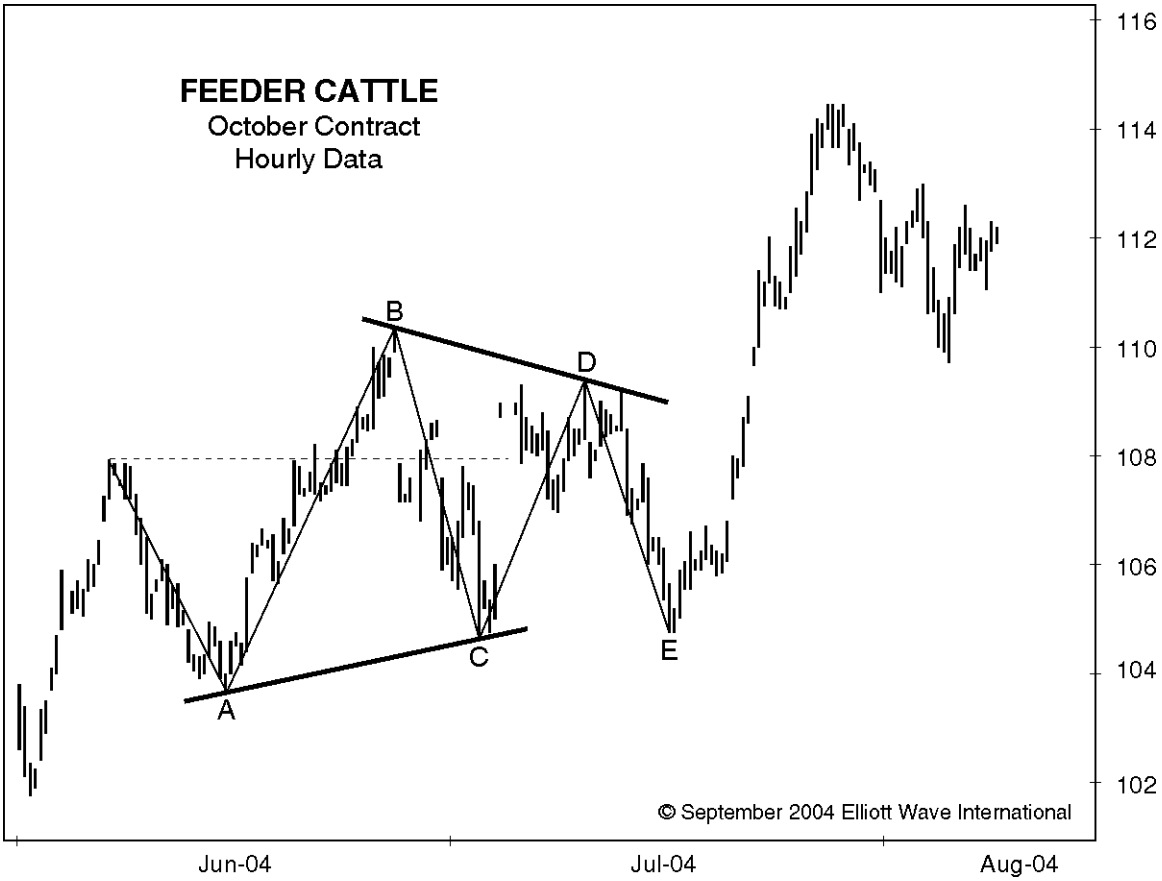


Figure 3-15

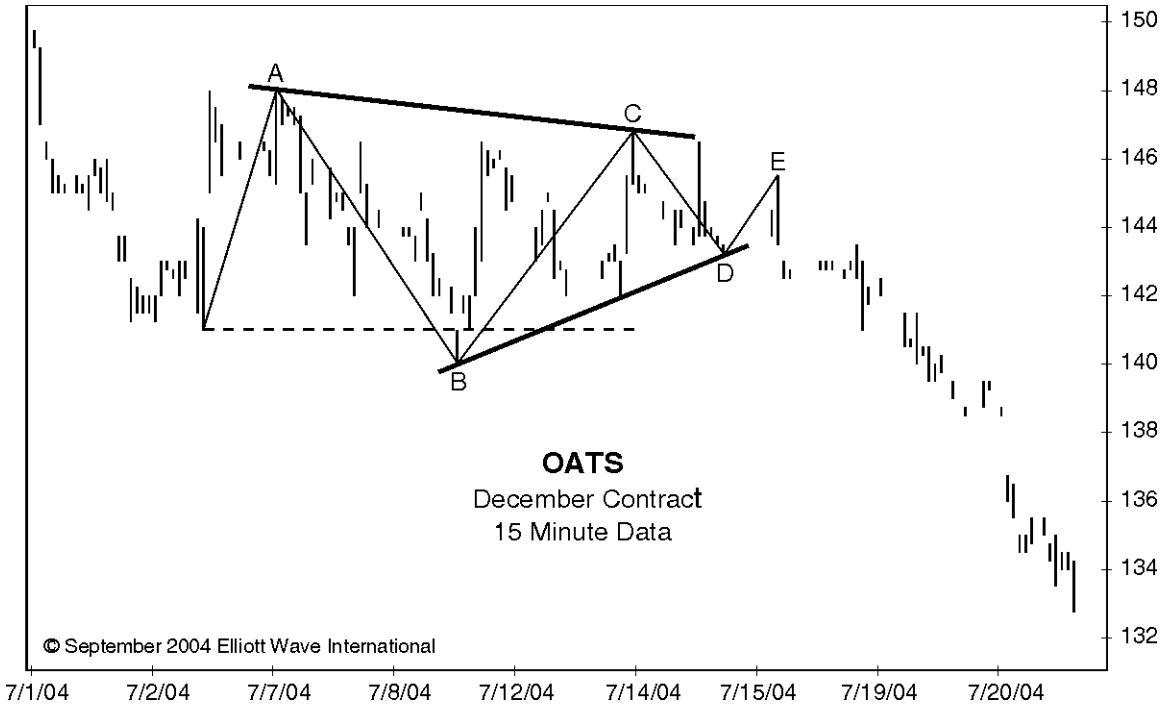


Figure 3-16

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]

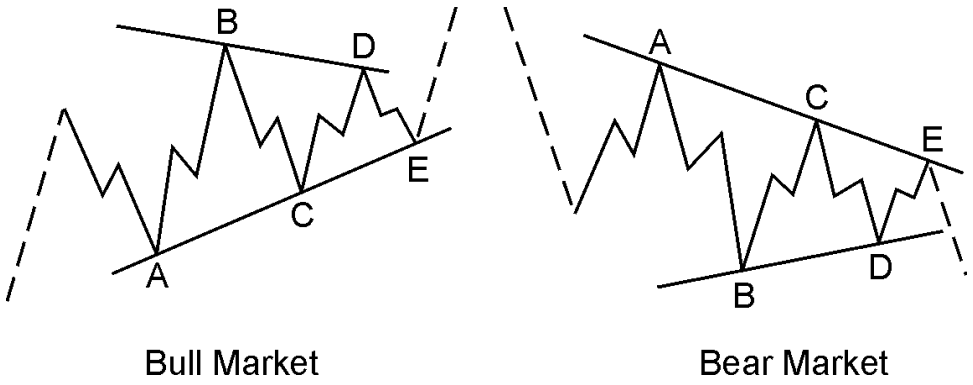
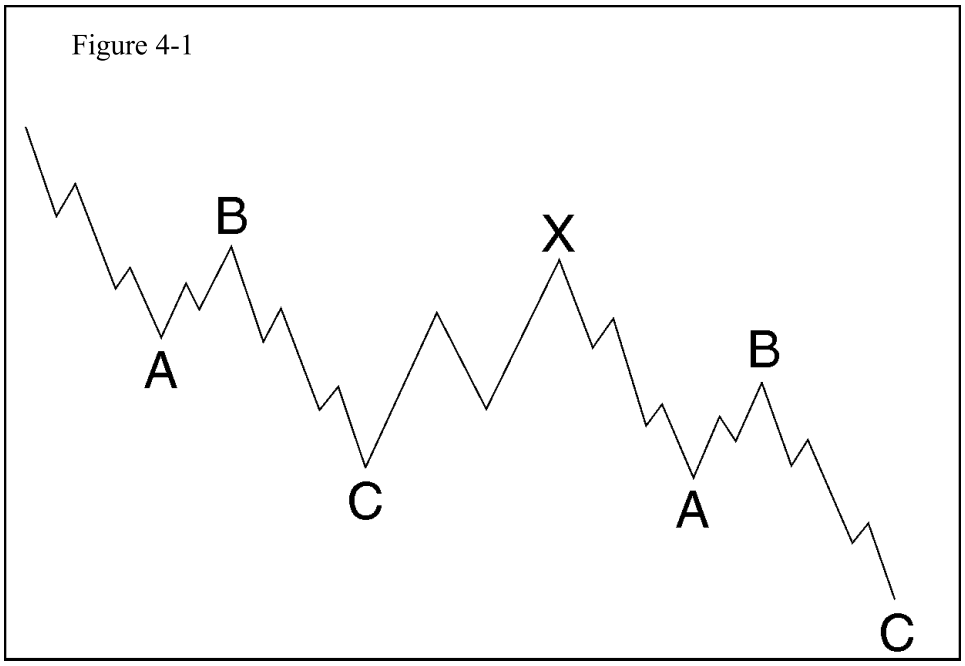
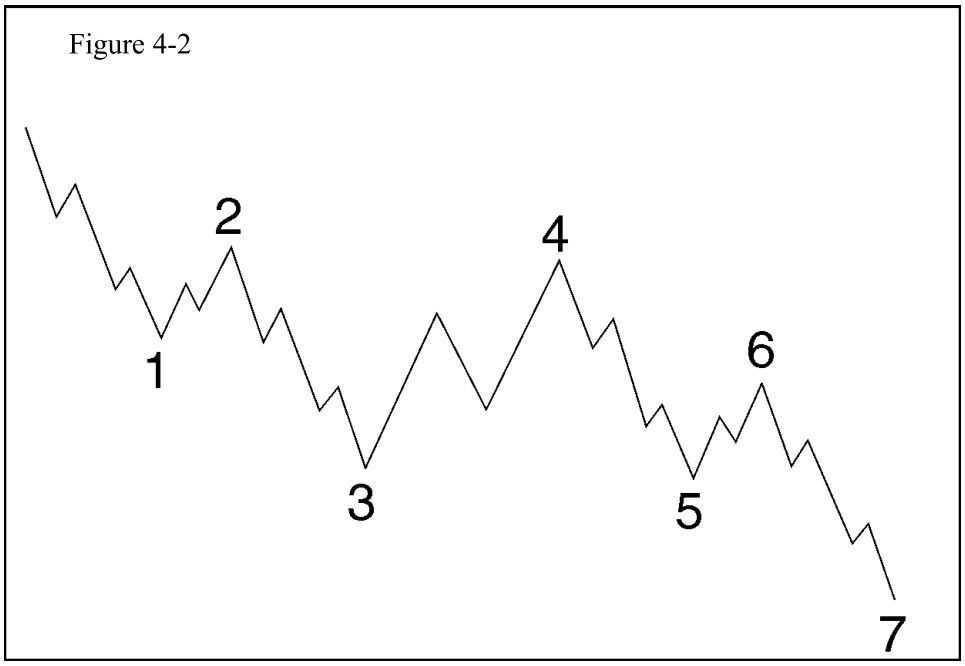


Figure 3-17

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).

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.

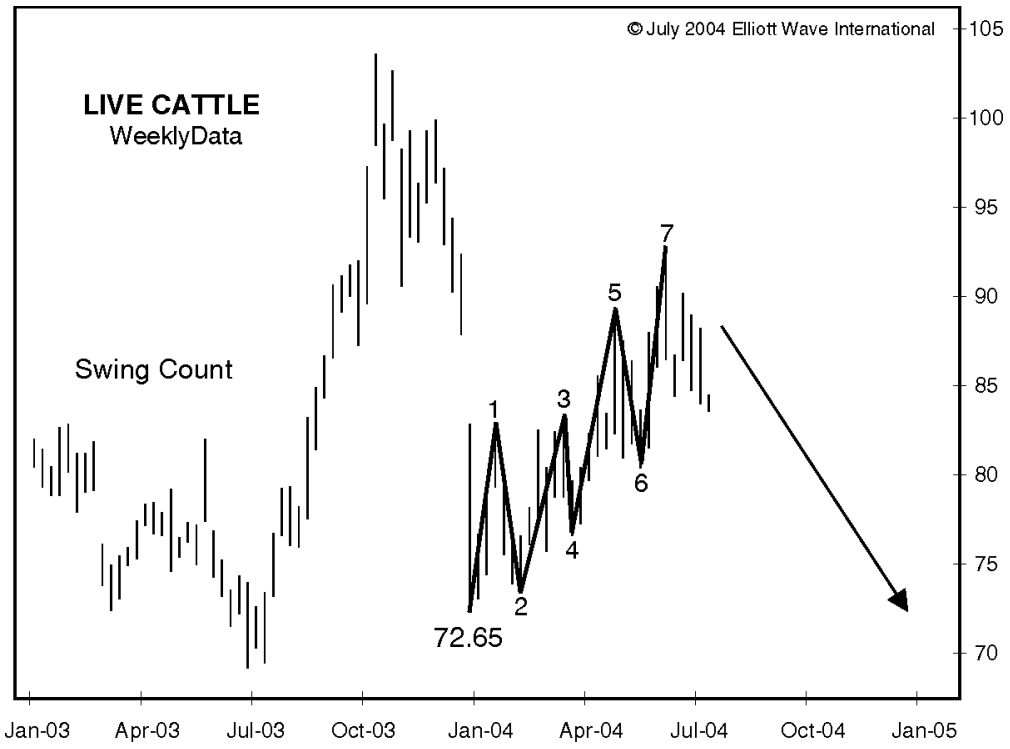


Figure 4-3

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.

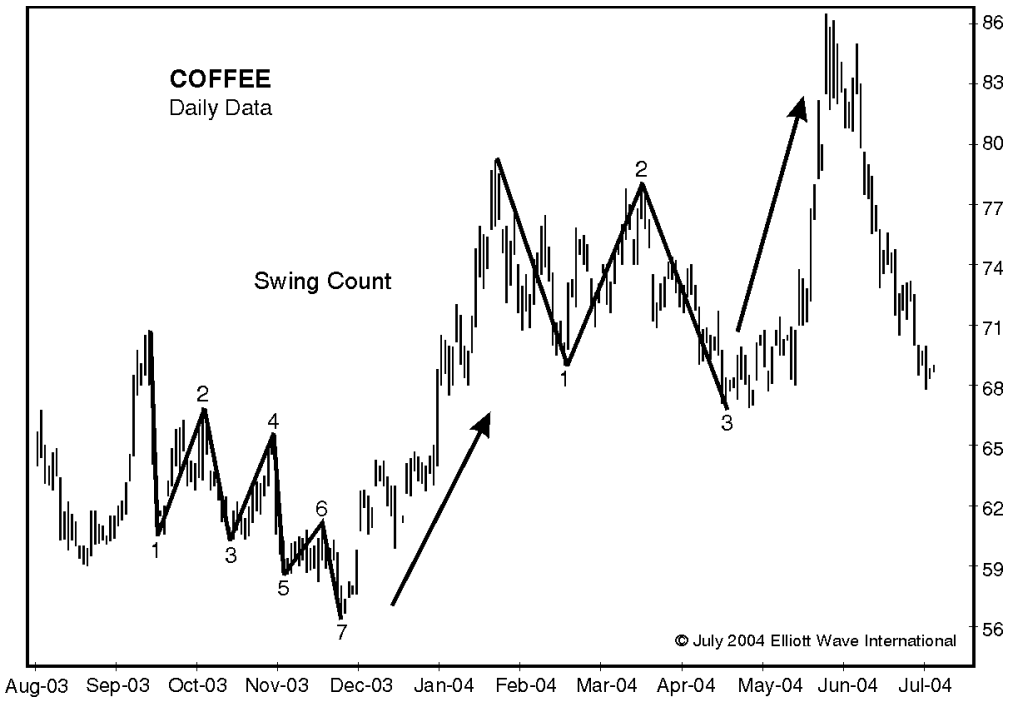


Figure 4-4

[July 2004]

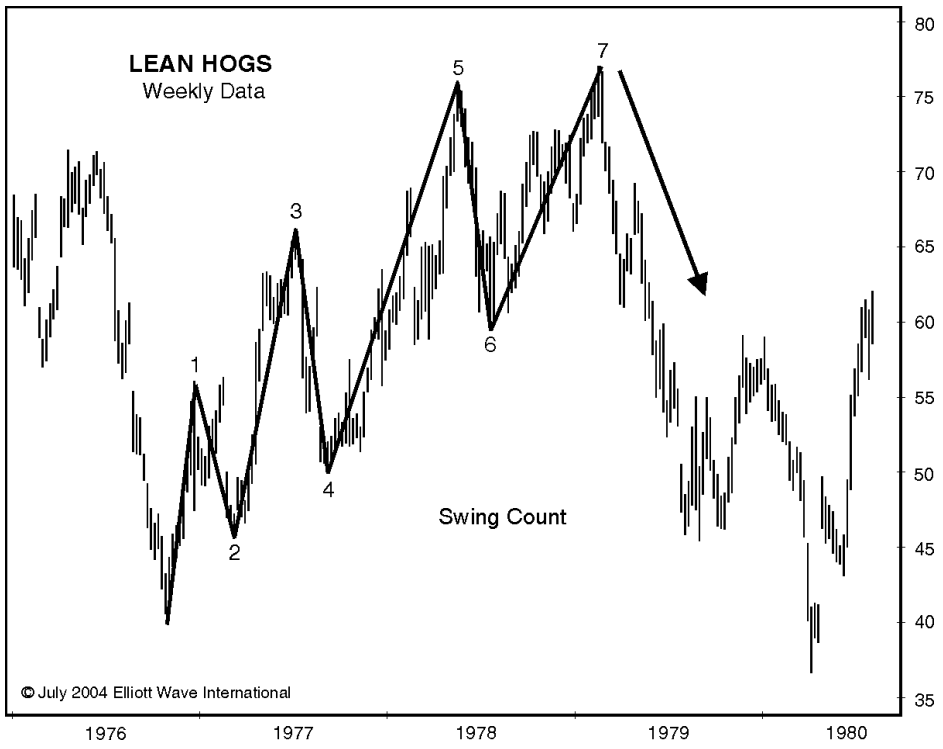


Figure 4-5

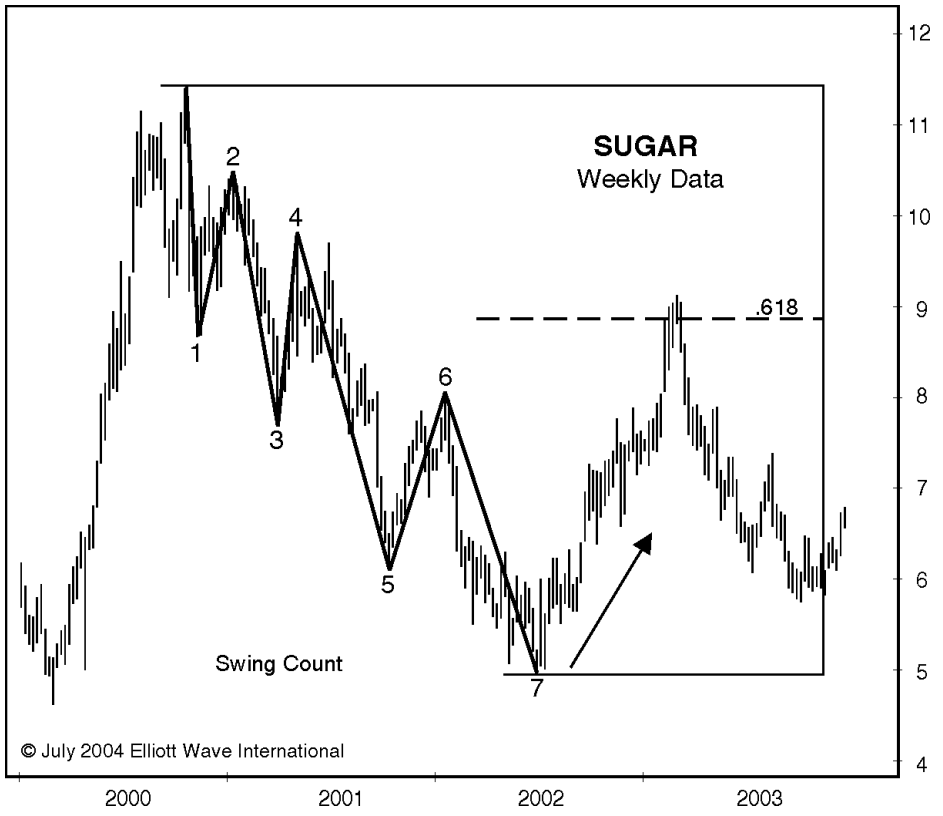


Figure 4-6

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.

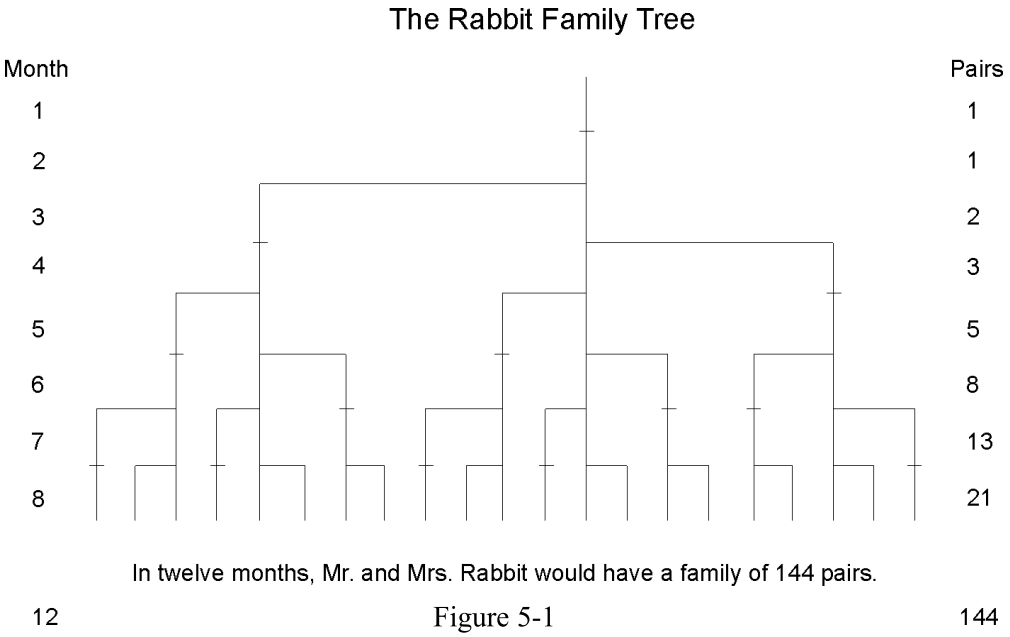


Figure 5-1

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

DENOMINATOR \ NUMERATOR	1	2	3	5	8	13	21	34	55	89	144
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.

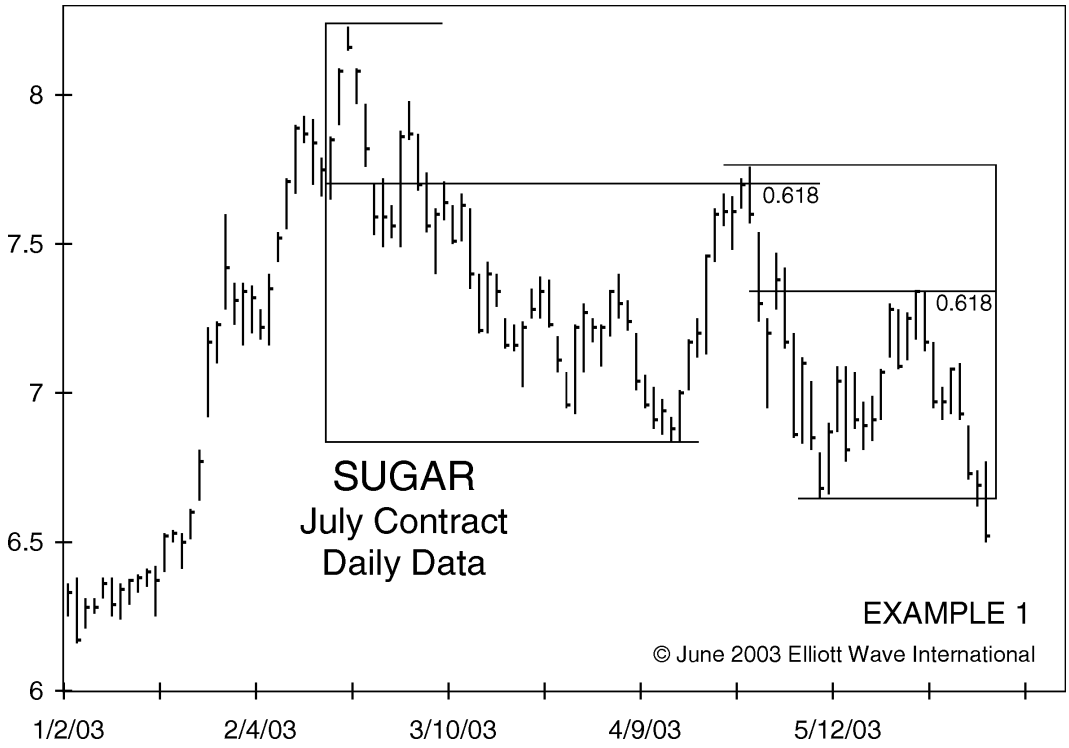


Figure 5-3

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]

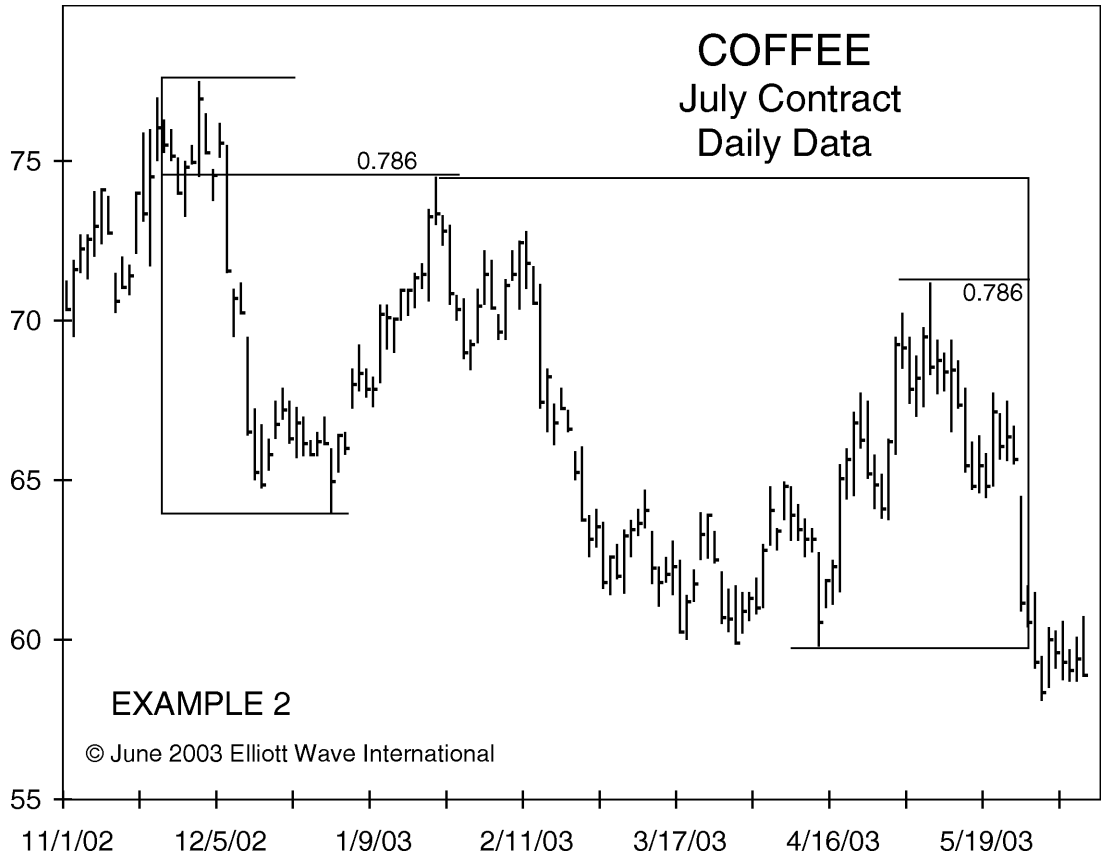


Figure 5-4

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.

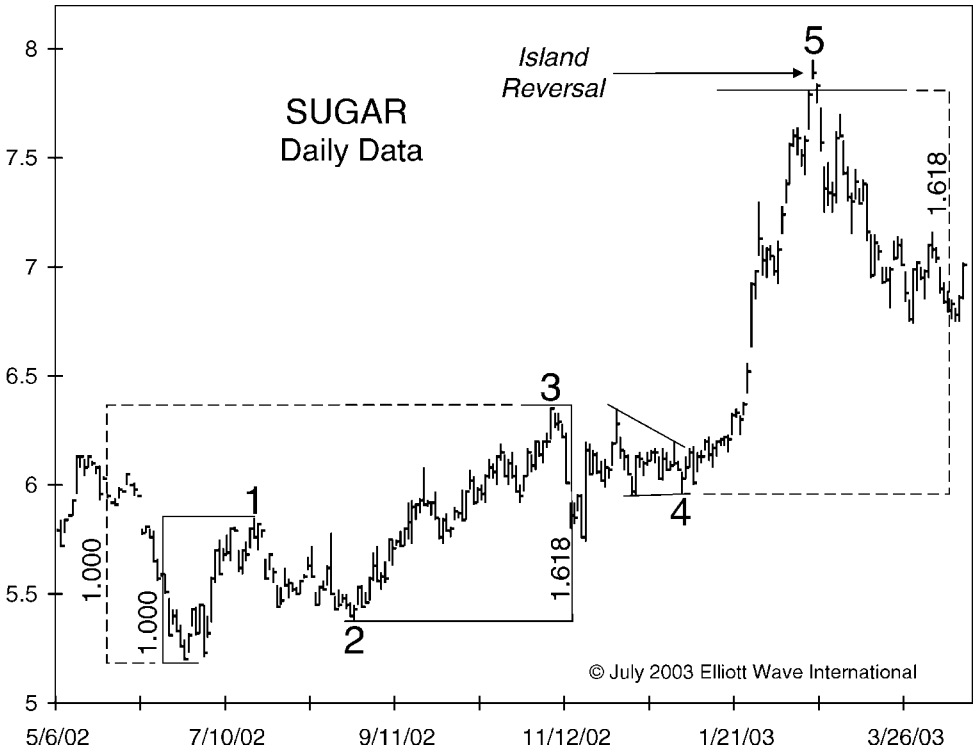


Figure 5-5

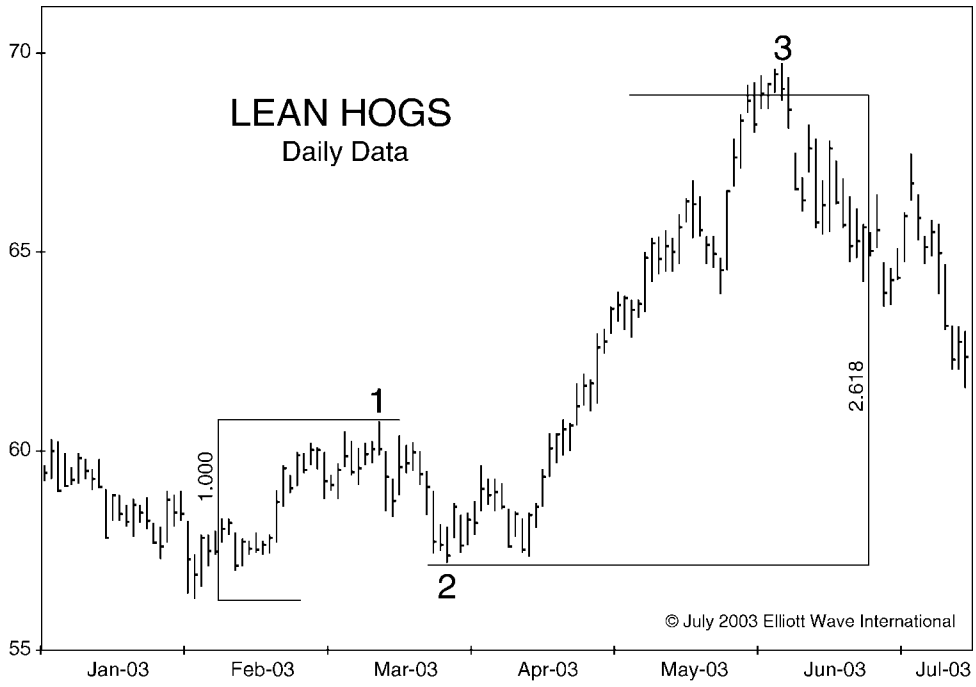


Figure 5-6

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.

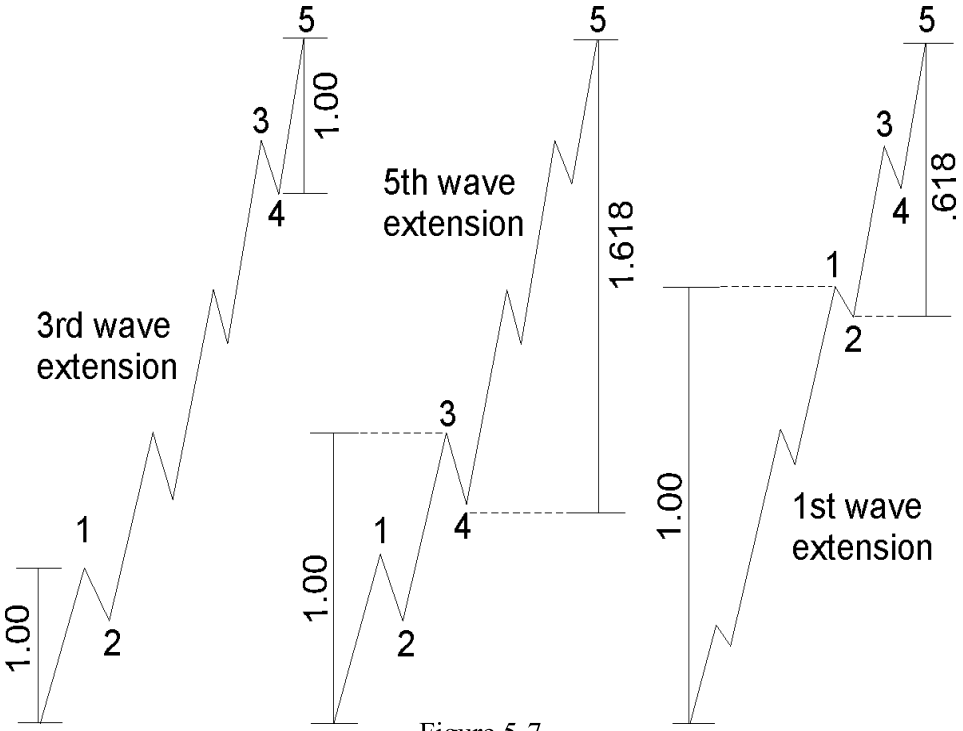


Figure 5-7

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.

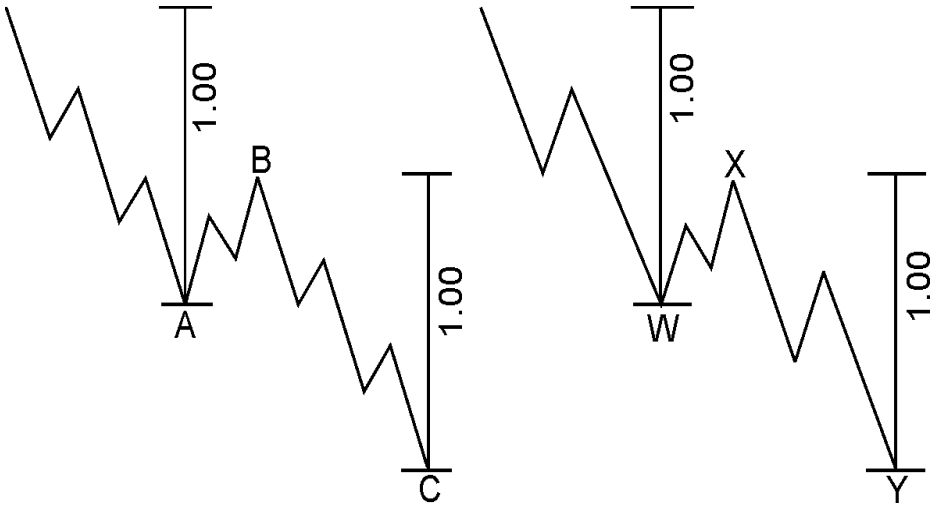


Figure 5-8

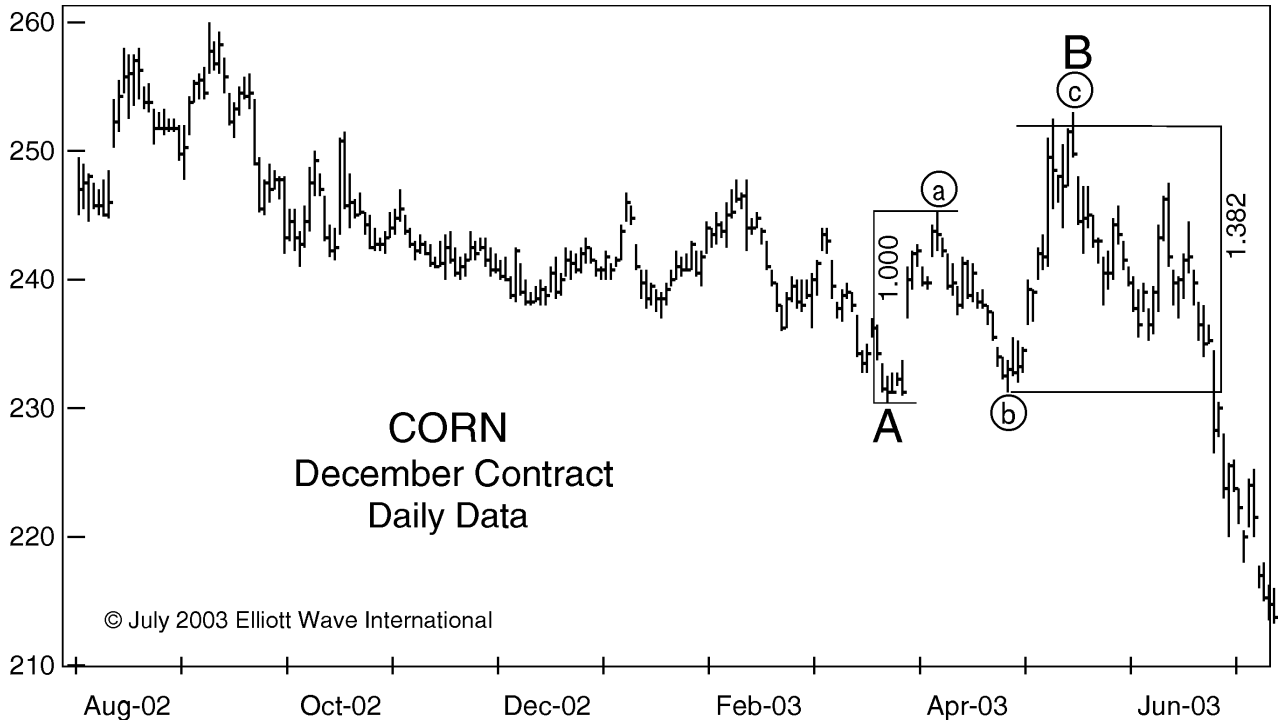


Figure 5-9

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).

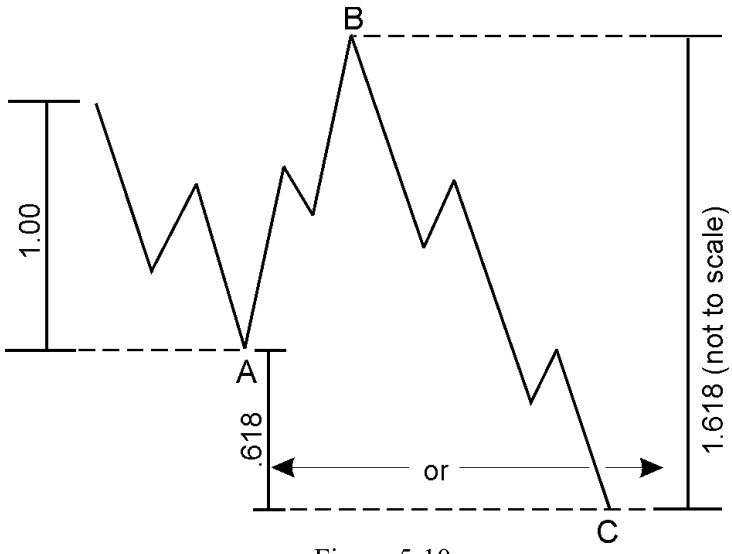


Figure 5-10

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

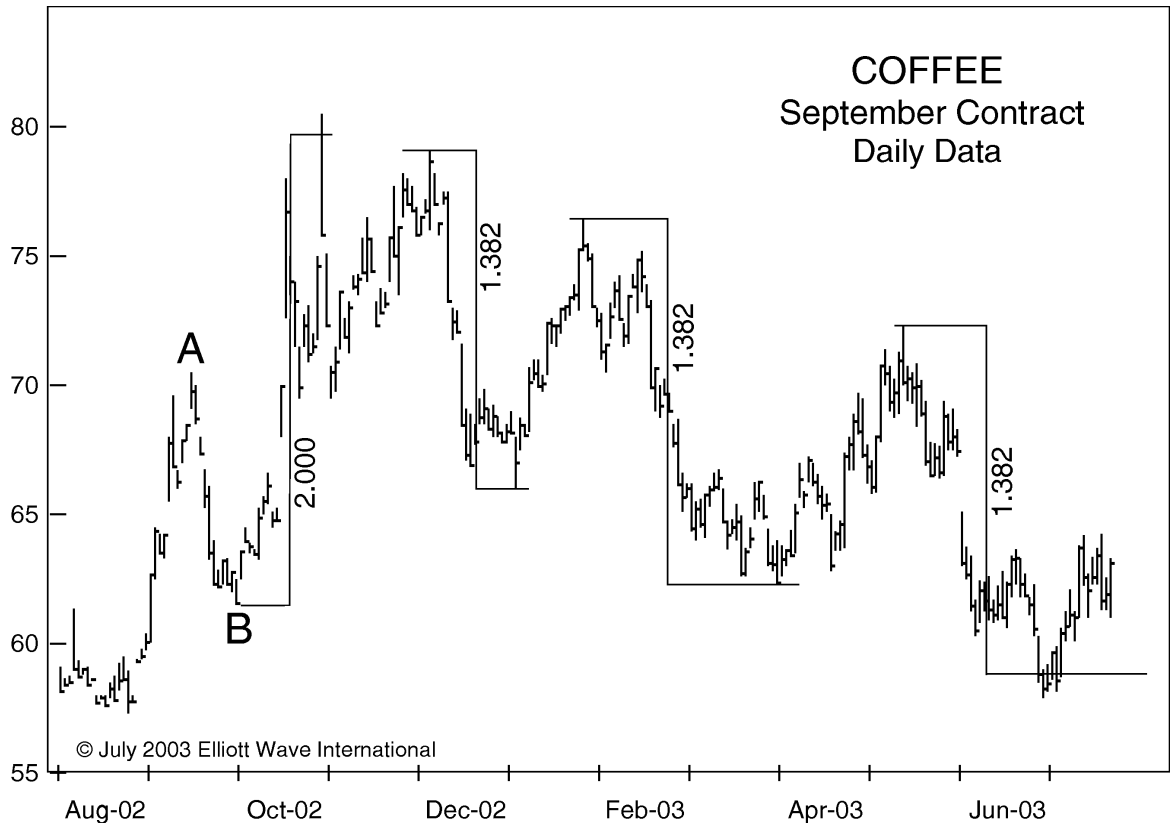


Figure 5-11

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 Junctures, 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.

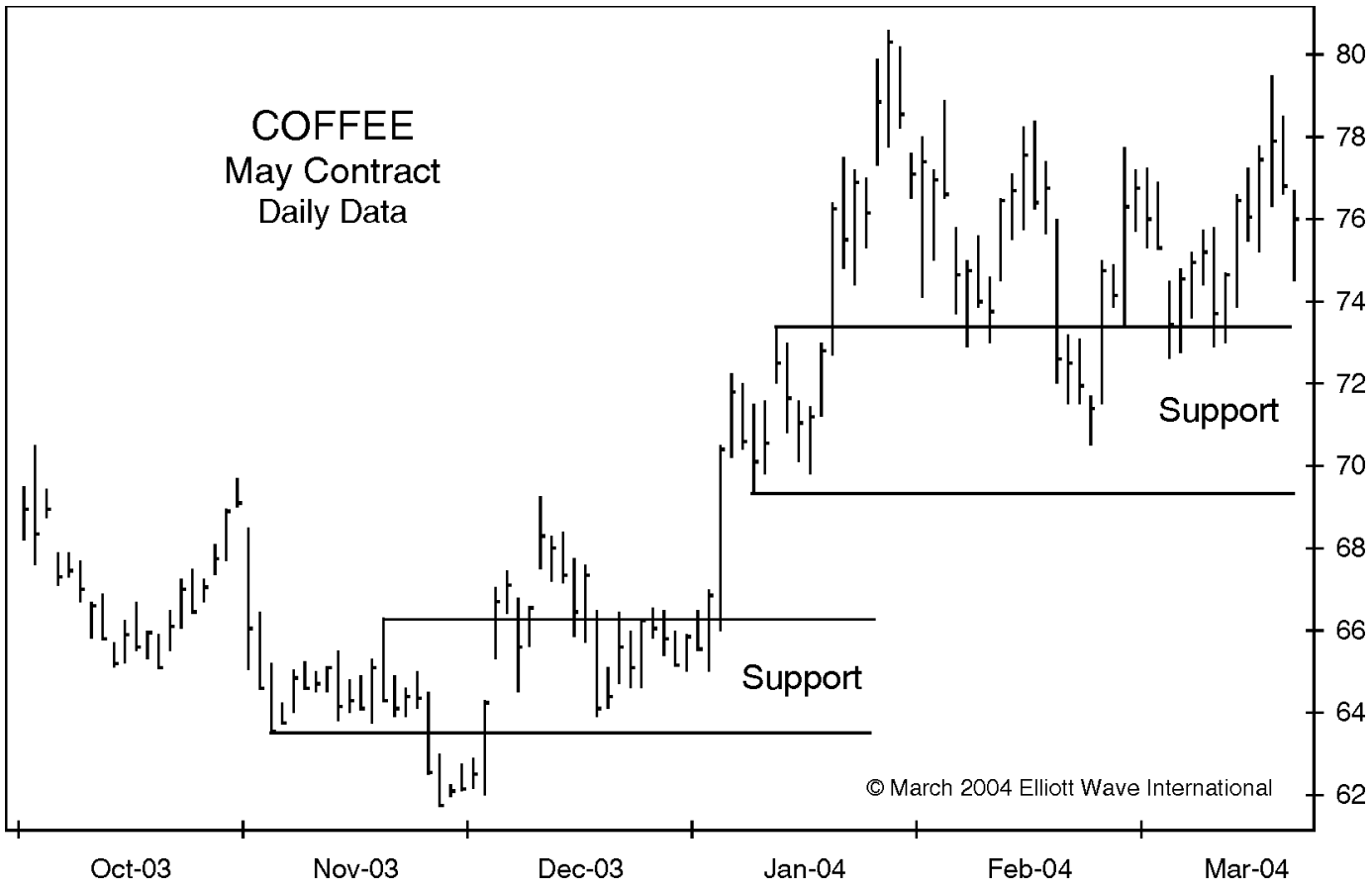


Figure 6-1

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.

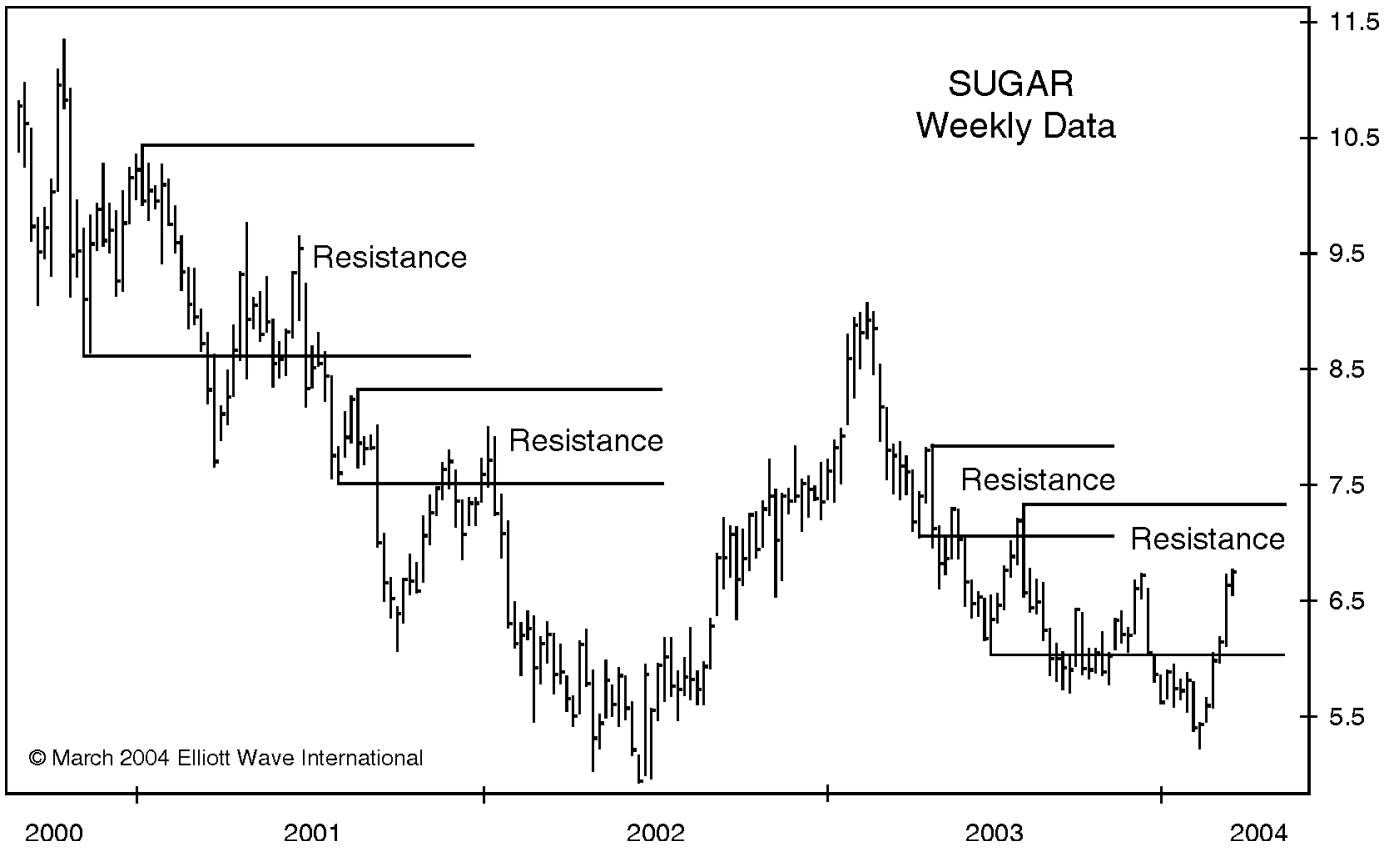


Figure 6-2

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.

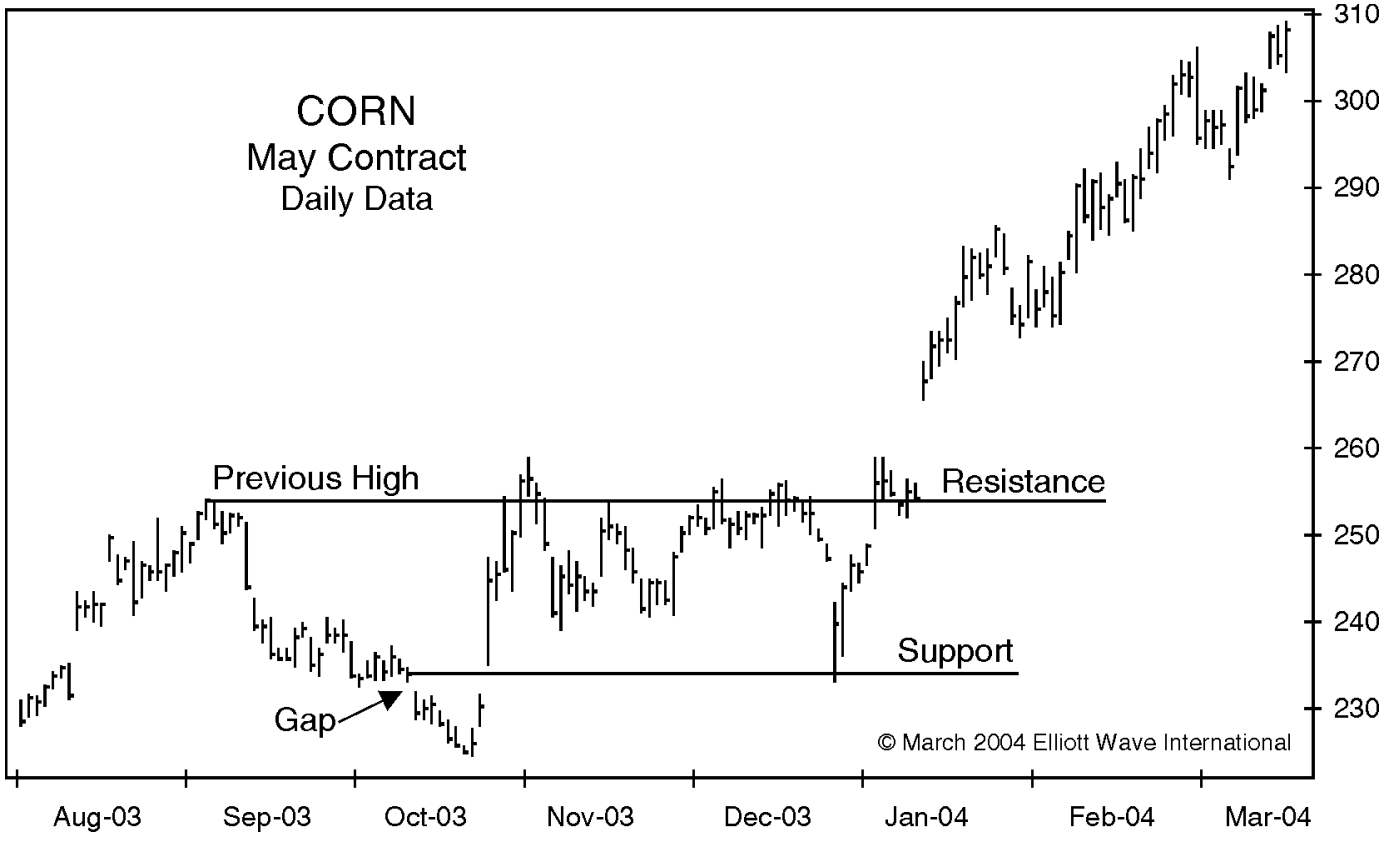


Figure 6-3

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.

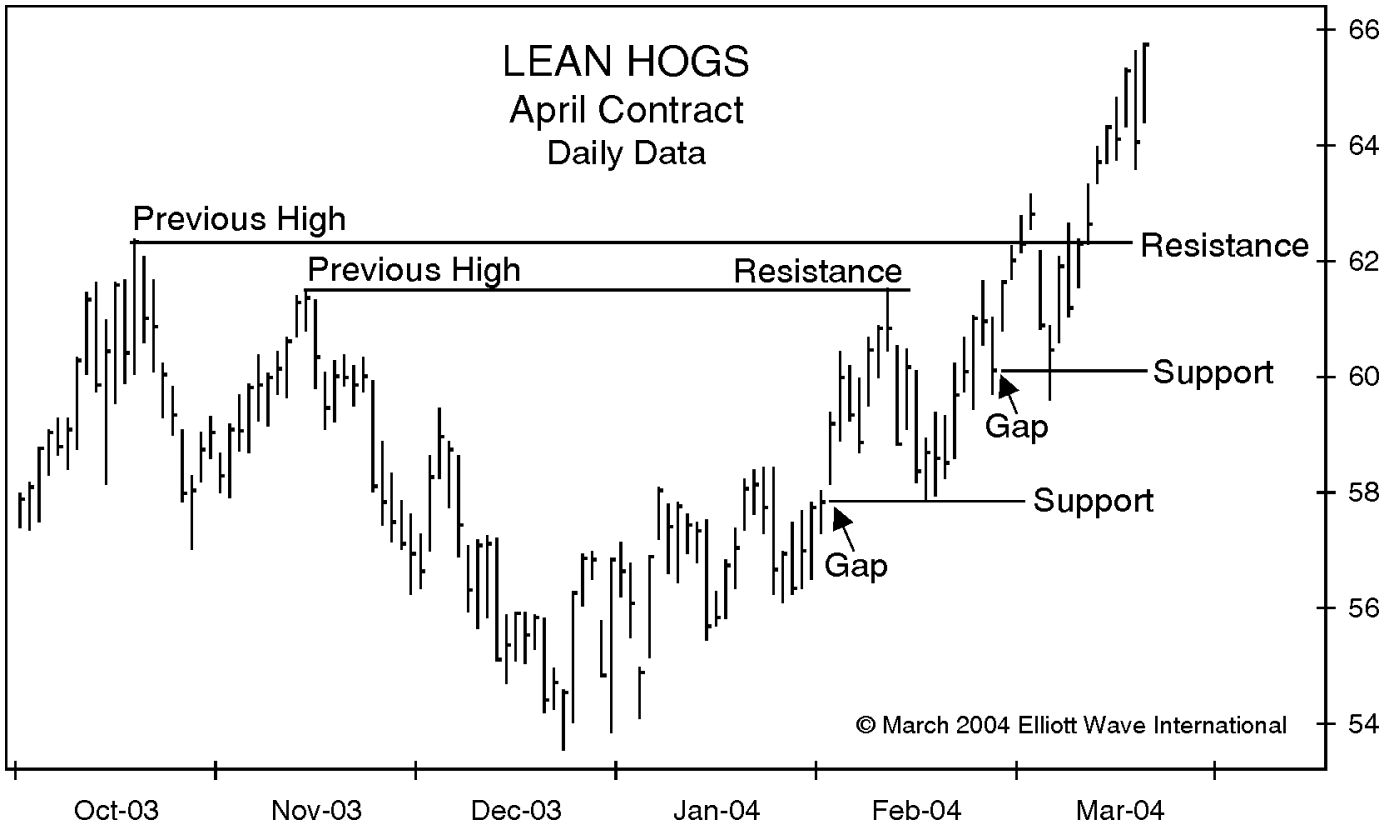


Figure 6-4

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]

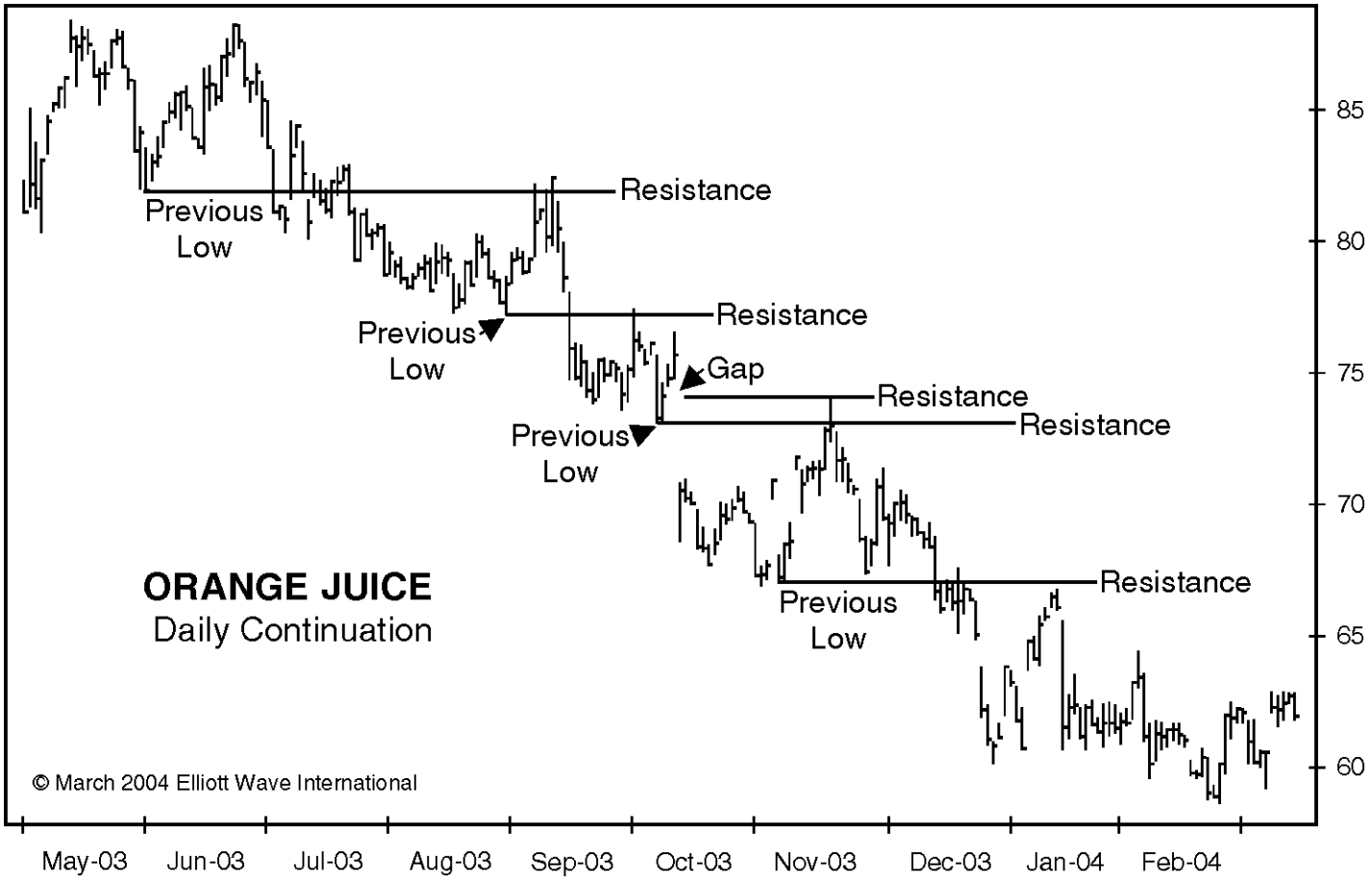


Figure 6-5

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.

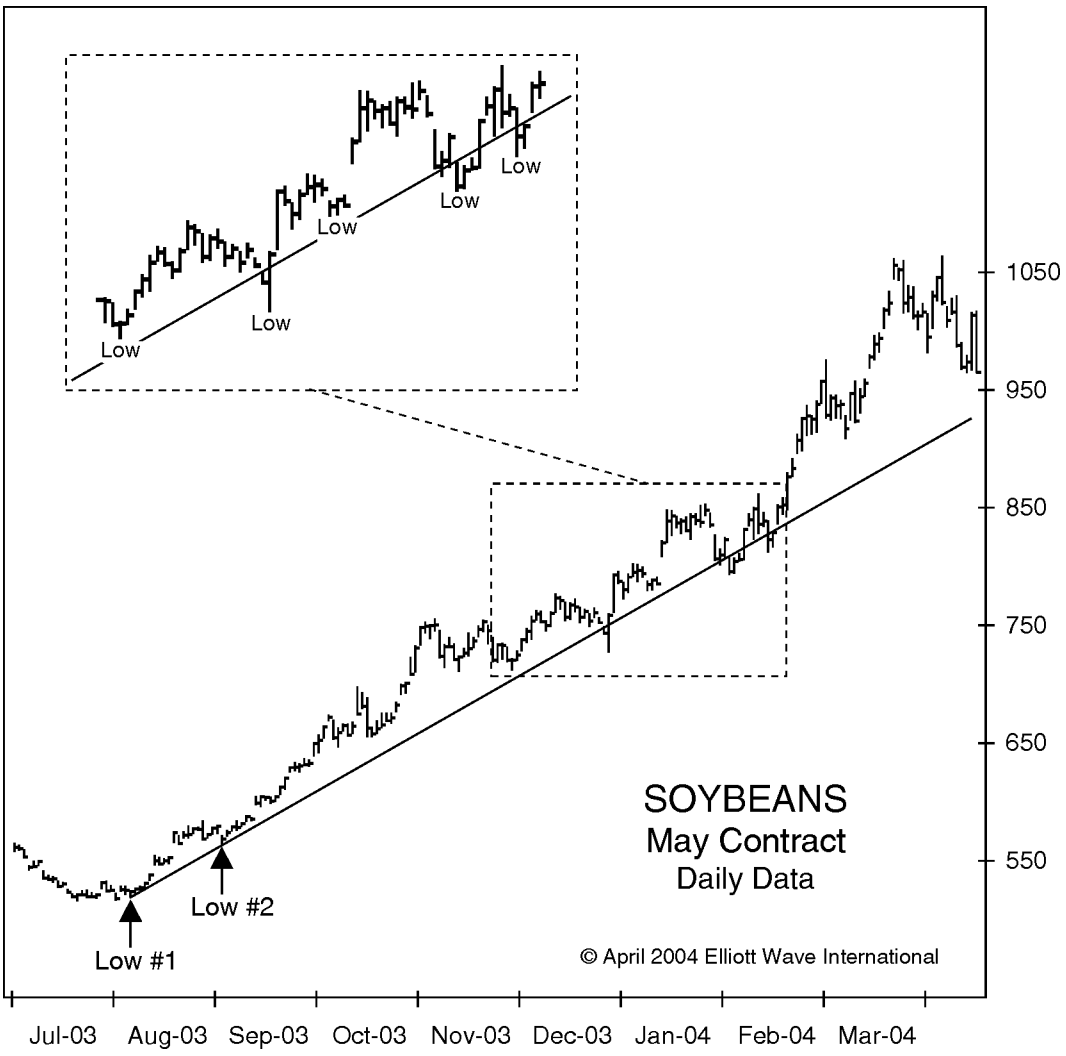


Figure 7-1

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!

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.

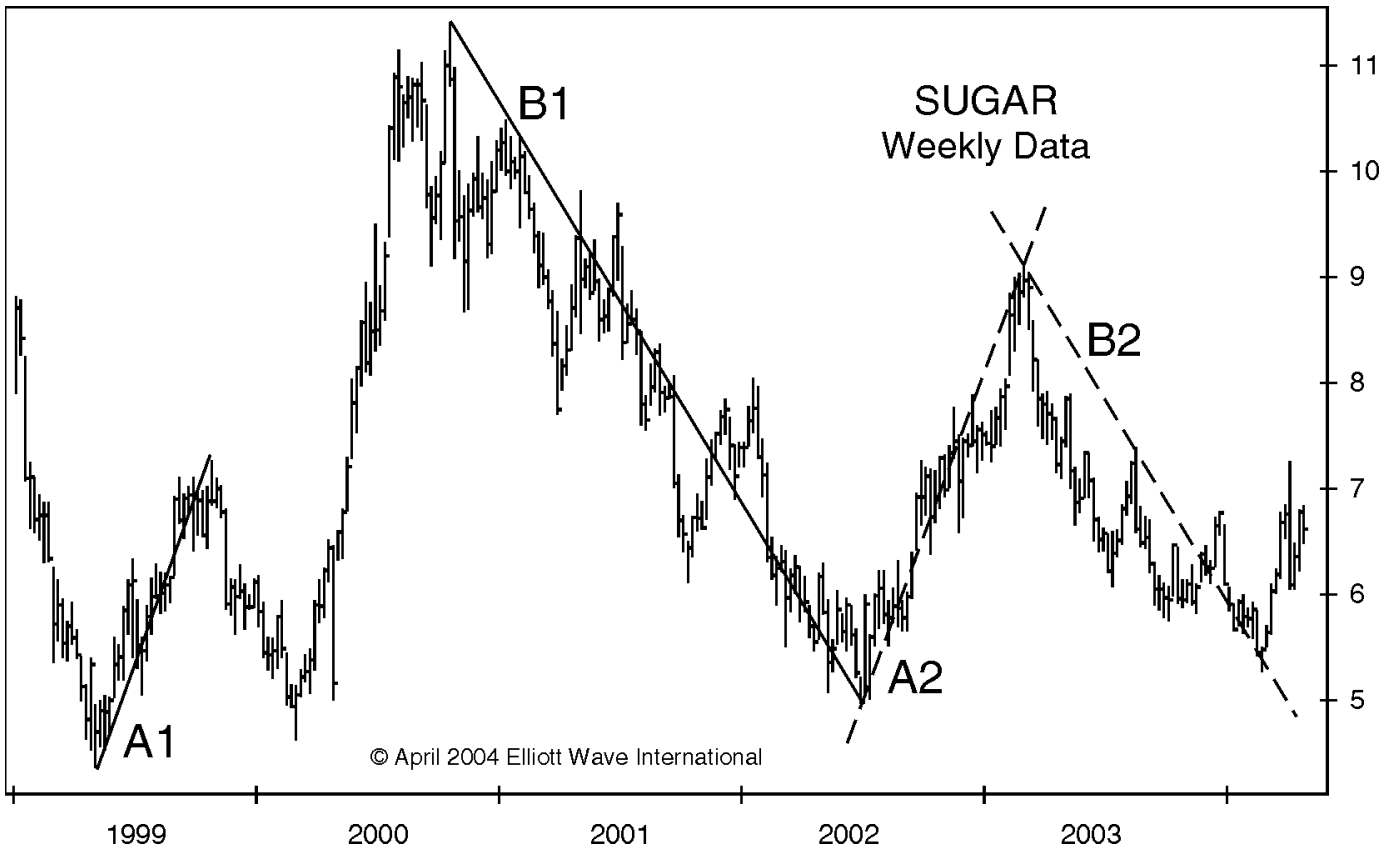


Figure 7-2

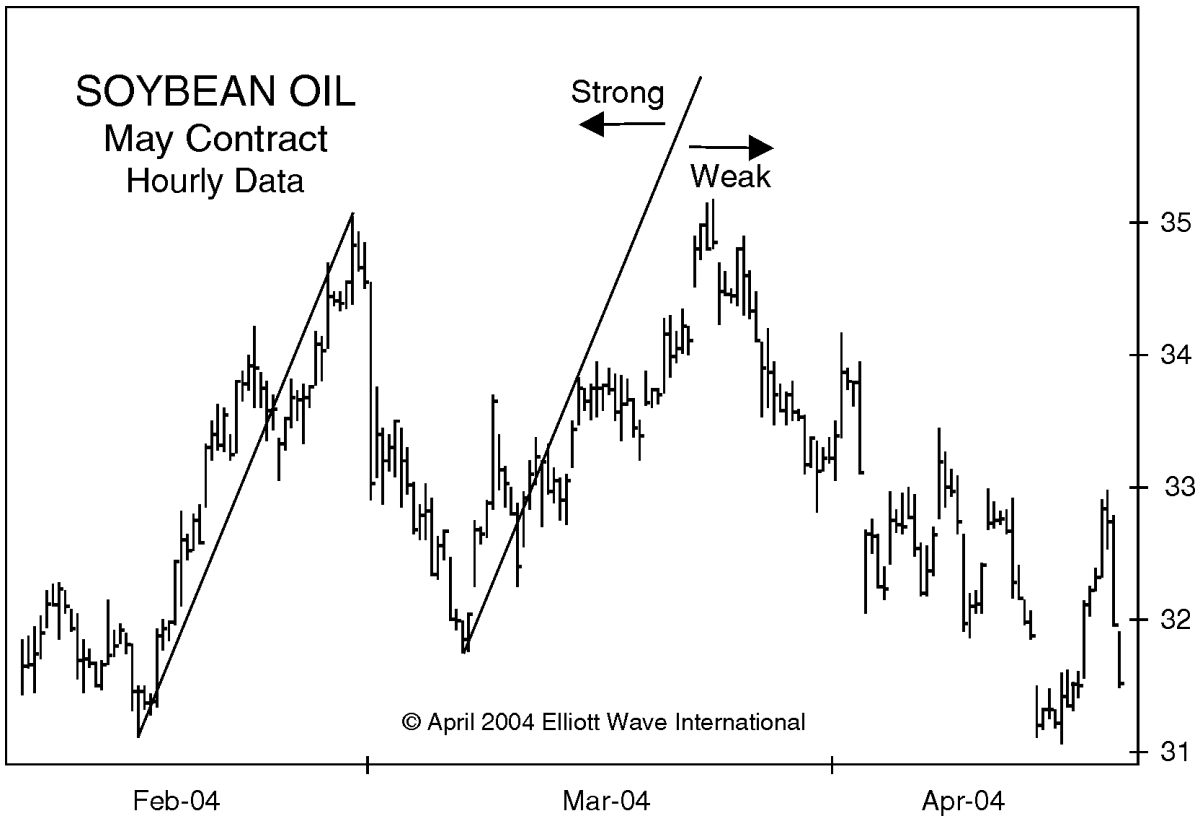


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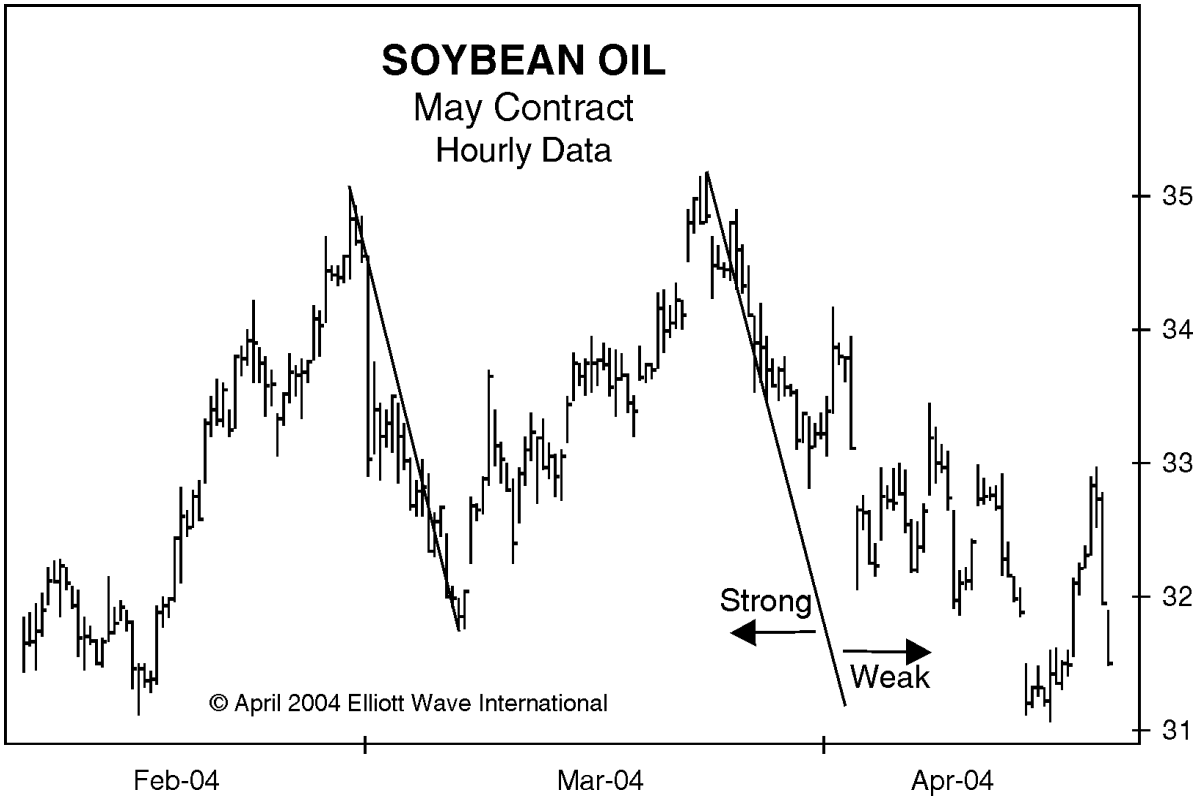


Figure 7-4

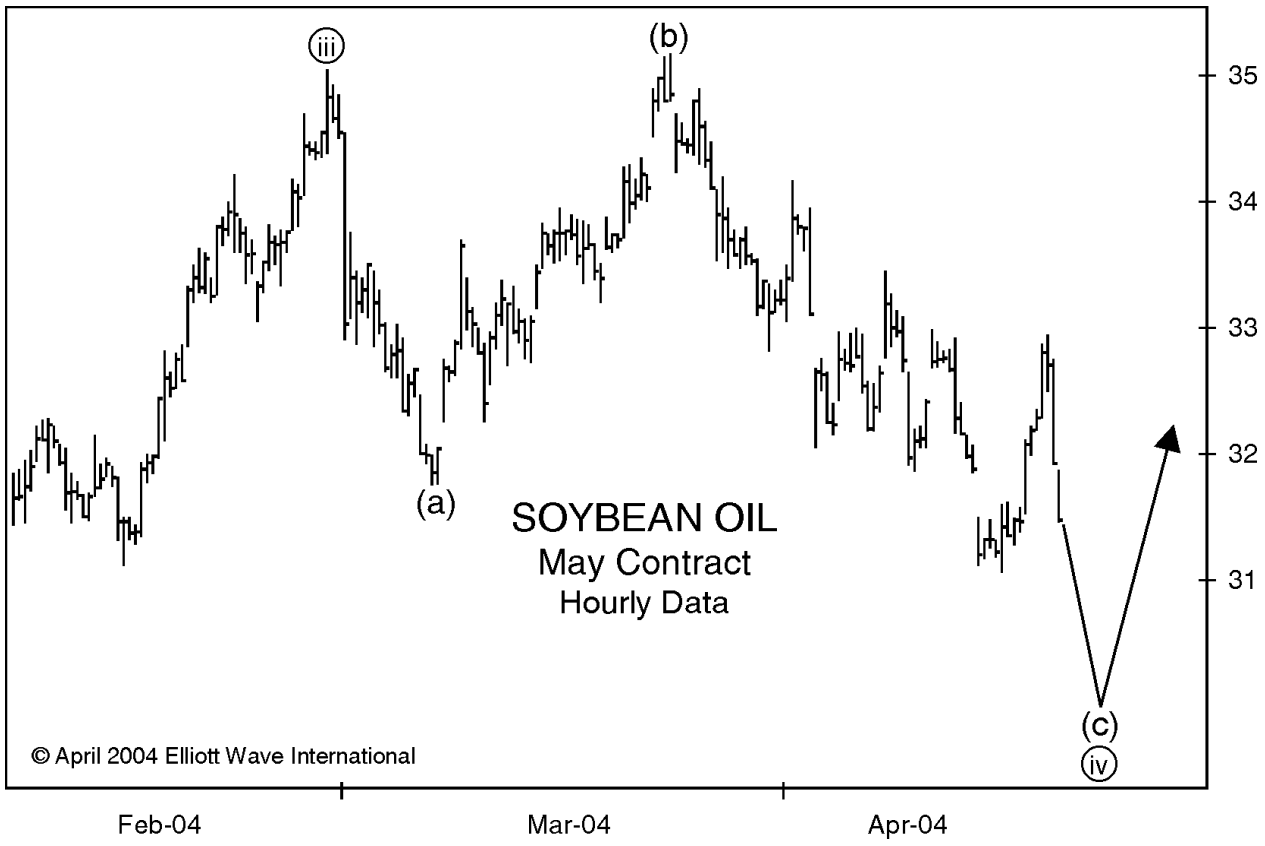


Figure 7-5

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]

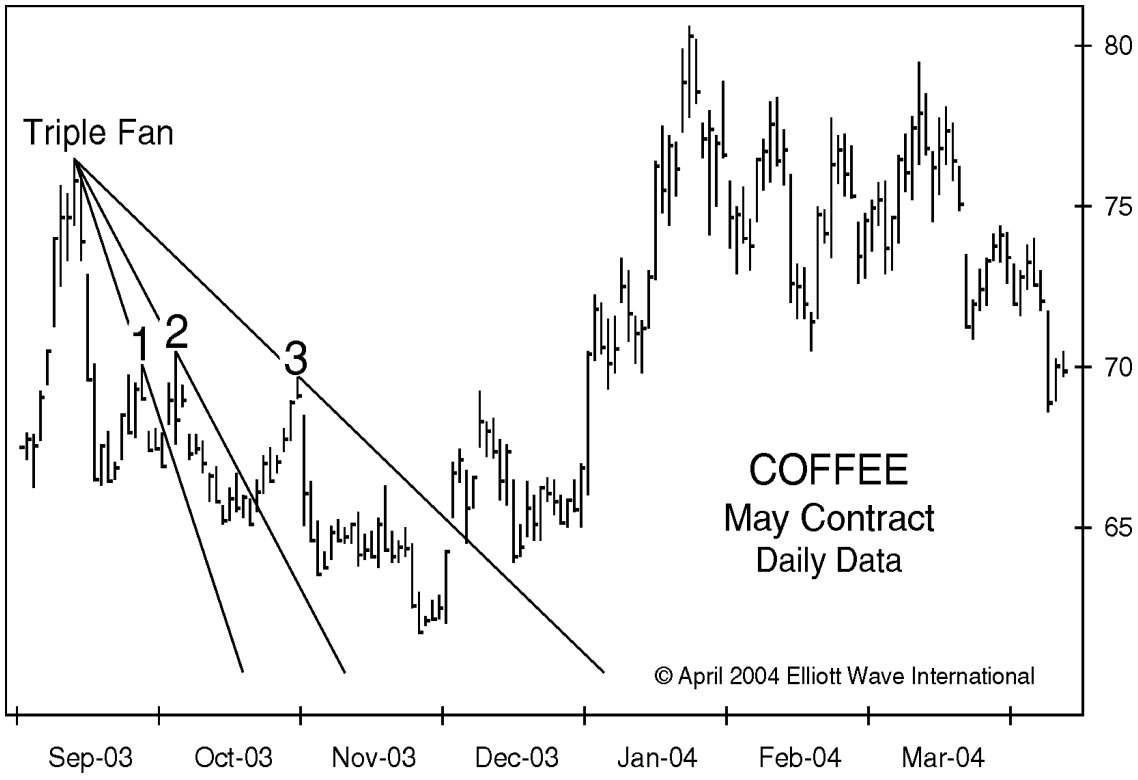


Figure 7-6

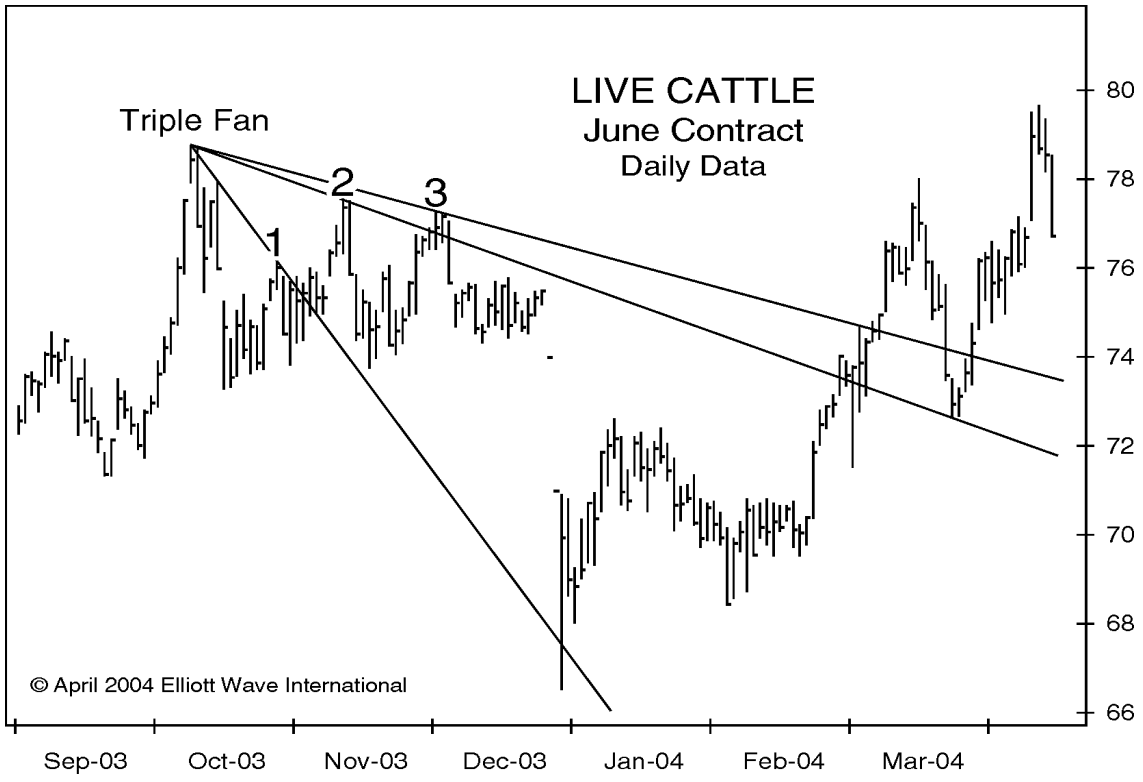


Figure 7-7

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.

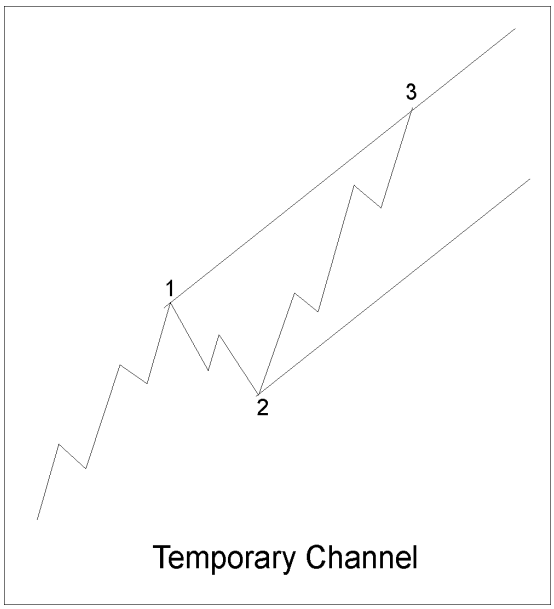


Figure 7-8

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

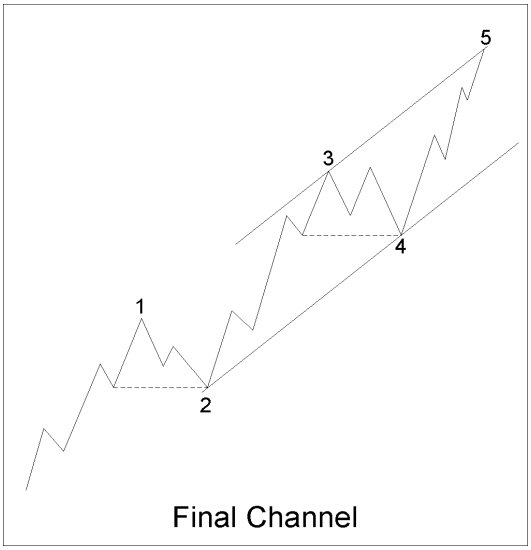


Figure 7-10

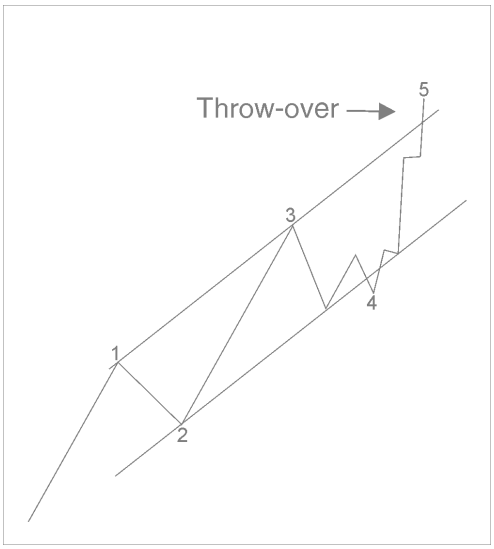


Figure 7-11

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]

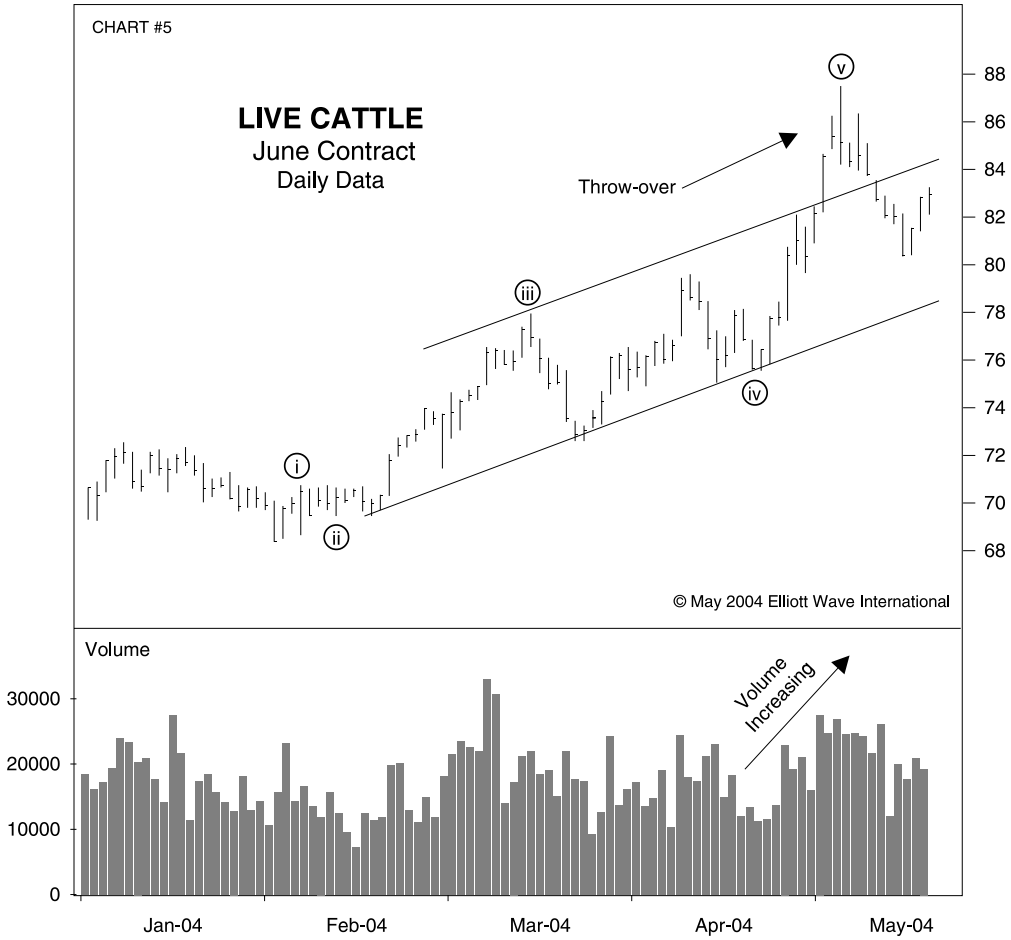


Figure 7-12

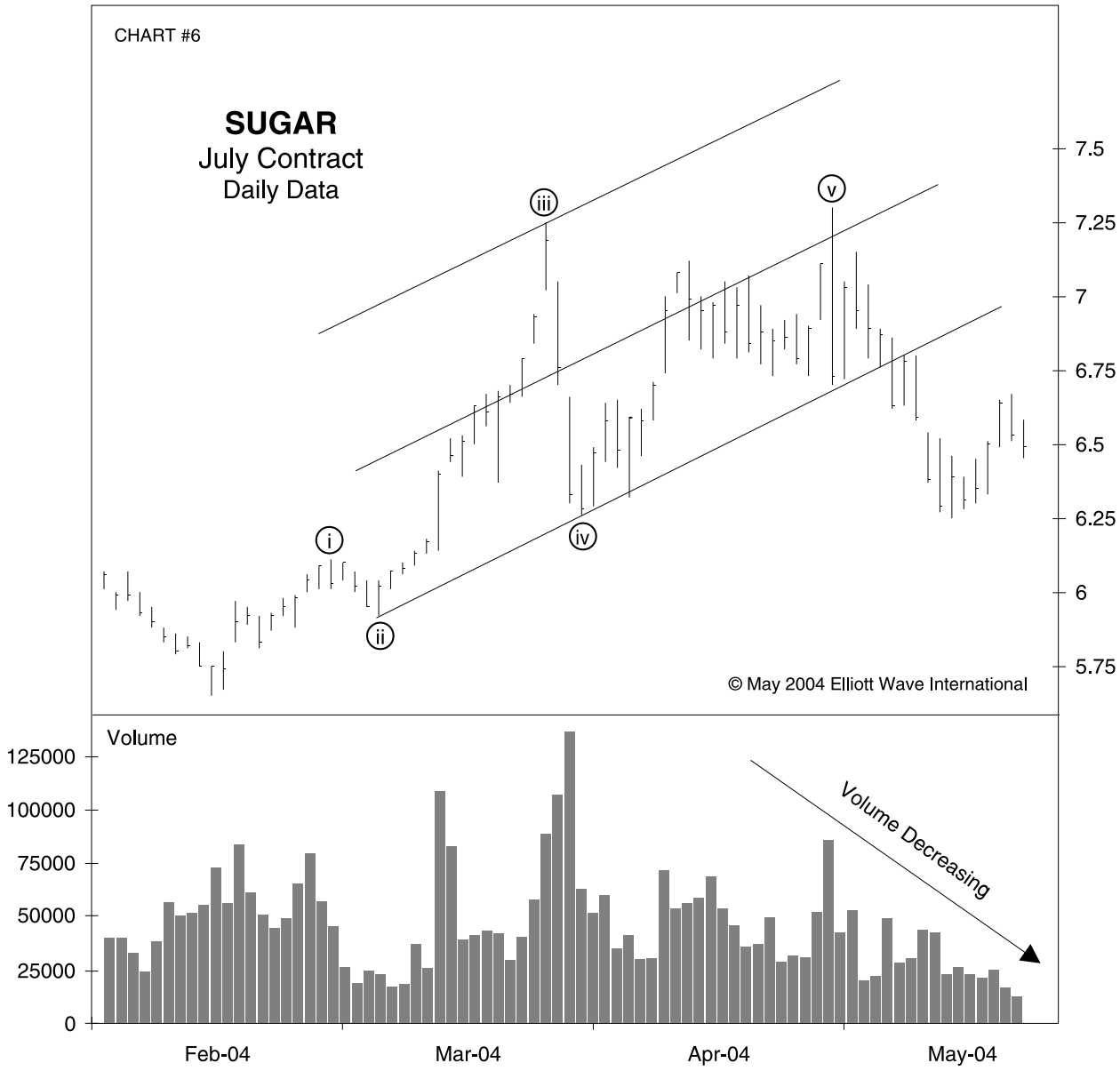


Figure 7-13

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.

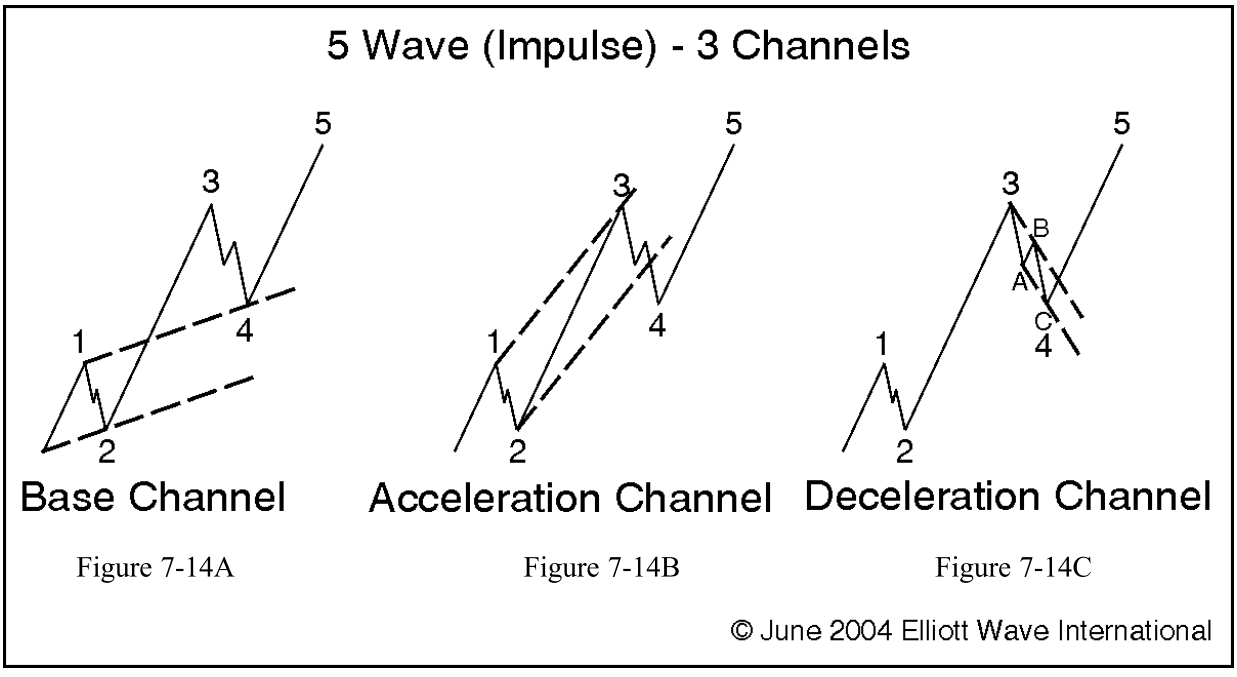


Figure 7-14A Figure 7-14B Figure 7-14C

Figure 7-14

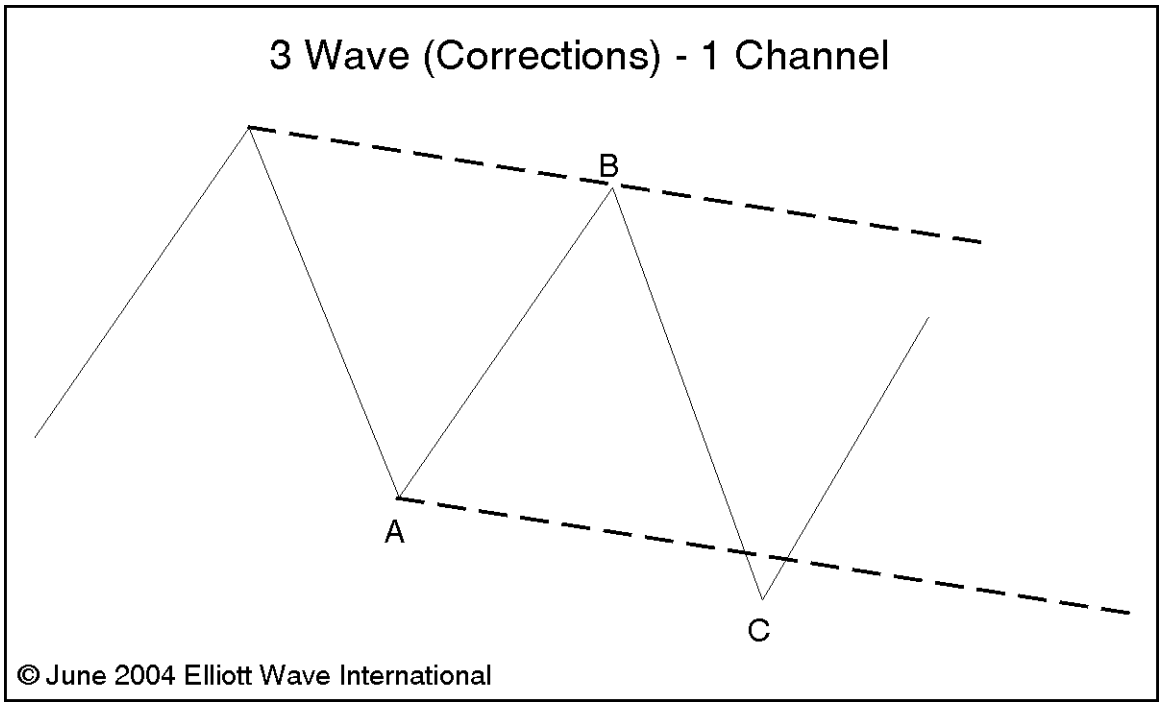


Figure 7-15

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]

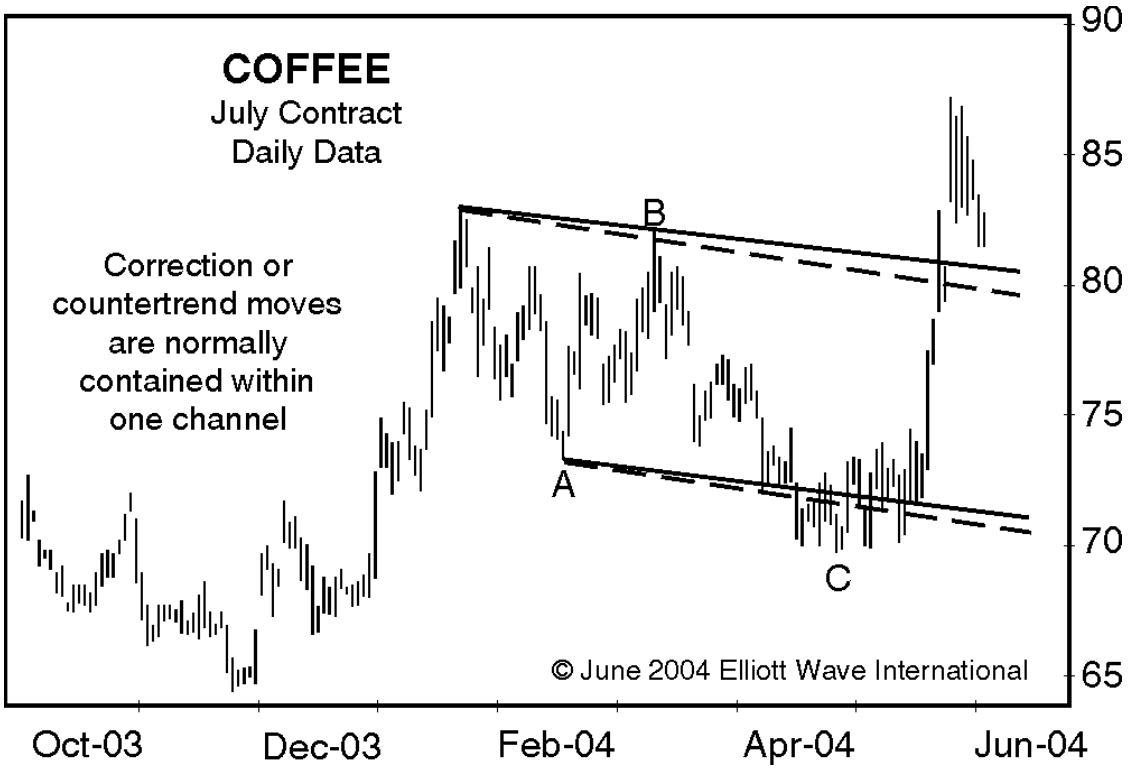


Figure 7-16

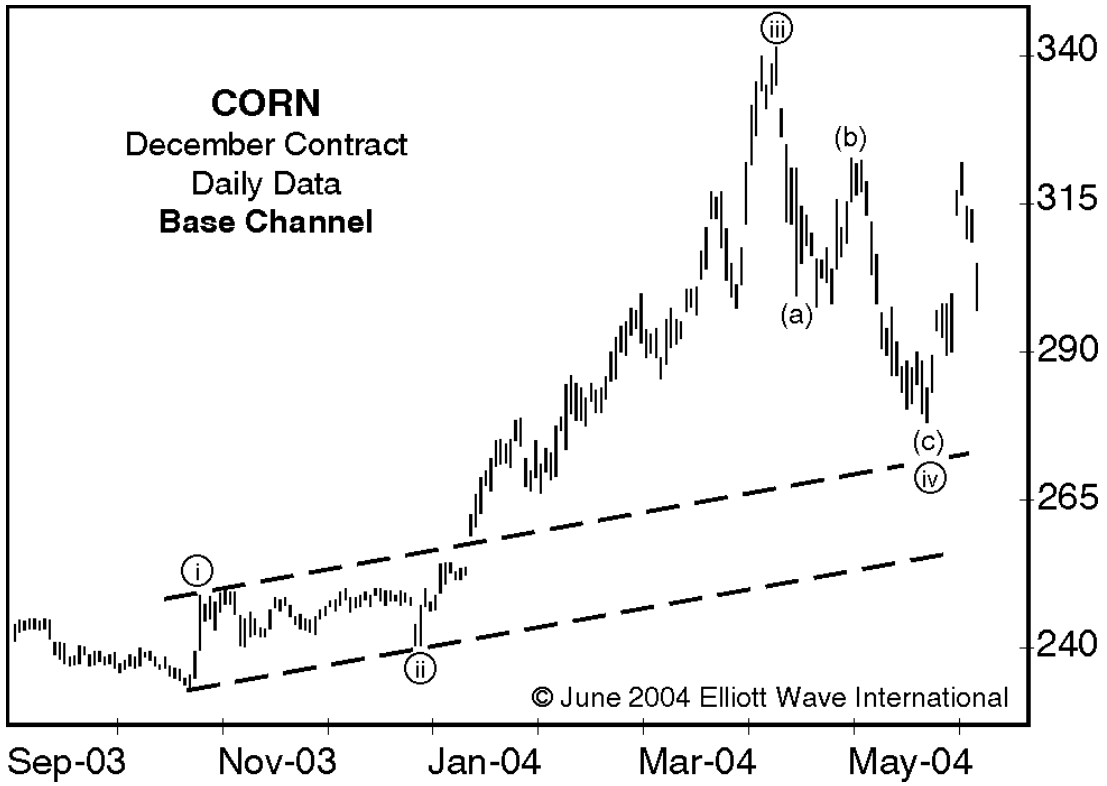


Figure 7-17

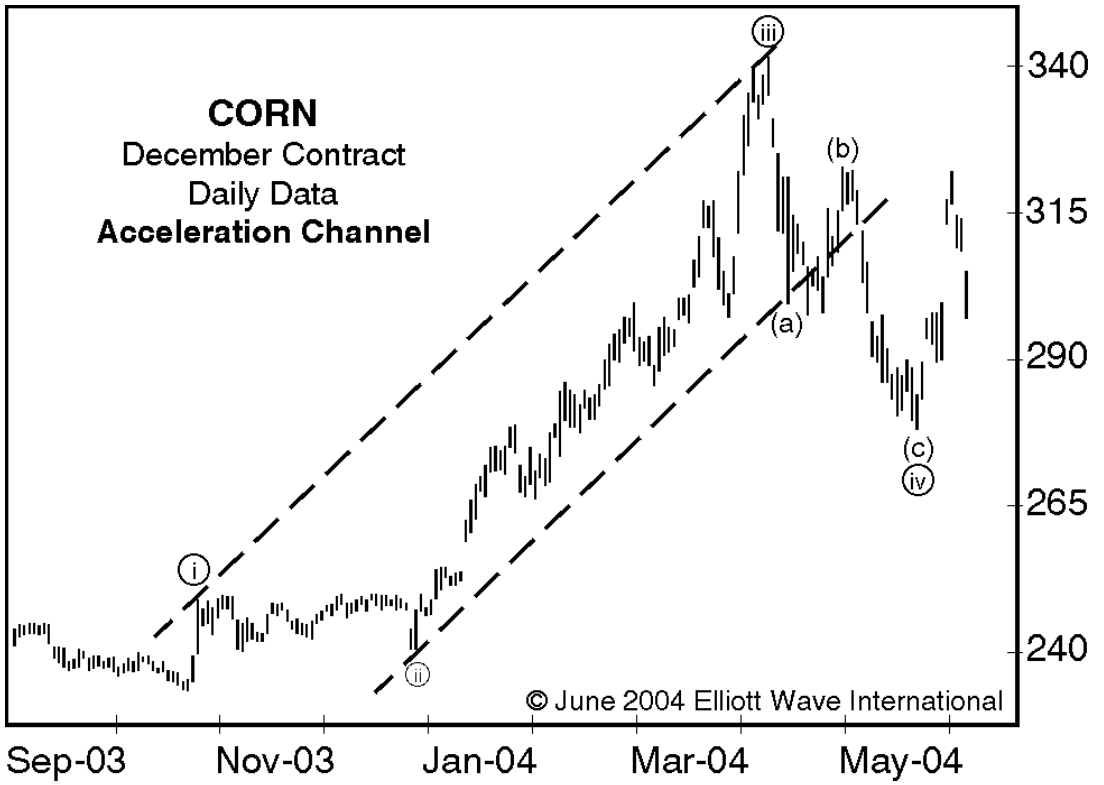


Figure 7-18

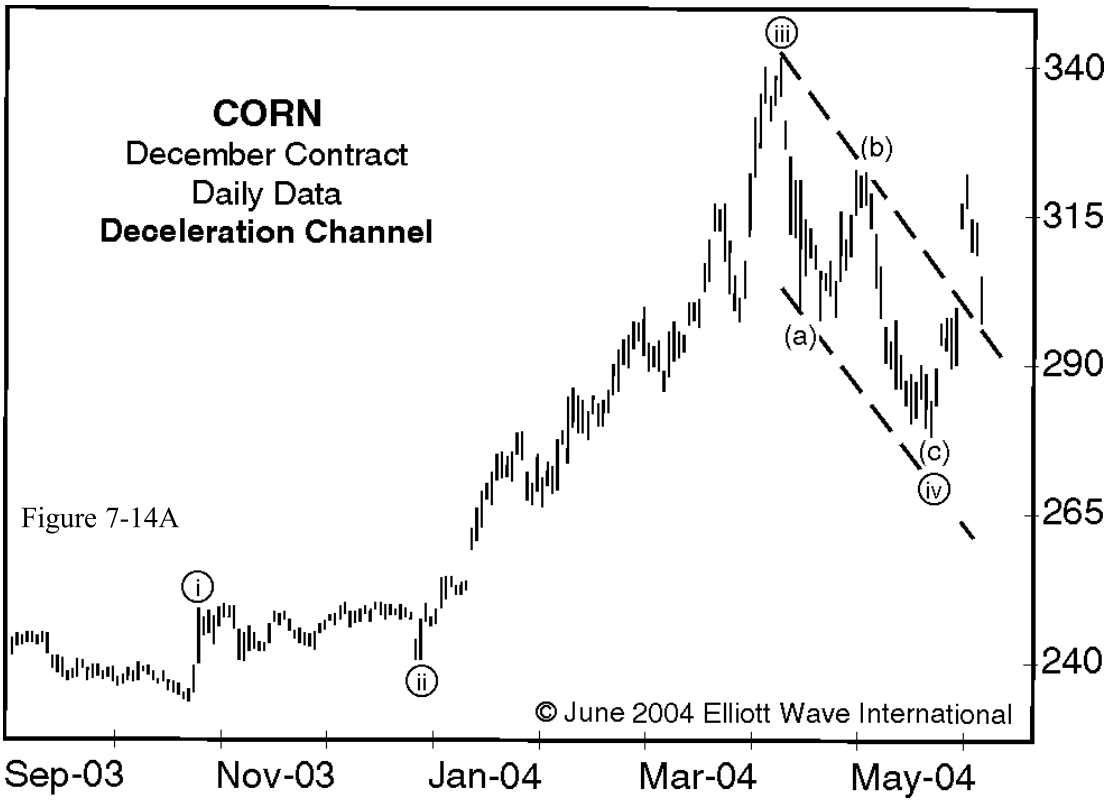


Figure 7-14A

Figure 7-19



Figure 7-20

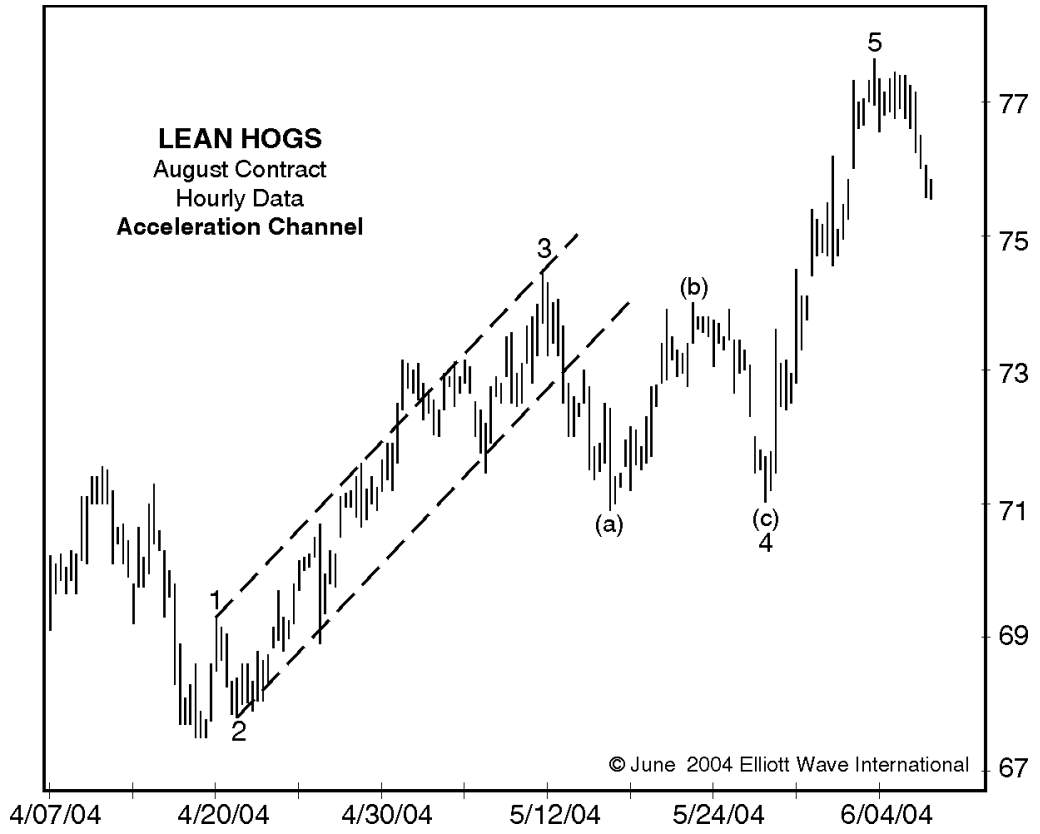


Figure 7-21

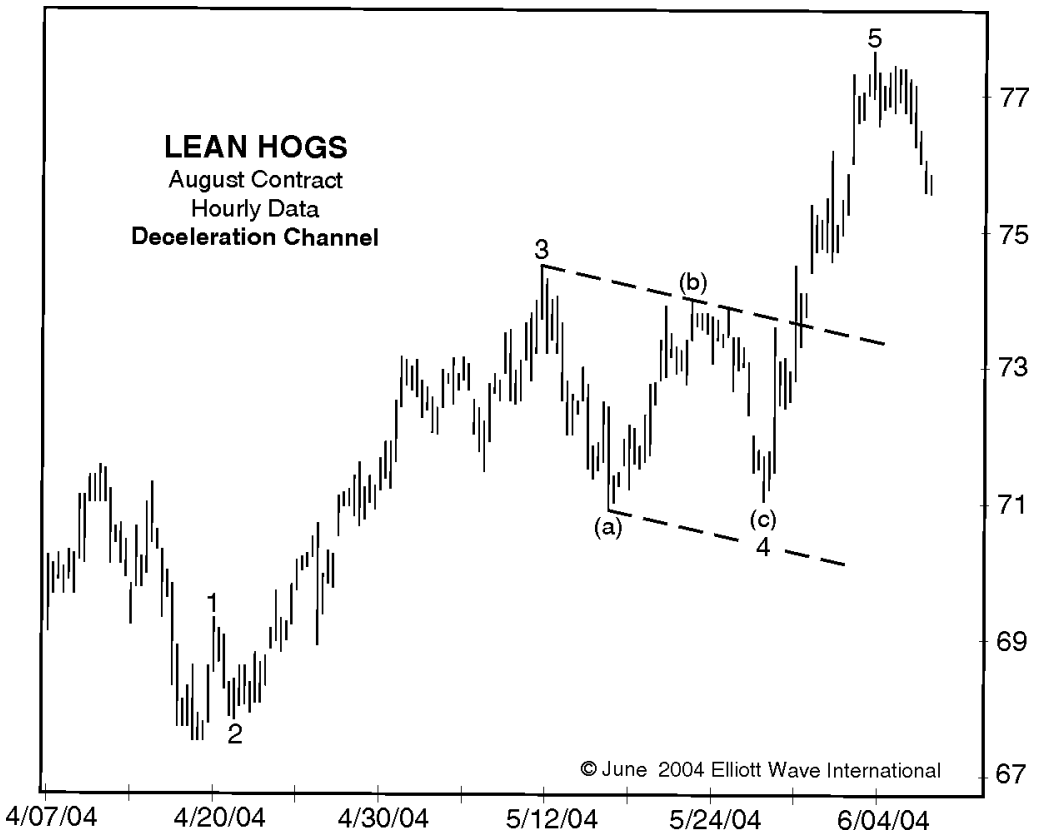


Figure 7-22

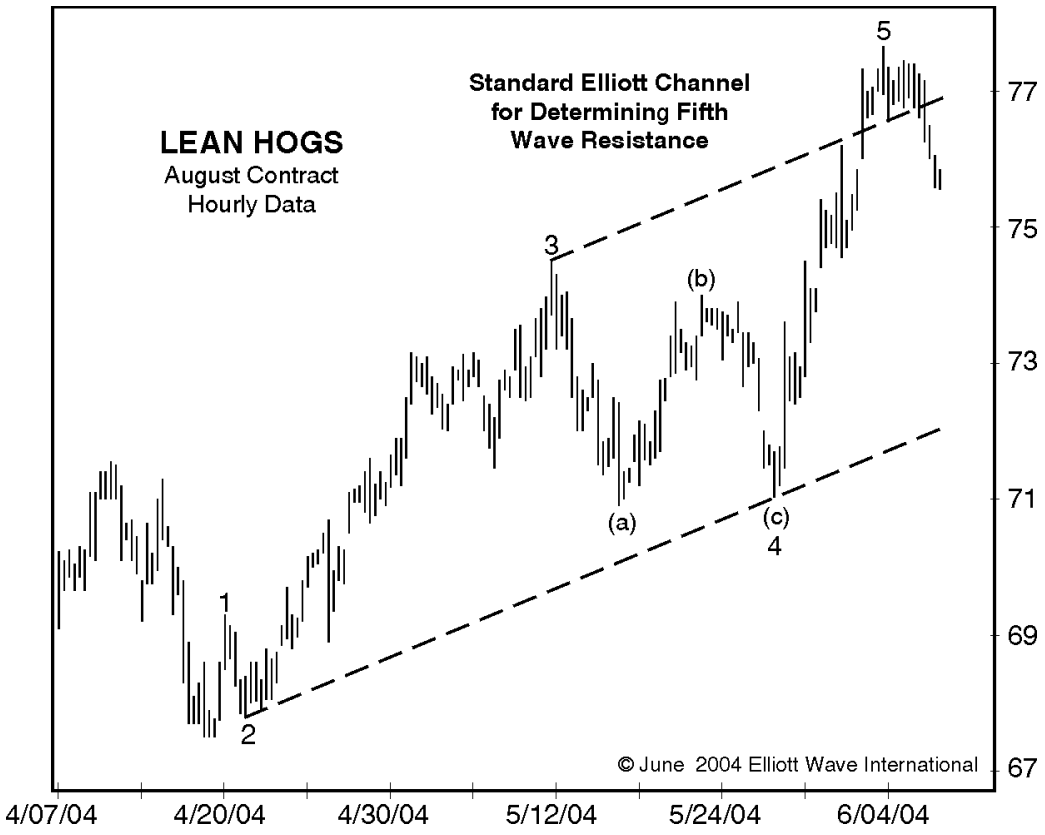


Figure 7-23

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.

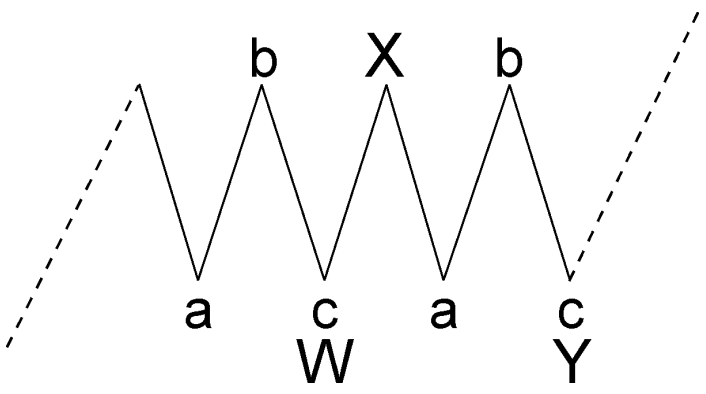


Figure 8-1

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.

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.

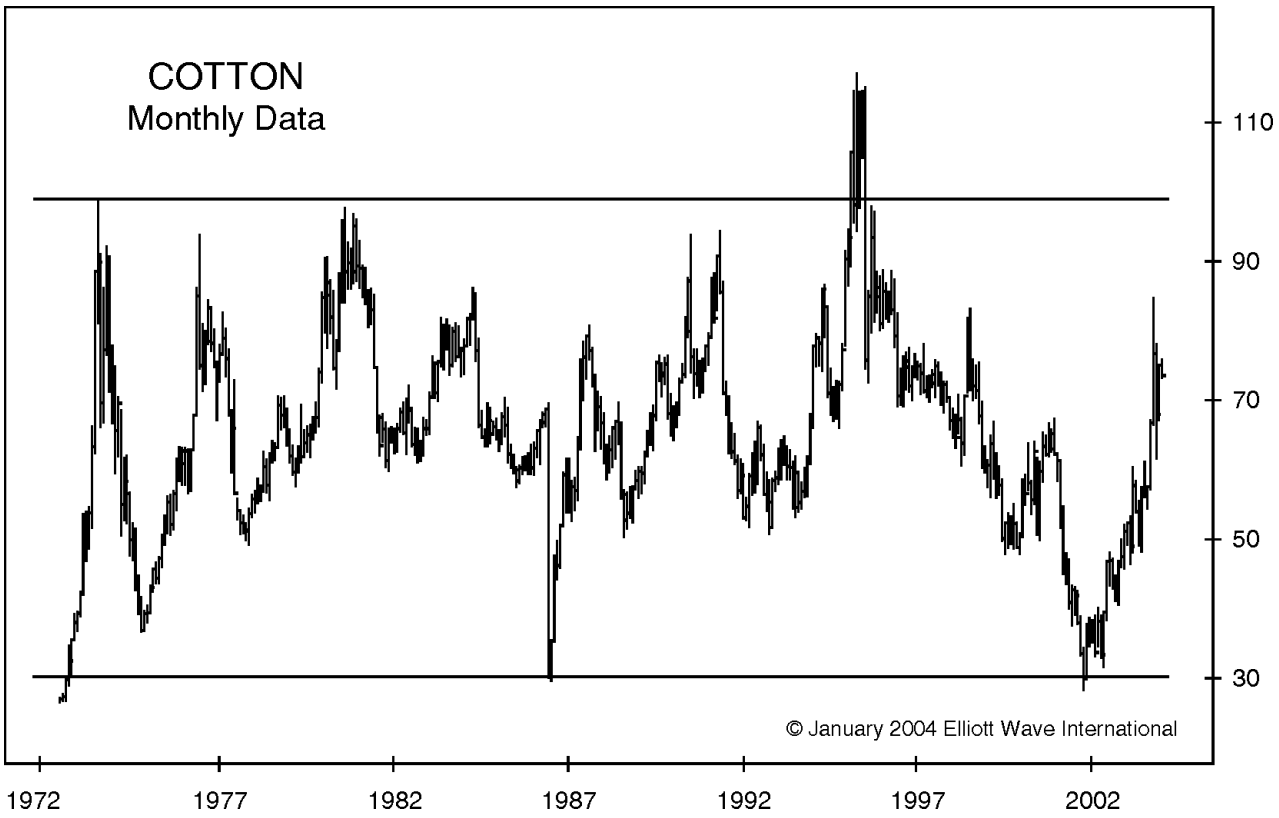


Figure 8-2

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]

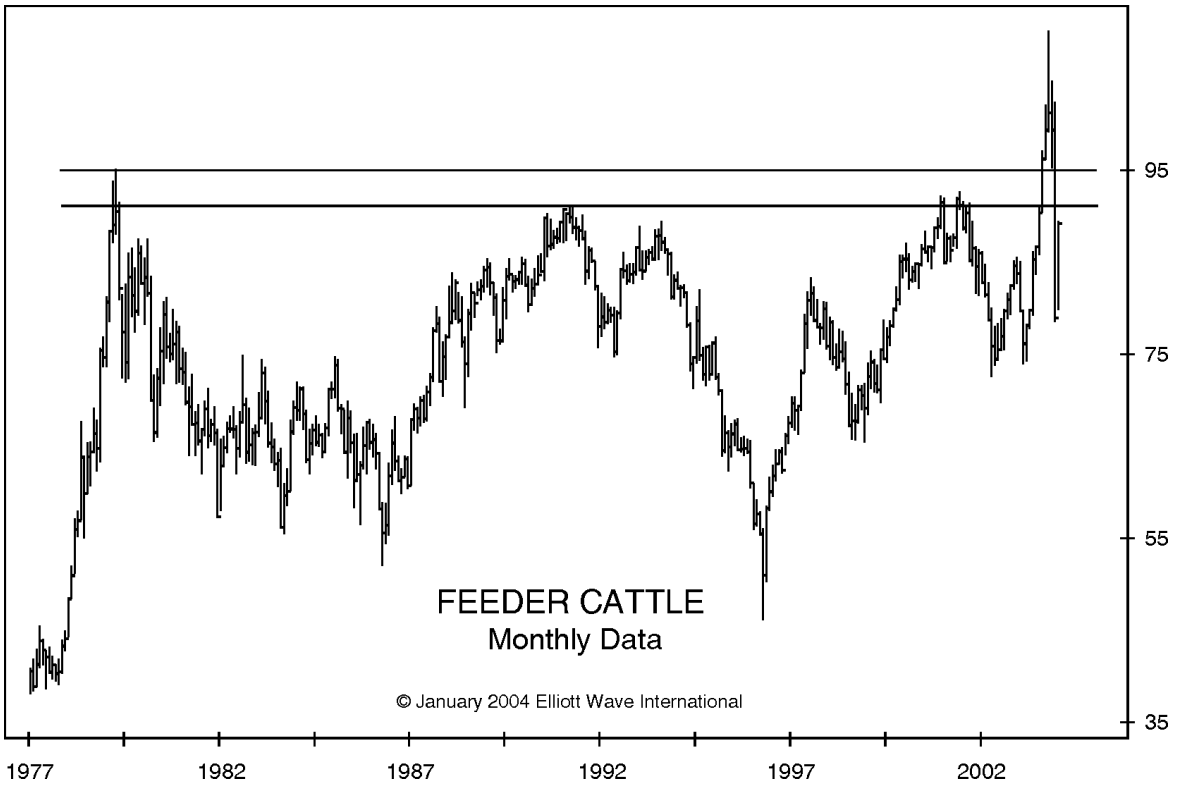


Figure 8-3

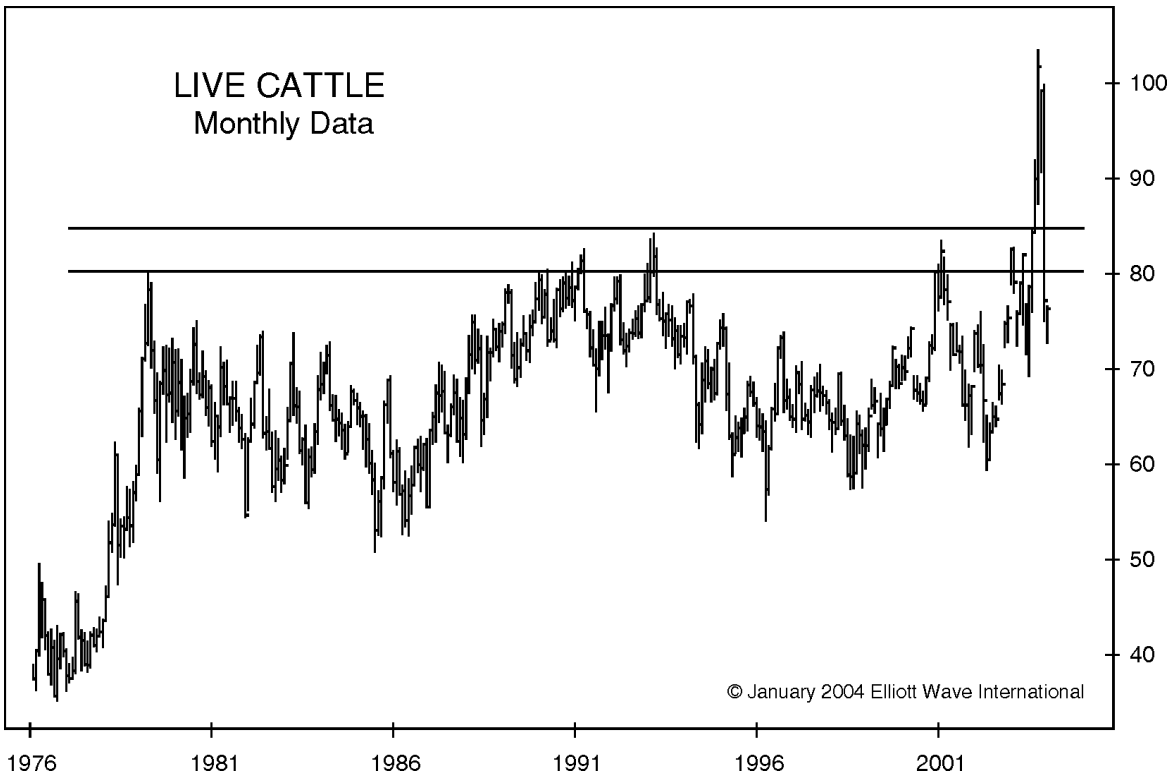


Figure 8-4

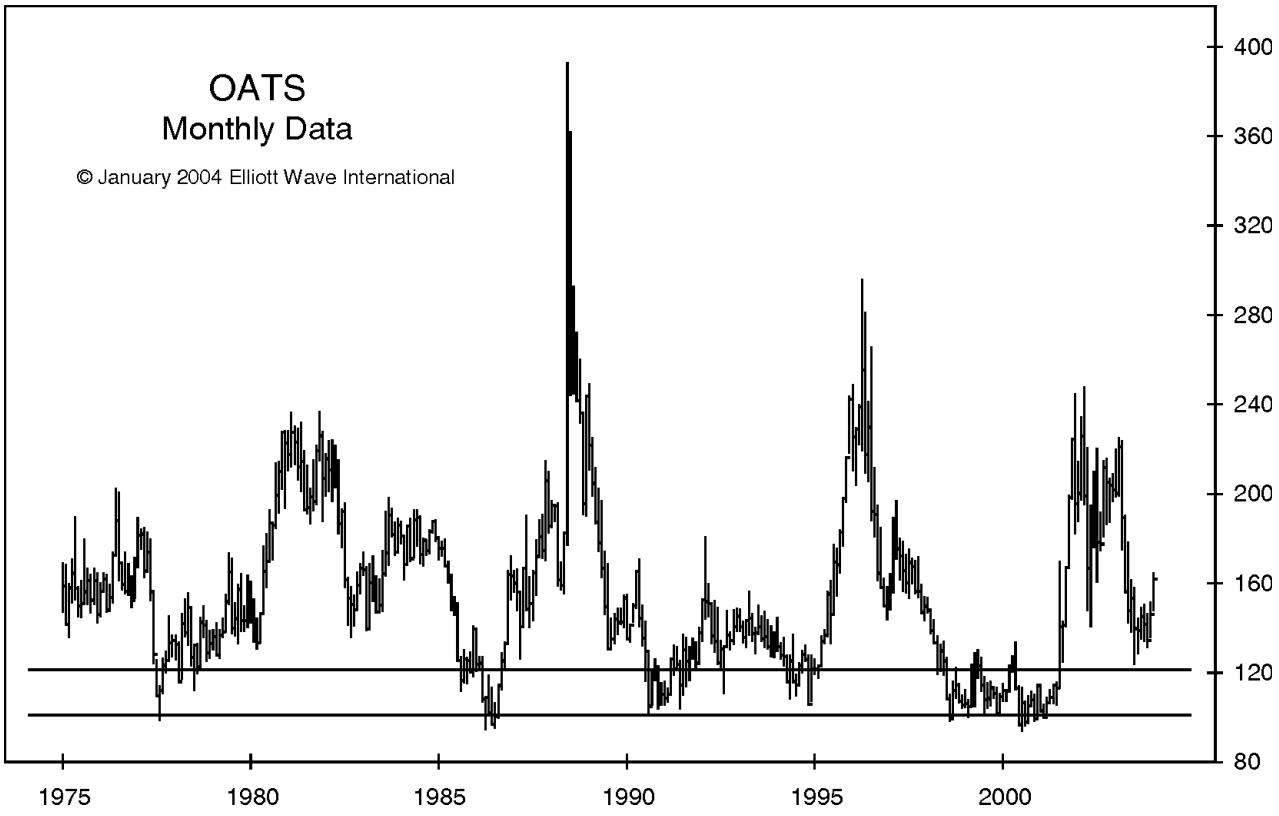


Figure 8-5

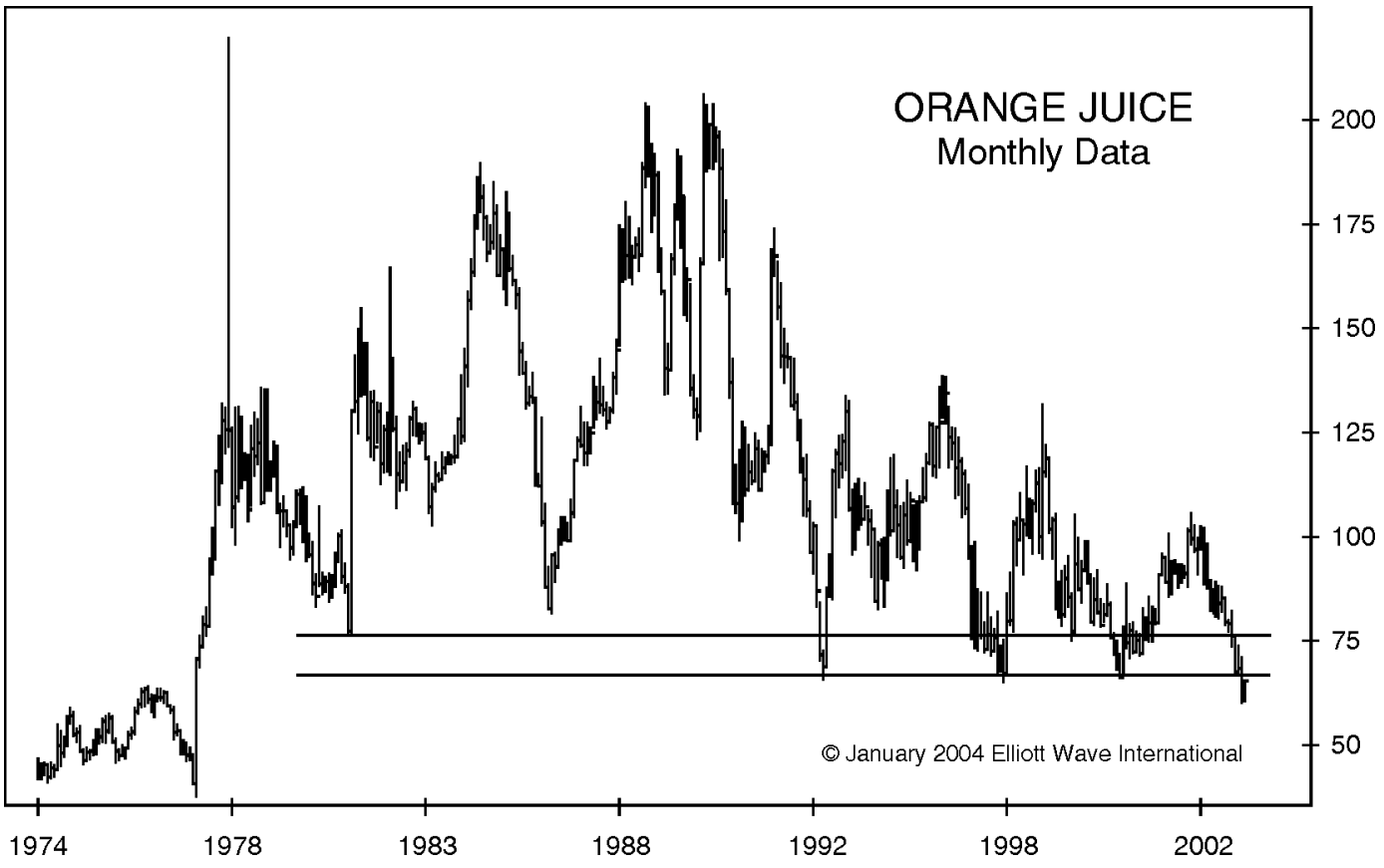

ORANGE JUICE
Monthly Data
© January 2004 Elliott Wave International
200
175
150
125
100
75
50
1974
1978
1983
1988
1992
1998
2002

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.

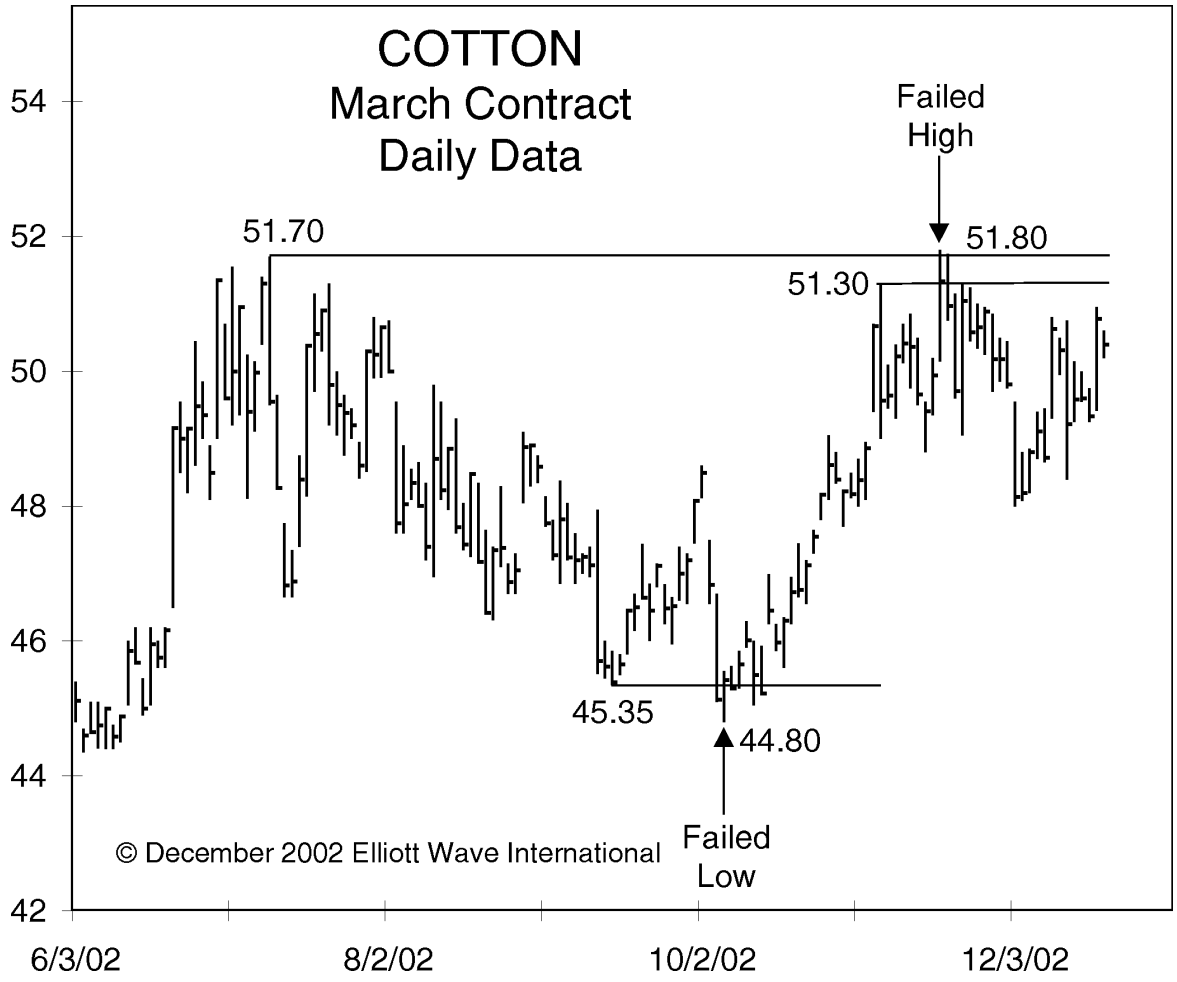


Figure 9-1

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.

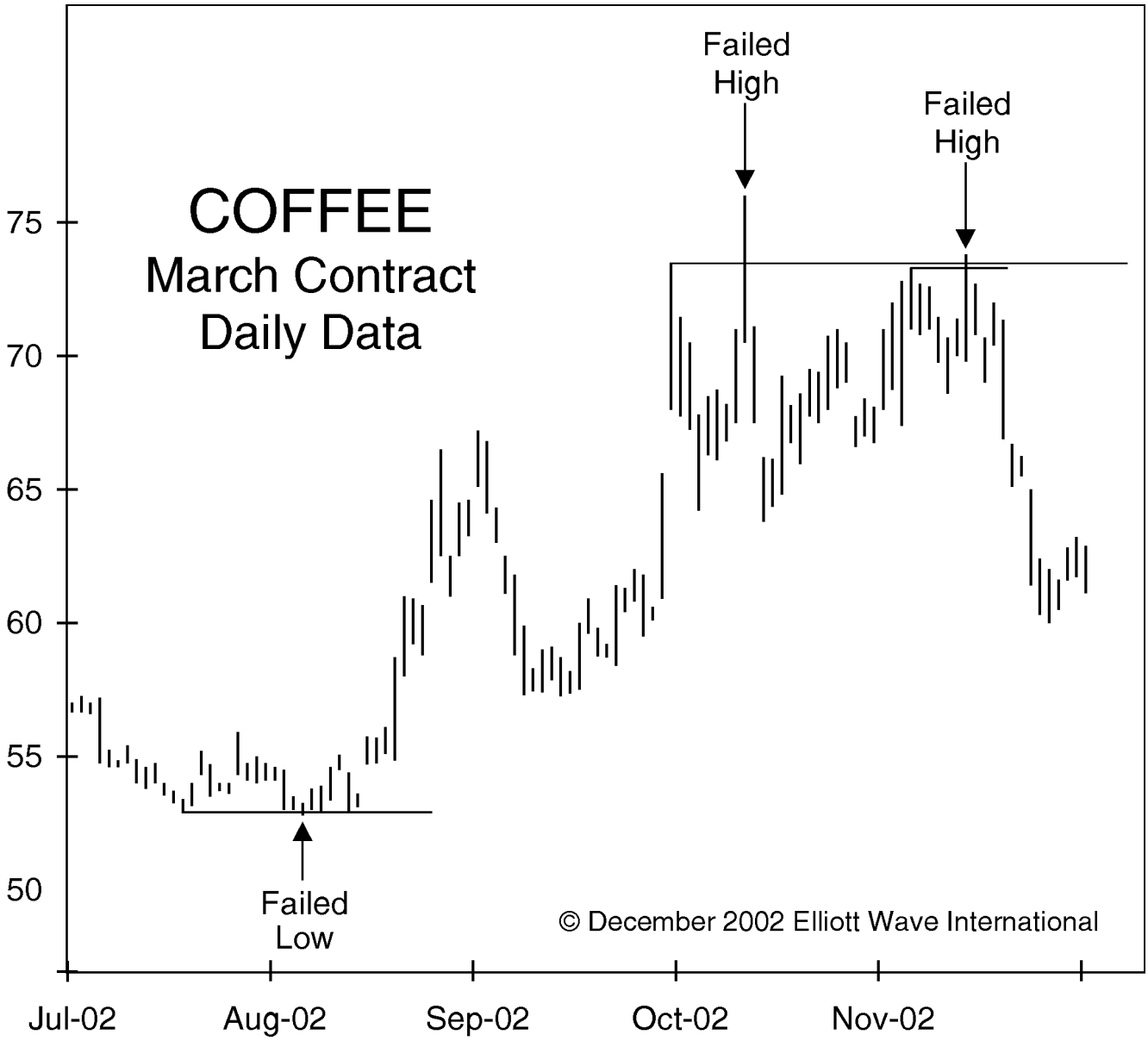


Figure 9-2

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.

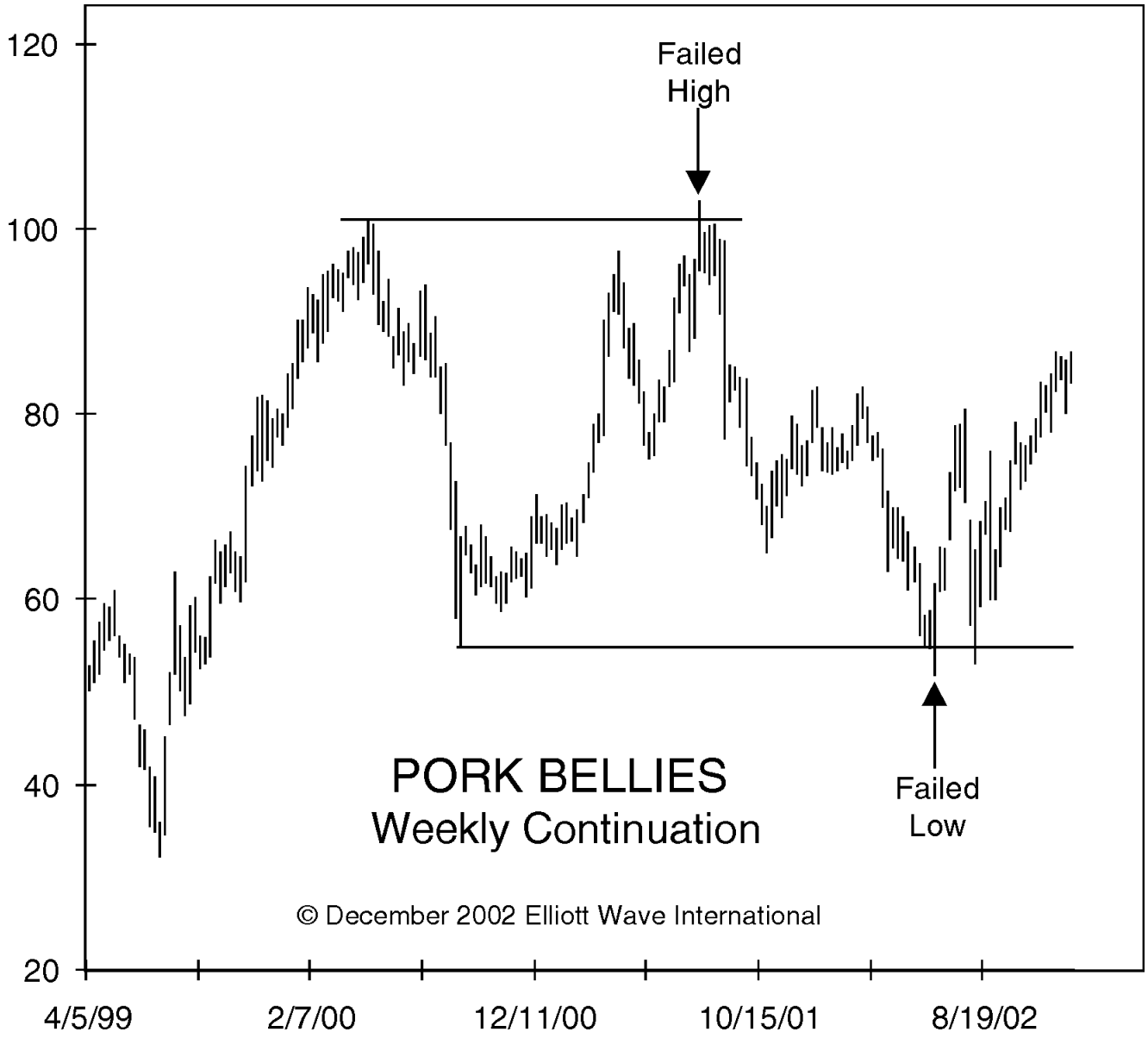


Figure 9-3

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 December13, prices came close to a new high and failed, leading to decline into the close. Also note the failed new low.

[December 2002]

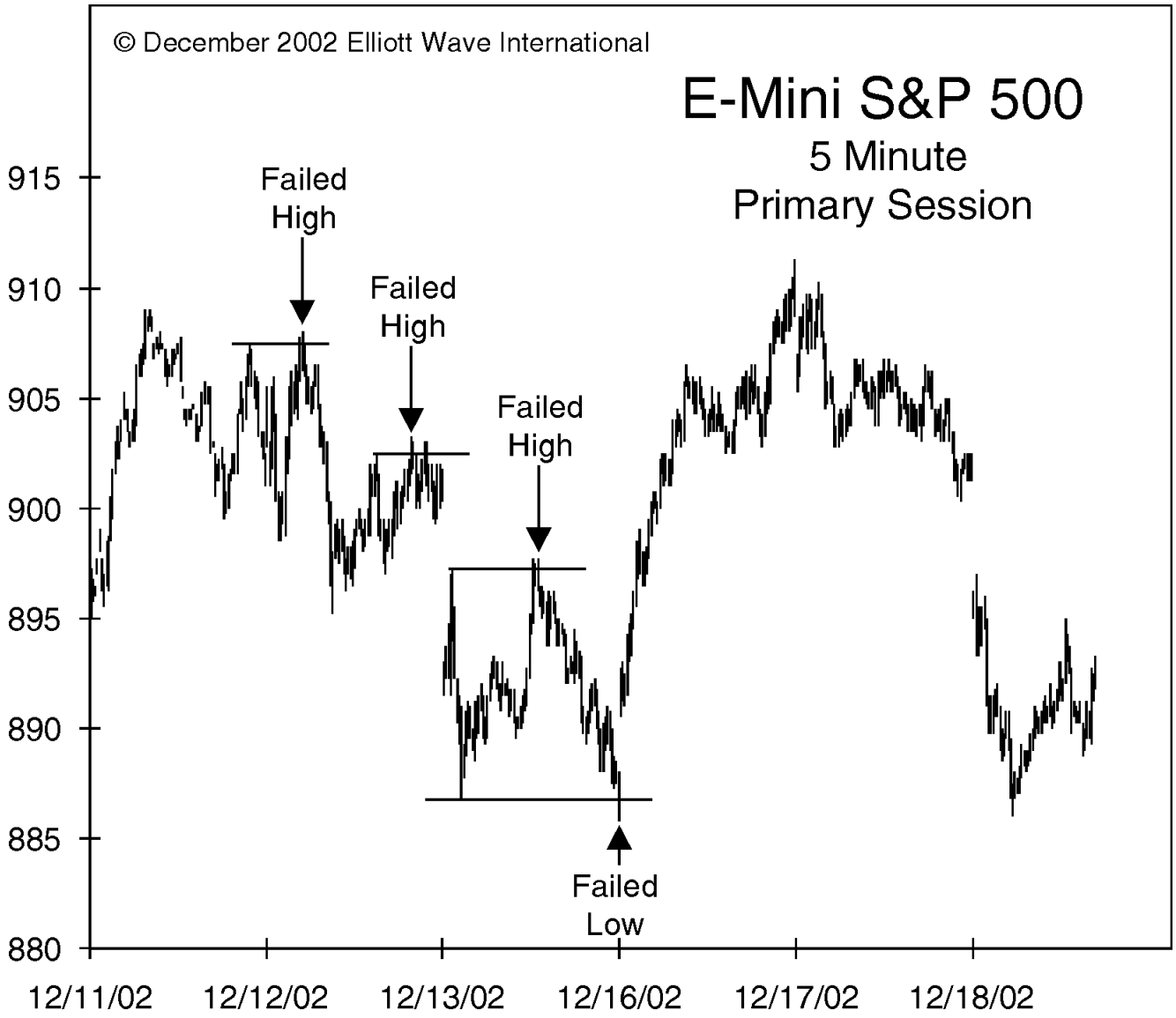


Figure 9-4

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

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 Junctures*, 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.

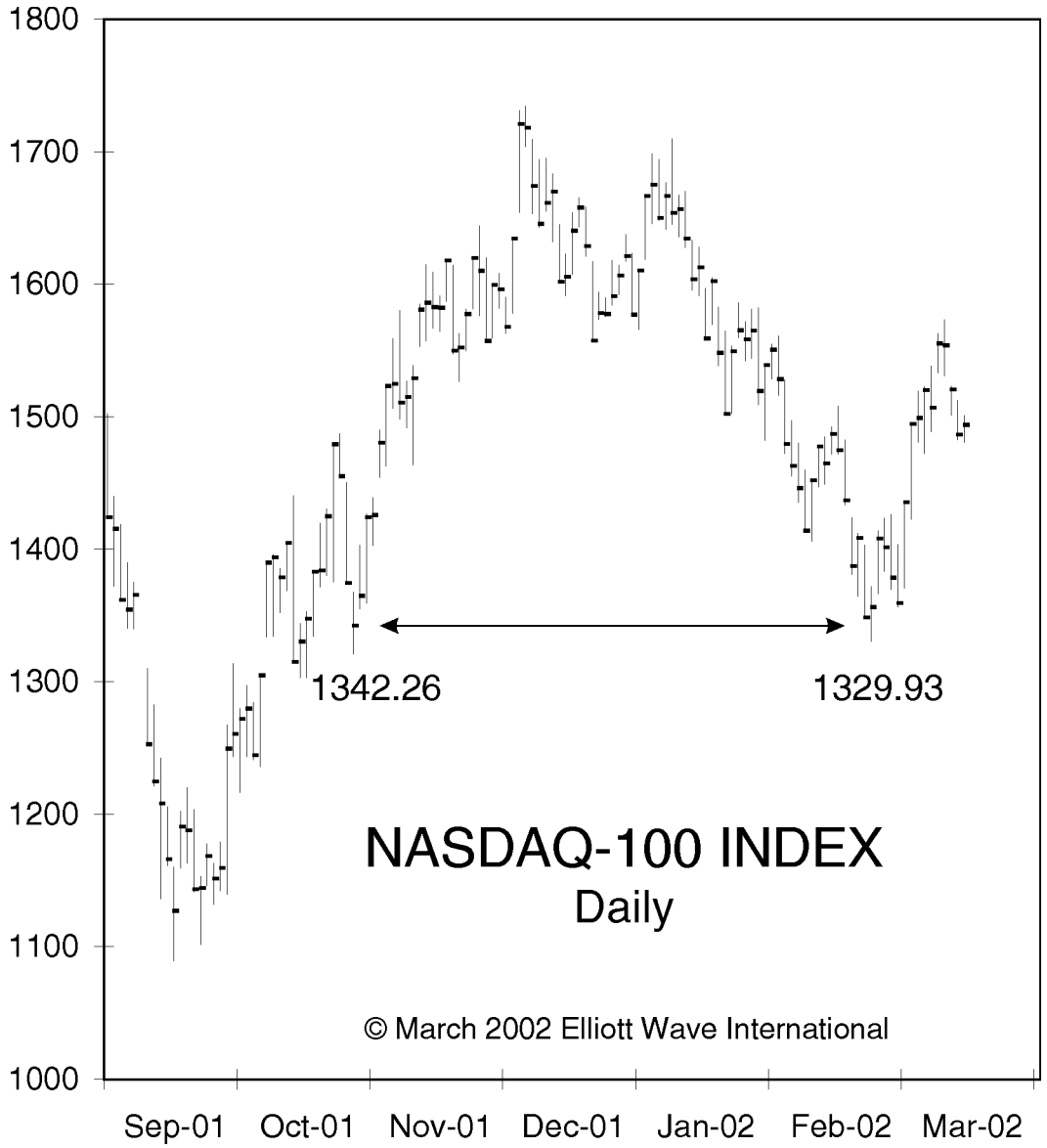


Figure 10-2

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]

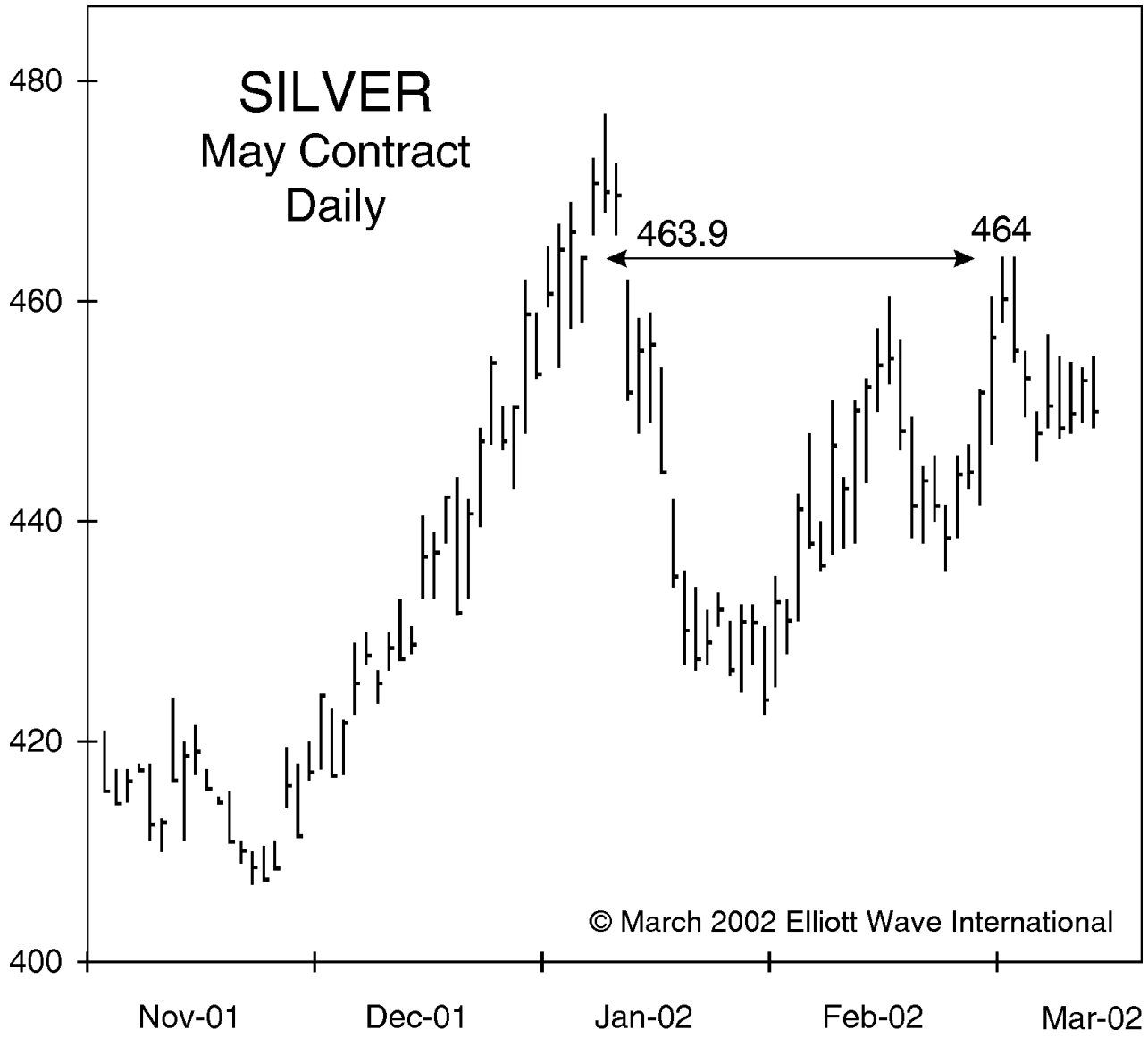


Figure 10-3

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.

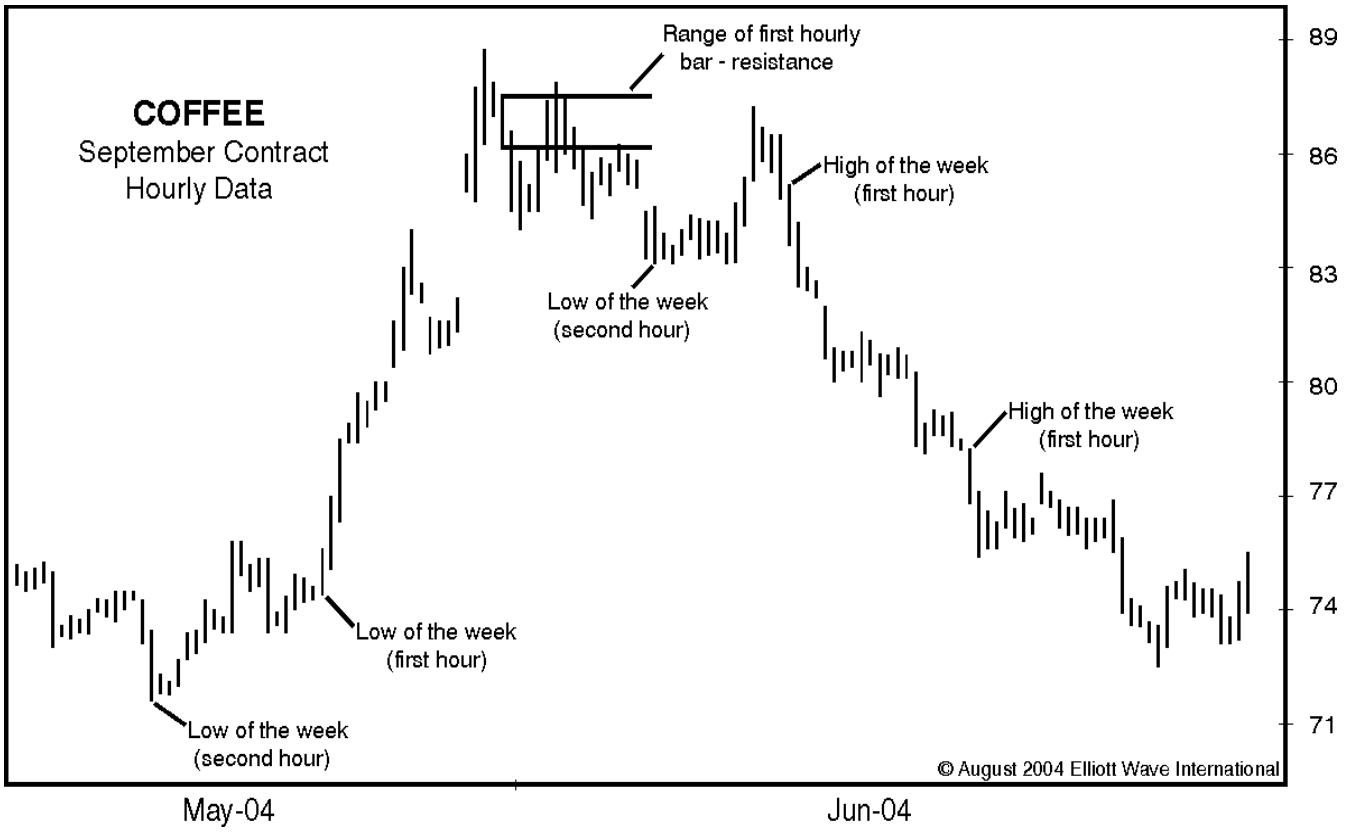


Figure 11-1

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]

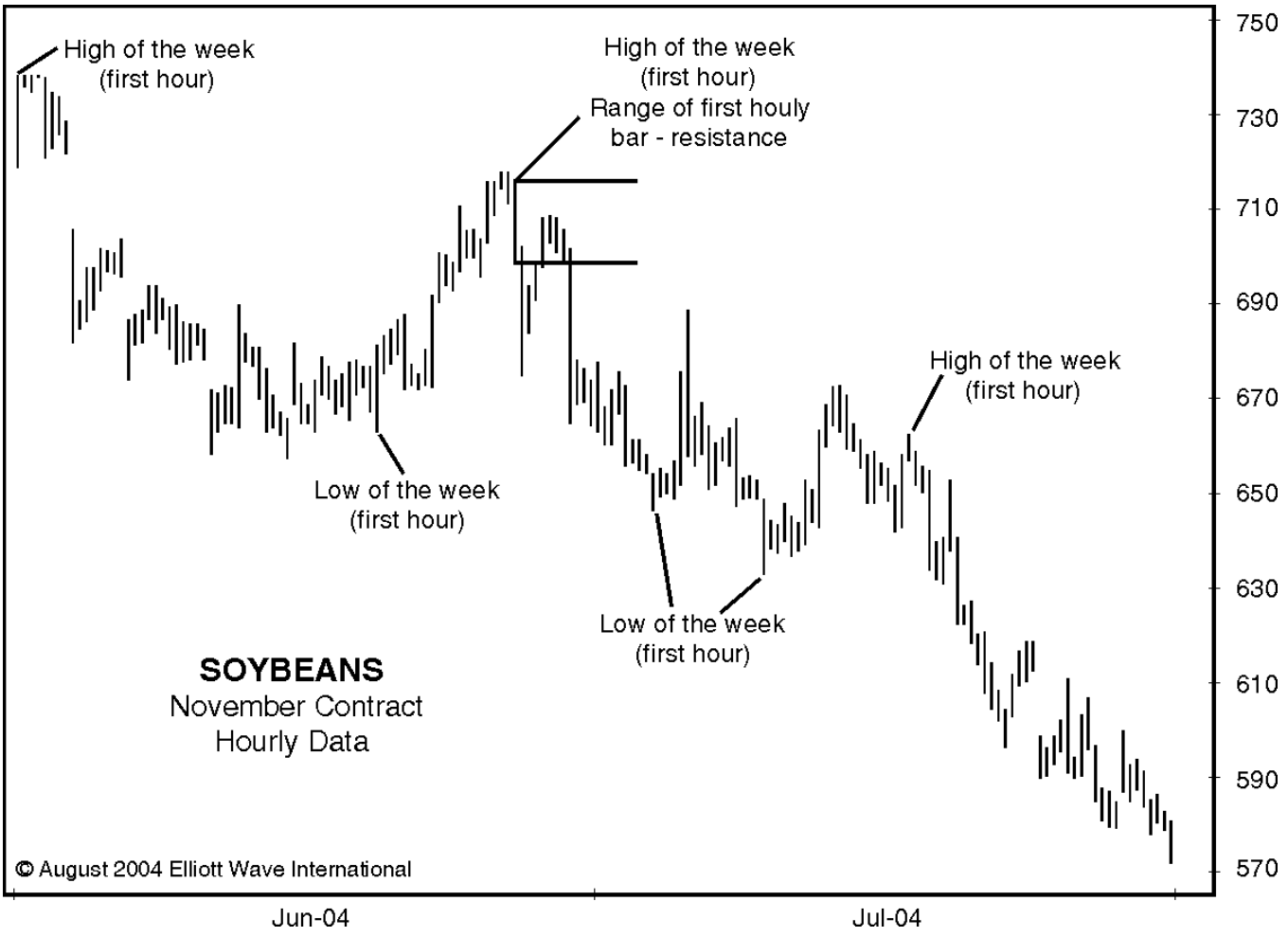


Figure 11-2

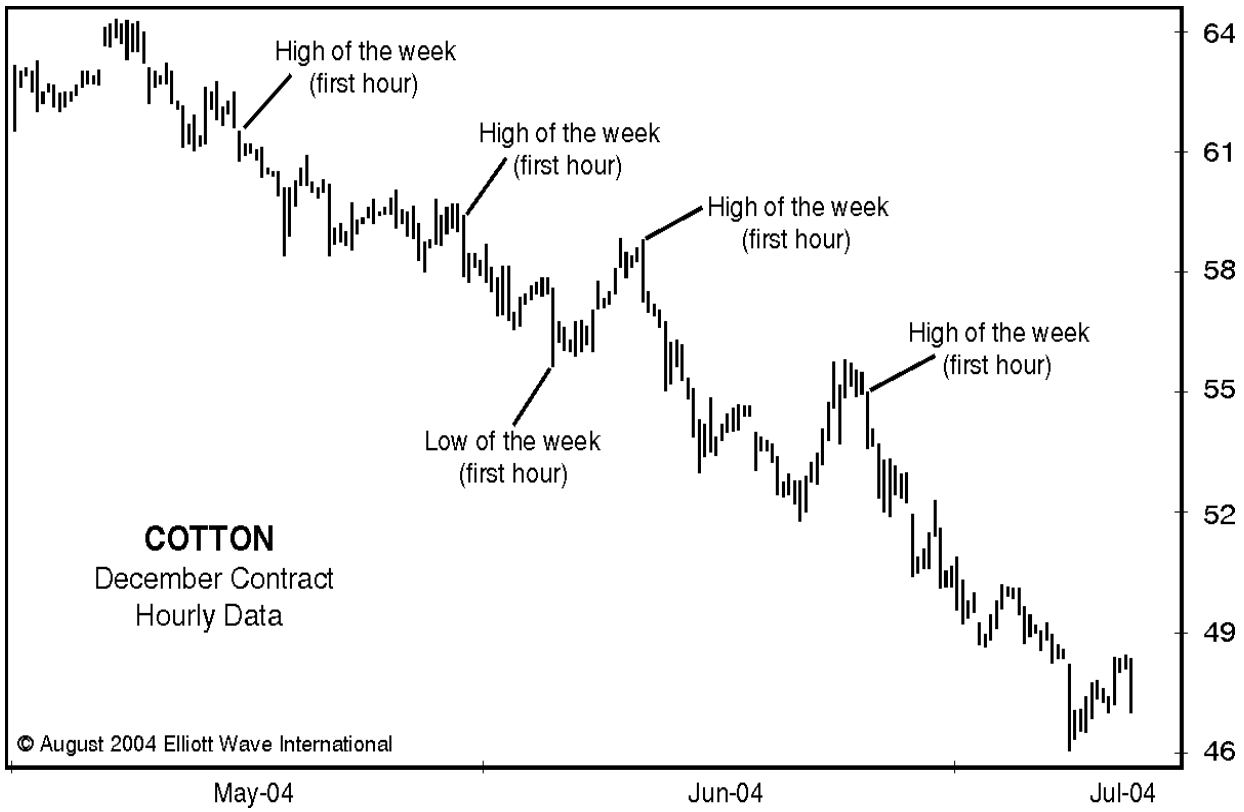


Figure 11-3

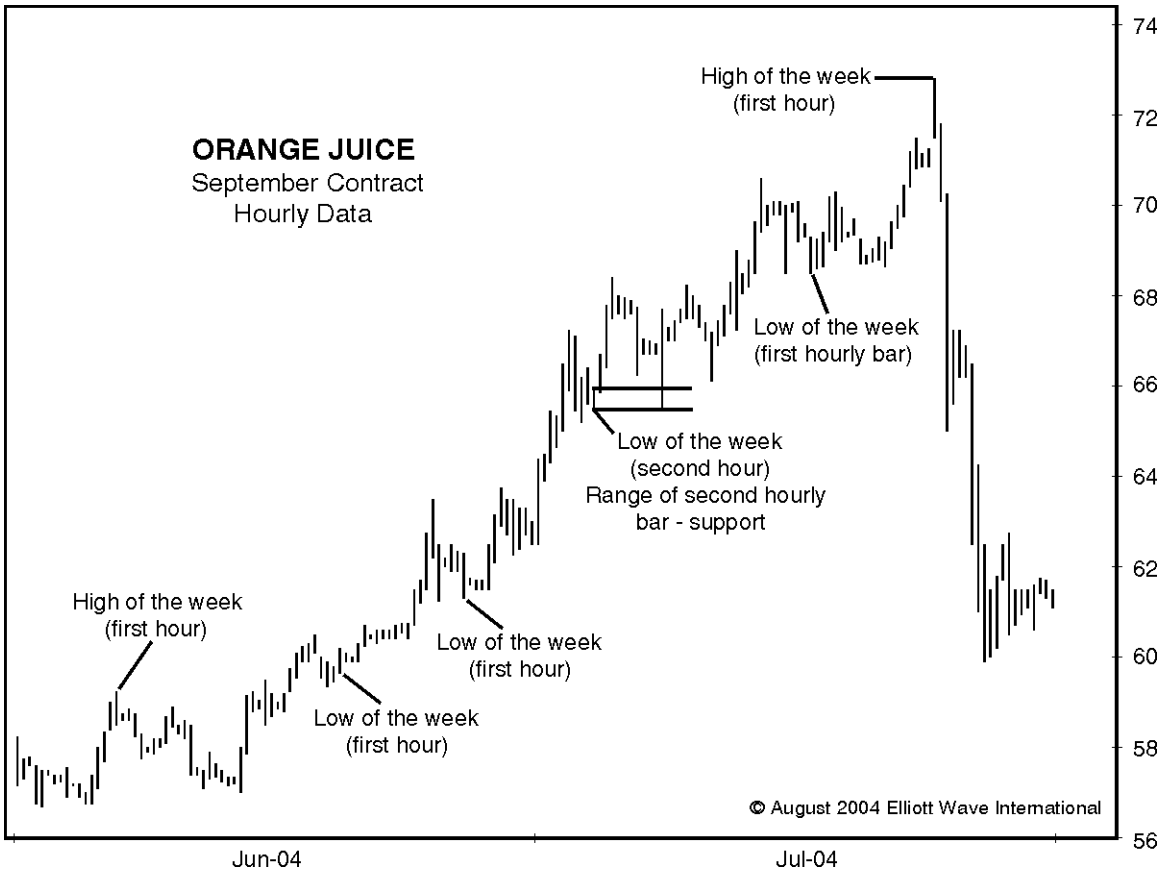


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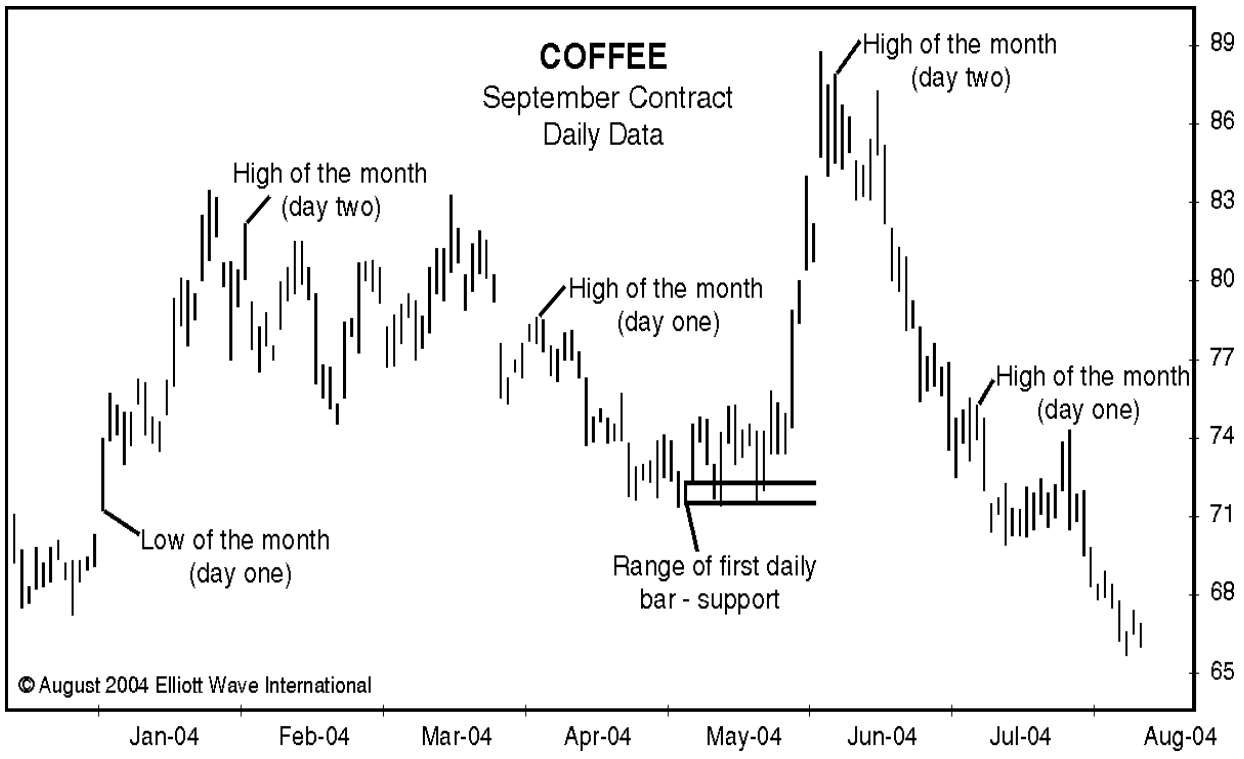


Figure 11-5

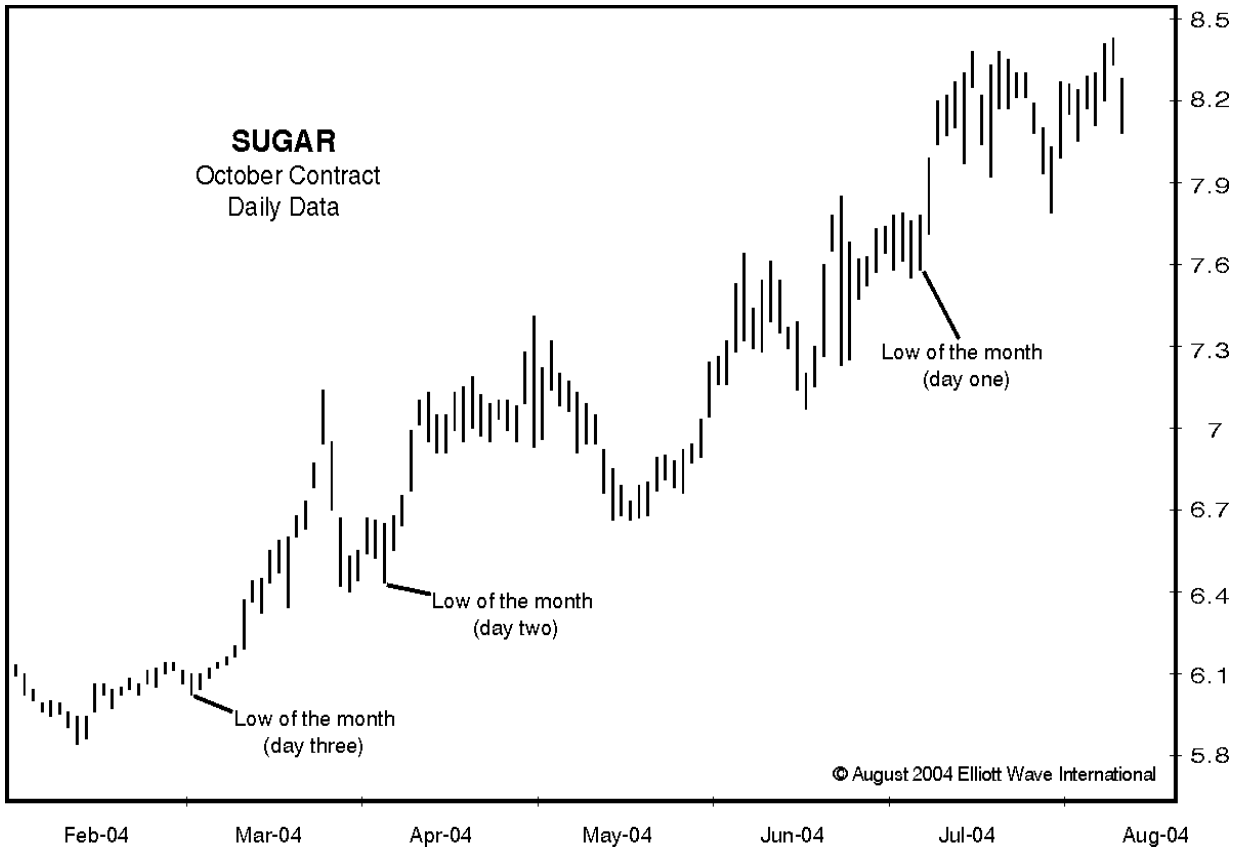


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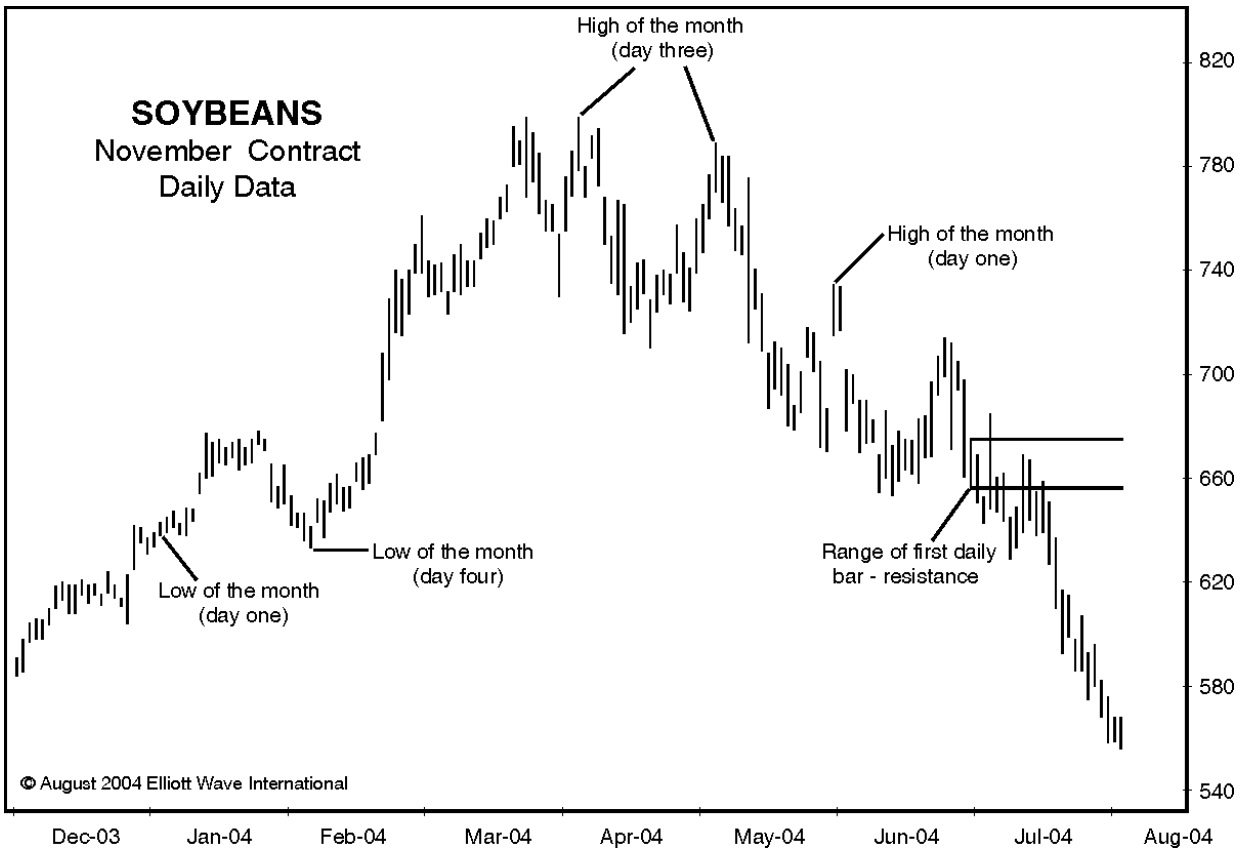


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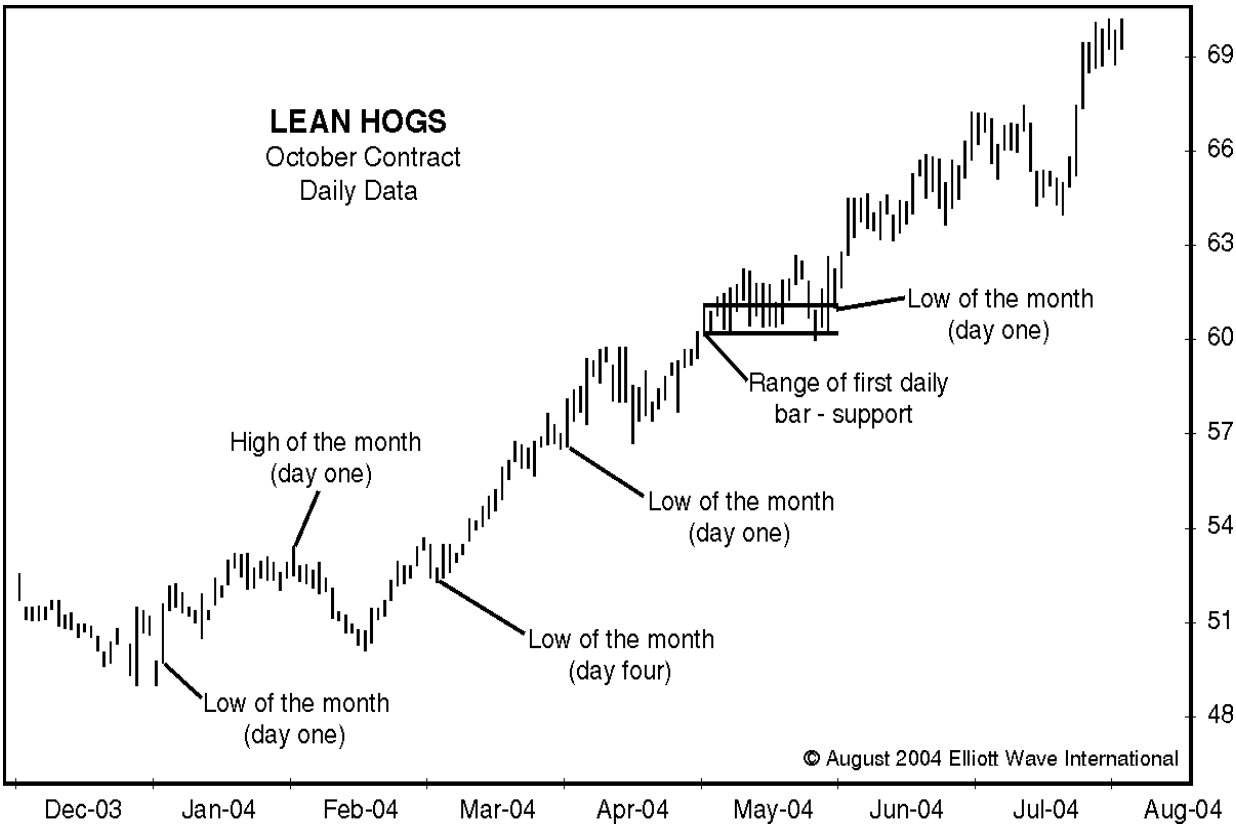


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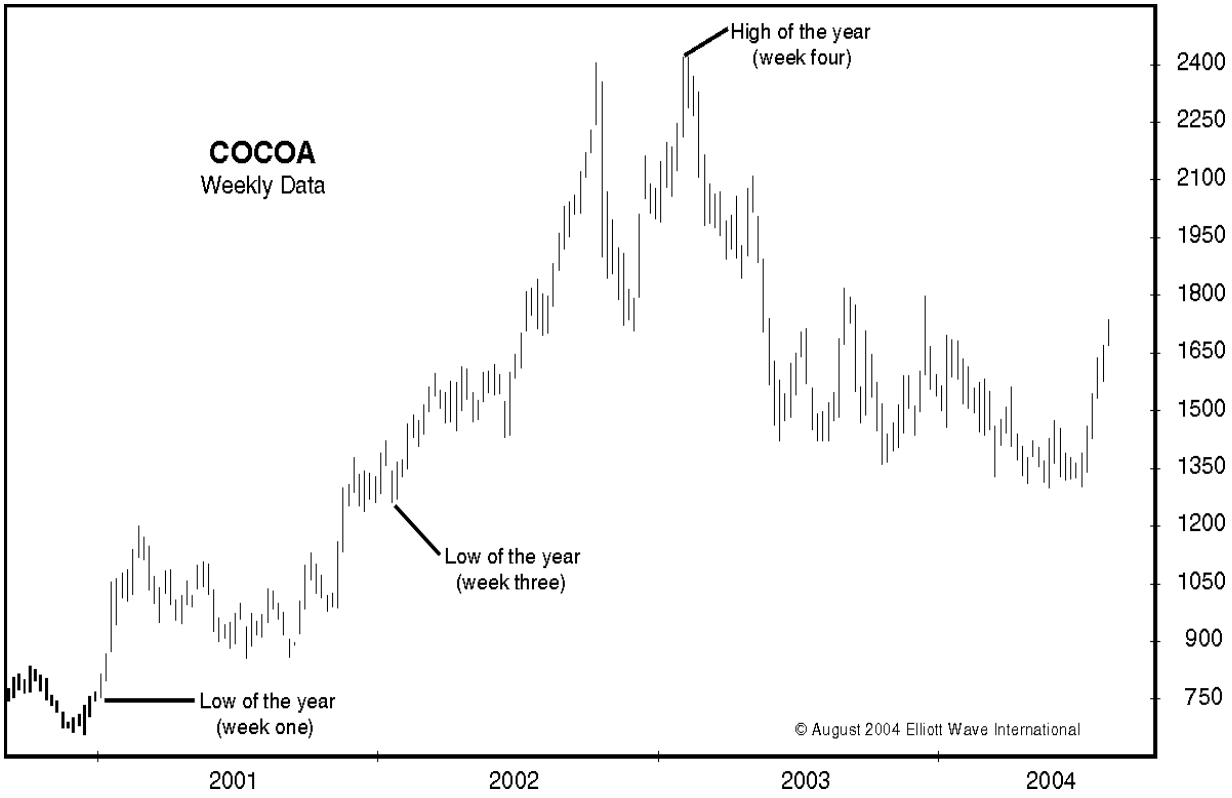


Figure 11-9

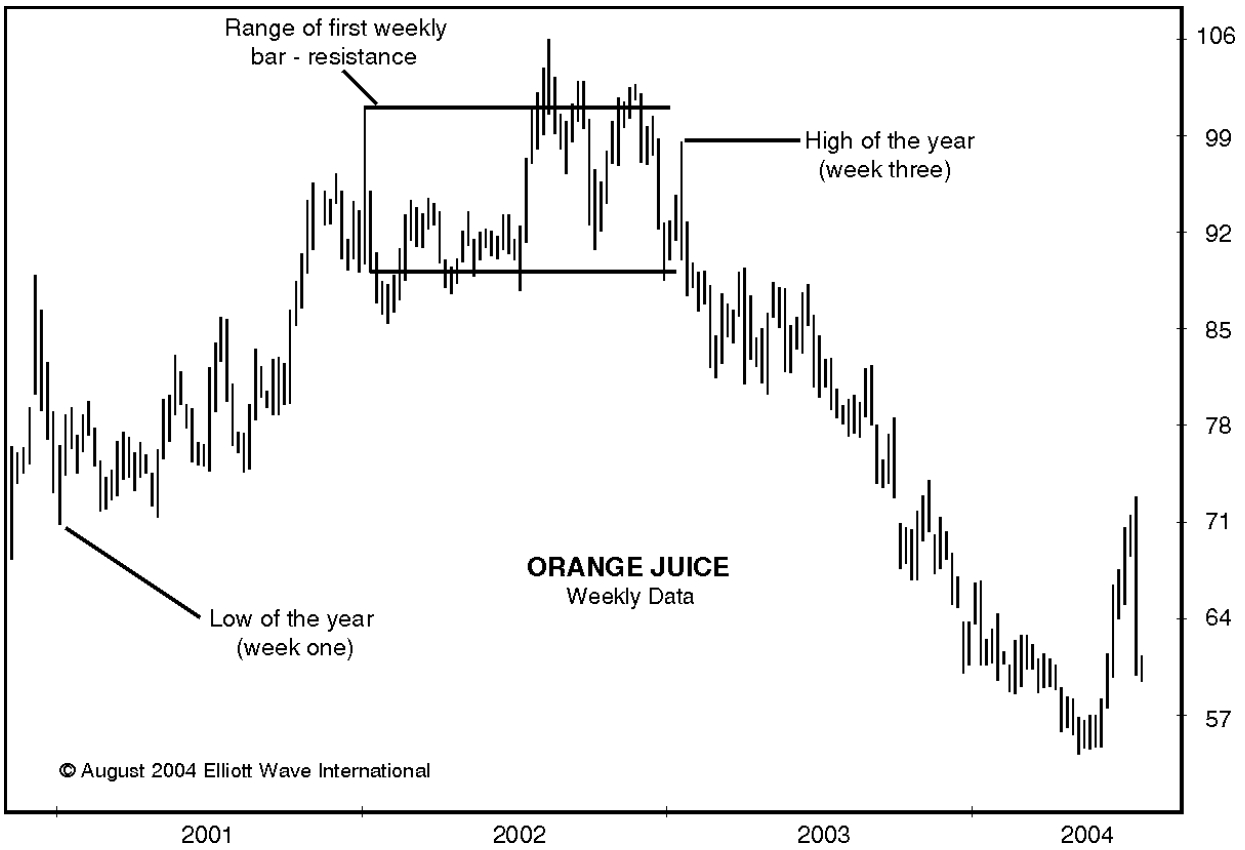


Figure 11-10

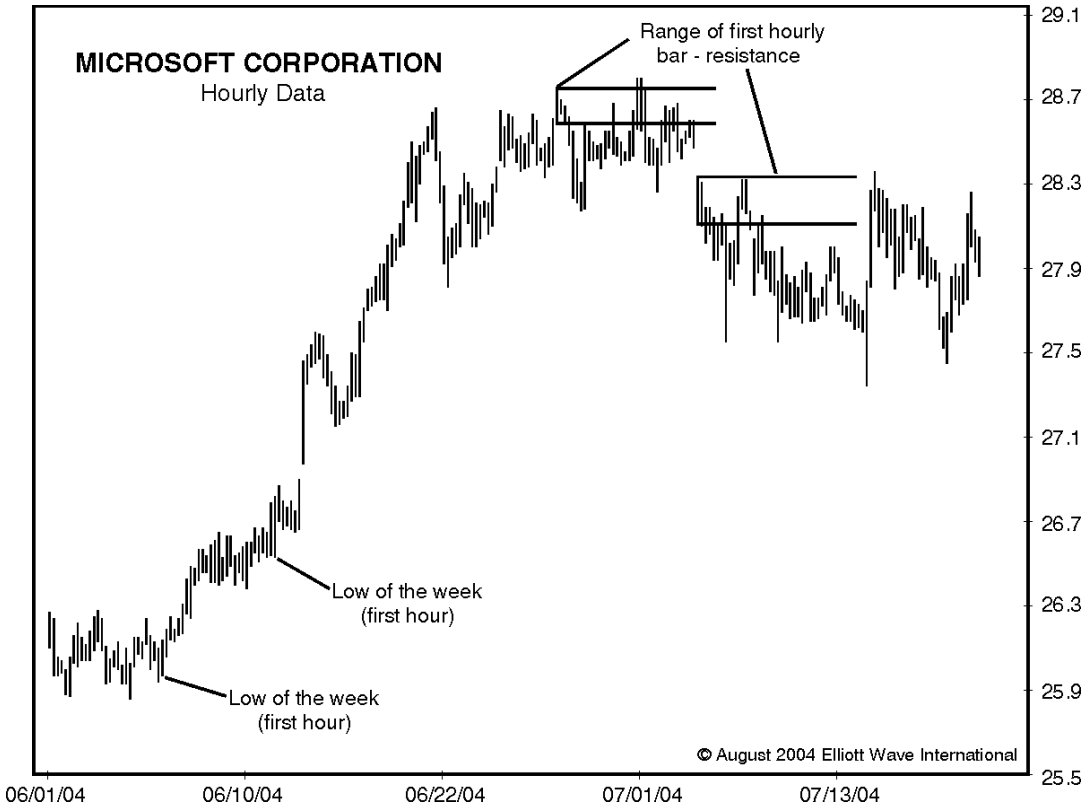


Figure 11-11

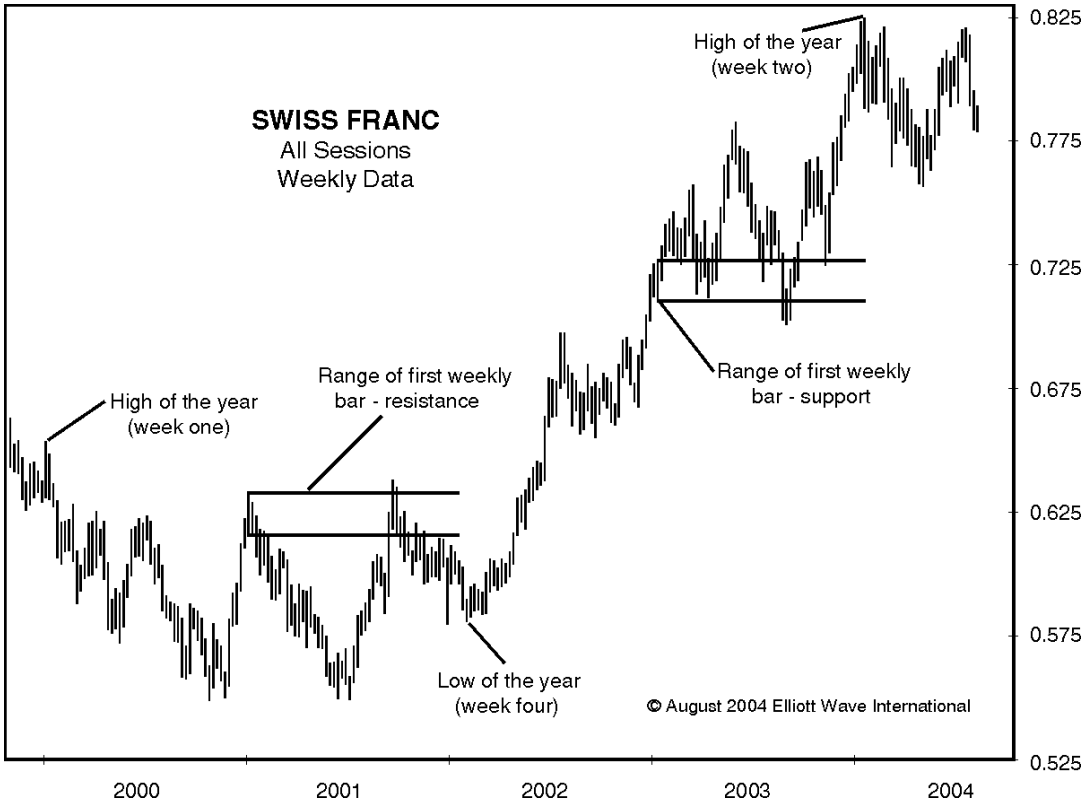


Figure 11-12

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.

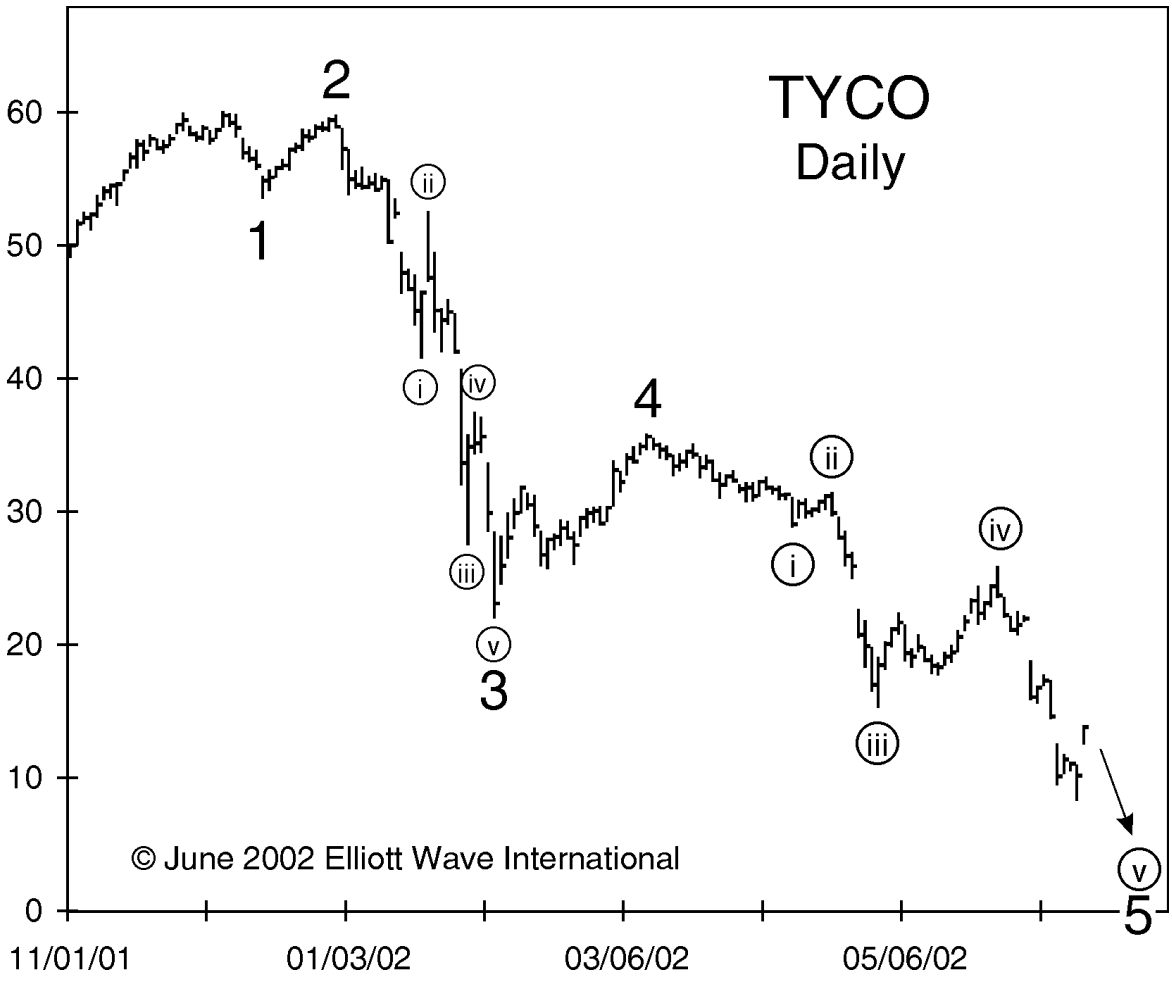


Figure A-1

- 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 ⓘⓘⓘ are both sharp, typical of third waves. Wave 4 and ⓘⓥ 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 ⓘⓘⓘ 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.

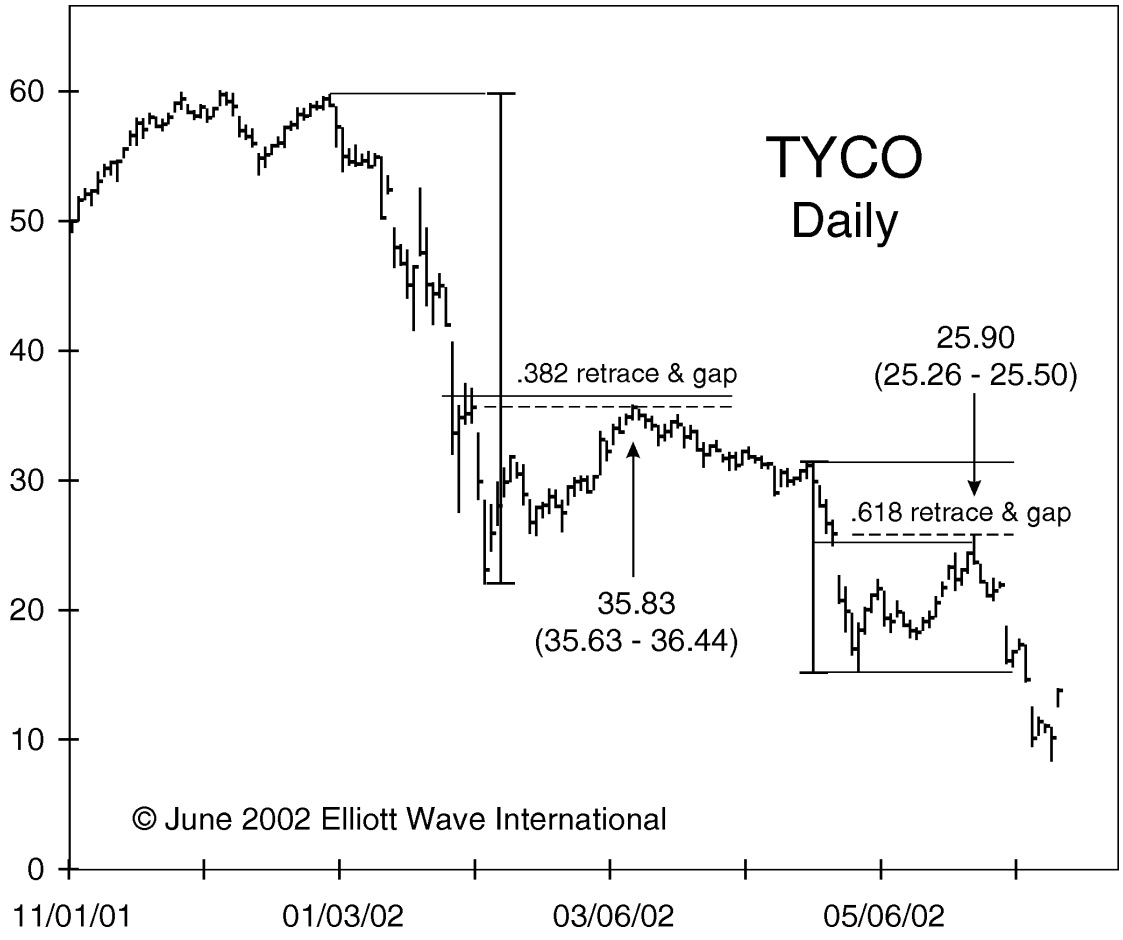


Figure A-2

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).

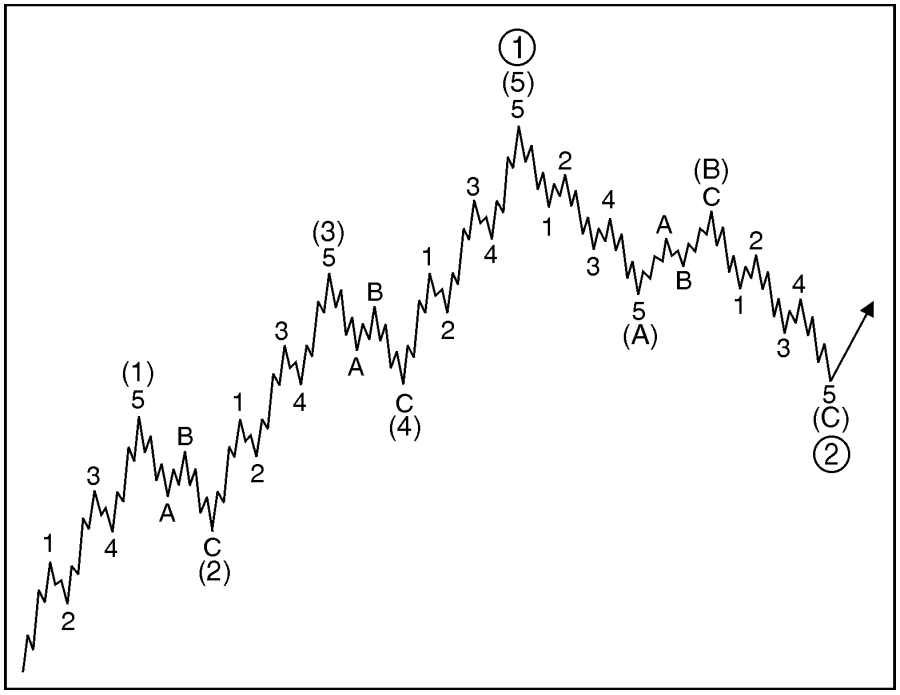


Figure B-1

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	ⓘ	ⓘⓘ	ⓘⓘⓘ	ⓘⓥ	ⓥ	ⓐ	ⓑ	ⓒ
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.

October 2004 – January 2006 Volume 2

Trader's Classroom Collection



More Lessons from *Futures Junctures*

Editor Jeffrey Kennedy

Elliott Wave International © 2004–2006

THE TRADER'S CLASSROOM COLLECTION

Volume 2

Lessons from *Futures Junctures*

Editor Jeffrey Kennedy

Published by

Elliott Wave International

www.elliottwave.com

THE TRADER'S CLASSROOM COLLECTION: Volume 2

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Elliott Wave International, Inc.

For information, address the publishers:

Elliott Wave International

Post Office Box 1618

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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.*

Shortly after we published the original *Trader's Classroom Collection* in late 2004, we realized it would have to be the first of a larger series; the amount of response it engendered was too much to ignore. Now I'm pleased to present Volume 2 of that series.

We have made a few notable changes to *Trader's Classroom* since the first Collection appeared, as part of our ongoing effort to improve *Futures Junctures*. Most obvious are the sixteen new lessons that this eBook comprises, each of which first appeared in *Monthly Futures Junctures* between October 2004 and January 2006. We have also made our trader education program more robust — by incorporating video updates into *Daily Futures Junctures*.

Yet what is at the heart of Trader's Classroom is the same as always. I remain devoted to teaching the methods that I use so that you can avoid learning them the hard way. And whenever I sit down to write a new lesson, my goal never changes — I want to supply a simple explanation of a method that will consistently work in any market and on any timeframe.

All of the following lessons address demands that I face daily as an Elliott wave analyst and trader. Because those demands fall into three broad categories, I tried throughout the last year to select topics that would make this eBook balanced. Sections II-V address how to trade using Elliott wave; sections VI-VIII focus on how to use Fibonacci math to improve your trading; and sections IX-XI show how technical indicators and bar patterns work with the Wave Principle to identify trade opportunities.

I am thrilled to be able to offer all of these lessons in one place at last. After you have had a chance to put these methods into practice, I can only hope that you will share my excitement.

Finally, my thanks go to Sally Webb, David Moore and Aaron Danley for helping me to put together Volume 2.

Welcome to the Trader's Classroom,



Jeffrey Kennedy

Senior Analyst and *Futures Junctures* Editor

Elliott Wave International

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I. What It Takes To Be a Consistently Successful Trader

What does it take to be a consistently successful trader? It takes having a clearly defined trading method and the discipline to follow it. But these, by themselves, aren't enough. Being a consistently successful trader also requires sufficient capital, money management skills and emotional self-control, to name just a few essential traits.

But out of all these characteristics I have mentioned — and the many I haven't — what is the most important quality of a consistently successful trader? I believe it is *patience*: the patience to move on only the highest probability trades.

Let's look at how counting waves and labeling them can teach the importance of being patient. We all know that the Wave Principle categorizes three-wave moves as corrections and, as such, countertrend moves. We also know that corrective moves demonstrate a strong tendency to stay within parallel lines, and that within A-B-C corrections the most common relationship between waves C and A is equality. Furthermore, we know that the .618 retracement of wave one is the most common retracement for second waves, and that the .382 retracement of wave three is the most common retracement for fourth waves.

Knowing that all of these are traits of countertrend moves, why do traders take positions when a pattern demonstrates only one or two of these traits? We do it *because we lack patience*. We lack the patience to wait for opportunities that meet all of our criteria, be it from an Elliott wave or a technical perspective.

What is the source of this impatience? It could be from not having a clearly defined trading methodology or not being able to control emotions. However, I think impatience stems more from a sense of not wanting to miss anything. And because we're afraid of missing the next big move, or perhaps because we want to pick up some lost ground, we act on less-than-ideal trade setups.

Another reason traders lack patience is boredom. That's because – and this may sound odd at first – textbook wave patterns and ideal, high-probability trade setups don't occur all that often. In fact, I have always gone by the rule of thumb that for any given market there are only two or three tradable moves in a specific time frame. For example, during a normal trading day, there are typically only two or three trades that warrant attention from day traders. In a given week, short-term traders will usually find only two or three good opportunities worth participating in, while long-term traders will most likely find only two or three viable trade setups in a given month or even a year.

So as traders wait for these textbook wave patterns and ideal, high-probability trade setups to occur, boredom sets in. Too often, we get itchy fingers and want to trade any pattern that comes along that looks even remotely like a high probability trade setup.

The big question then is, how do you overcome the tendency to be impatient? Understand the triggers that cause it: fear of missing out and boredom. The first step in overcoming impatience is to consciously define the minimum requirements of an acceptable trade setup and vow to accept nothing less. Next, feel comfortable in knowing that the markets will be around tomorrow, next week, next year and beyond, so there is plenty of time to wait for the ideal opportunity. Remember, trading is not a race, and over-trading does little to improve your bottom line.

If there is one piece of advice I can offer that will improve your trading skills, it is simply to be patient. Be patient and wait for only those textbook wave patterns and ideal, high-probability trade setups to act. Because when it comes to being a consistently successful trader, it's all about the *quality* of your trades, not the quantity.

[SEPTEMBER 2005]

II. How the Wave Principle Can Improve Your Trading

Every trader, every analyst and every technician has favorite techniques to use when trading. But where traditional technical studies fall short, the Wave Principle kicks in to show high probability price targets. Just as important, it can distinguish high probability trade setups from the ones that traders should ignore.

Where Technical Studies Fall Short

There are three categories of technical studies: trend-following indicators, oscillators and sentiment indicators. Trend-following indicators include moving averages, Moving Average Convergence-Divergence (MACD) and Directional Movement Index (ADX). A few of the more popular oscillators many traders use today are Stochastics, Rate-of-Change and the Commodity Channel Index (CCI). Sentiment indicators include Put-Call ratios and Commitment of Traders report data.

Technical studies like these do a good job of illuminating the way for traders, yet they each fall short for one major reason: they limit the scope of a trader's understanding of current price action and how it relates to the overall picture of a market. For example, let's say the MACD reading in XYZ stock is positive, indicating the trend is up. That's useful information, but wouldn't it be more useful if it could also help to answer these questions: Is this a new trend or an old trend? If the trend is up, how far will it go? Most technical studies simply don't reveal pertinent information such as the maturity of a trend and a definable price target – but the Wave Principle does.

How Does the Wave Principle Improve Trading?

Here are five ways the Wave Principle improves trading:

1. Identifies Trend

The Wave Principle identifies the direction of the dominant trend. A five-wave advance identifies the overall trend as up. Conversely, a five-wave decline determines that the larger trend is down. Why is this information important? Because it is easier to trade in the direction of the dominant trend, since it is the path of least resistance and undoubtedly explains the saying, "the trend is your friend." Simply put, the probability of a successful commodity trade is much greater if a trader is long Soybeans when the other grains are rallying.

2. Identifies Countertrend

The Wave Principle also identifies countertrend moves. The three-wave pattern is a corrective response to the preceding impulse wave. Knowing that a recent move in price is merely a correction within a larger trending market is especially important for traders, because corrections are opportunities for traders to position themselves in the direction of the larger trend of a market.

3. Determines Maturity of a Trend

As Elliott observed, wave patterns form larger and smaller versions of themselves. This repetition in form means that price activity is fractal, as illustrated in Figure 2-1. Wave (1) subdivides into five small waves, yet is part of a larger five-wave pattern. How is this information useful? It helps traders recognize the maturity of a trend. If prices are advancing in wave 5 of a five-wave advance for example, and wave 5 has already completed three or four smaller waves, a trader knows this is not the time to add long positions. Instead, it may be time to take profits or at least to raise protective stops.

Since the Wave Principle identifies trend, countertrend, and the maturity of a trend, it's no surprise that the Wave Principle also signals the return of the dominant trend. Once a countertrend move unfolds in three waves (A-B-C), this structure can signal the point where the dominant trend has resumed, namely, once price action exceeds the extreme of wave B. Knowing precisely when a trend has resumed brings an added benefit: It increases the probability of a successful trade, which is further enhanced when accompanied by traditional technical studies.

4. Provides Price Targets

What traditional technical studies simply don't offer — high probability price targets — the Wave Principle again provides. When R.N. Elliott wrote about the Wave Principle in *Nature's Law*, he stated that the Fibonacci sequence was the mathematical basis for the Wave Principle. Elliott waves, both impulsive and corrective, adhere to specific Fibonacci proportions, as illustrated in Figure 2-2. For example, common objectives for wave 3 are 1.618 and 2.618 multiples of wave 1. In corrections, wave 2 typically ends near the .618 retracement of wave 1, and wave 4 often tests the .382 retracement of wave 3. These high probability price targets allow traders to set profit-taking objectives or identify regions where the next turn in prices will occur.

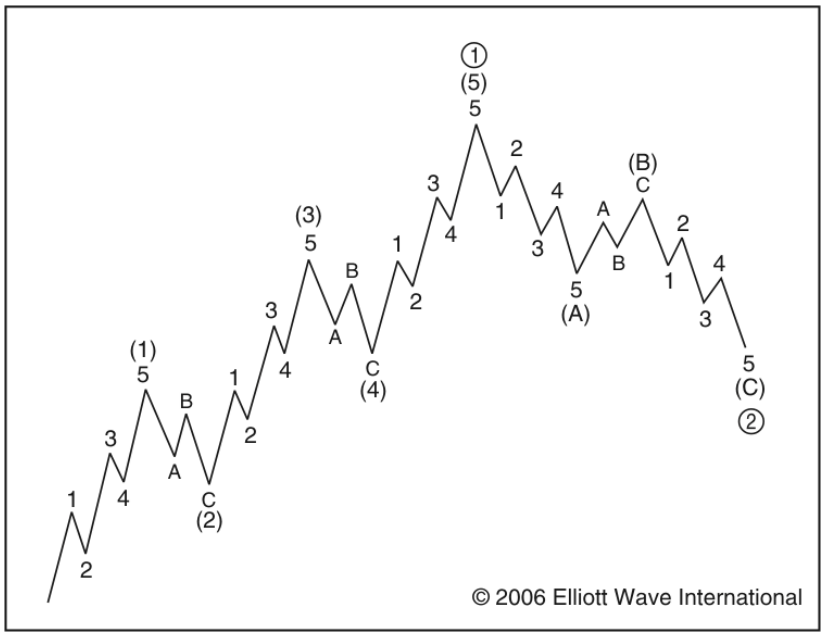


Figure 2-1

5. Provides Specific Points of Ruin

At what point does a trade fail? Many traders use money management rules to determine the answer to this question, because technical studies simply don't offer one. Yet the Wave Principle does — in the form of Elliott wave rules.

Rule 1: Wave 2 can never retrace more than 100% of wave 1.
Rule 2: Wave 4 may never end in the price territory of wave 1.
Rule 3: Out of the three impulse waves — 1, 3 and 5 — wave 3 can never be the shortest.

A violation of one or more of these rules implies that the operative wave count is incorrect. How can traders use this information? If a technical study warns of an upturn in prices, and the wave pattern is a second-wave pullback, the trader knows specifically at what point the trade will fail – a move beyond the origin of wave 1. That kind of guidance is difficult to come by without a framework like the Wave Principle.

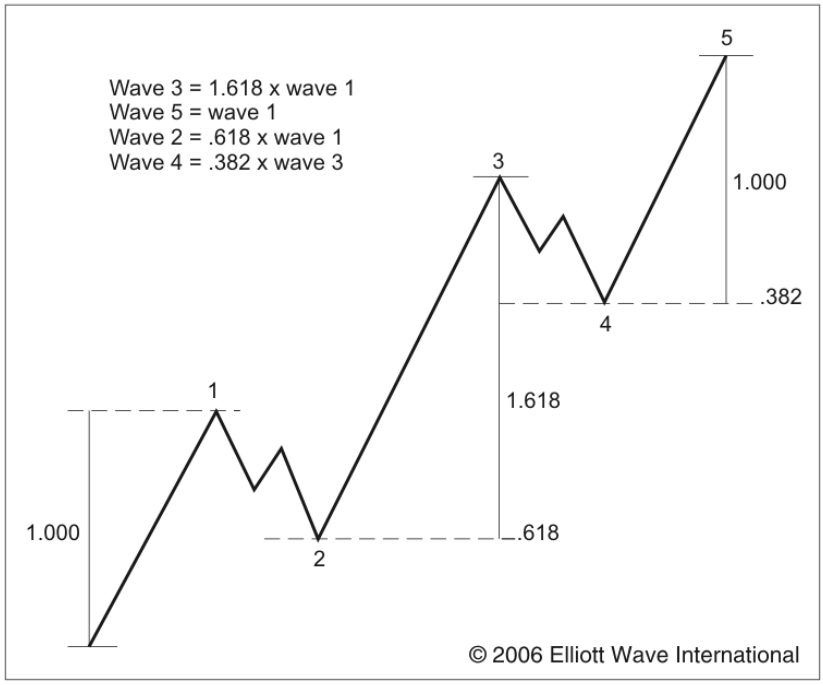


Figure 2-2

What Trading Opportunities Does the Wave Principle Identify?

Here's where the rubber meets the road. The Wave Principle can also identify high probability trades over trade setups that traders should ignore, specifically by exploiting waves (3), (5), (A) and (C).

Why? Since five-wave moves determine the direction of the larger trend, three-wave moves offer traders an opportunity to join the trend. So in Figure 2-3, waves (2), (4), (5) and (B) are actually setups for high probability trades in waves (3), (5), (A) and (C).

For example, a wave (2) pullback provides traders an opportunity to position themselves in the direction of wave (3), just as wave (5) offers them a shorting opportunity in wave (A). By combining the Wave Principle with traditional technical analysis, traders can improve their trading by increasing the probabilities of a successful trade.

Technical studies can pick out many trading opportunities, but the Wave Principle helps traders discern which ones have the highest probability of being successful. This is because the Wave Principle is the framework that provides history, current information and a peek at the future. When traders place their technical studies within this strong framework, they have a better basis for understanding current price action.

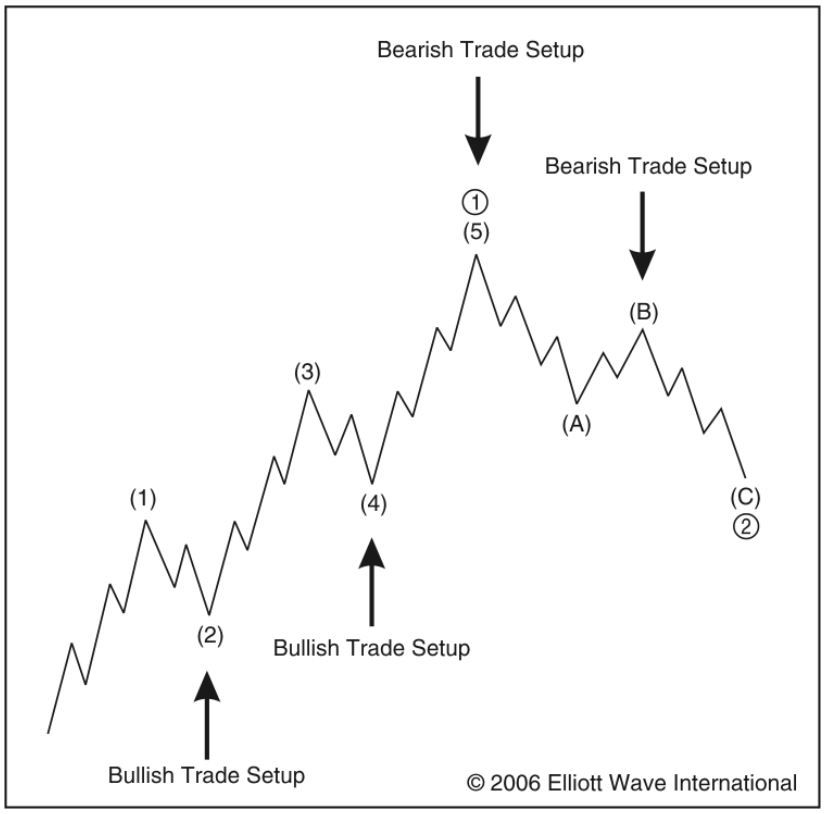


Figure 2-3

[JULY 2005]

III. How To Confirm That You Have the Right Elliott Wave Count

The Wave Principle describes 13 wave patterns – not to mention the additional patterns they make when combined. With so many wave patterns to choose from, ***how do you know if you are working the right wave count?*** Usually, the previous wave in a developing pattern gives the Elliott wave practitioner an outline of what to expect (i.e., wave 4 follows wave 3, and wave C follows wave B). But only after the fact do we know with complete confidence which kind of wave pattern has just unfolded. So as patterns are developing, we are faced with questions like these: It looks like a five-wave advance, but is it wave A, 1 or 3? Here's a three-wave move, but is it wave A, B or X?

How can we tell the difference between a correct and an incorrect labeling? The obvious answer is that prices will move in the *direction* you expect them to. However, the more useful answer to this question, I believe, is that prices will move in the *manner* they are supposed to. For example, within a five-wave move, if wave three doesn't travel the farthest in the shortest amount of time, then odds are that the labeling is incorrect. Yes, I know that sometimes first waves extend and so do fifth waves (especially in commodities), but most typically, prices in third waves travel the farthest in the shortest amount of time. In other words, *the personality of price action will confirm your wave count*.

Each Elliott wave has a distinct personality that supports its labeling. As an example, second waves are most often deep and typically end on low volume. So if you have a situation where prices have retraced a .382 multiple of the previous move and volume is high, odds favor the correct labeling as wave B of an A-B-C correction and not wave 2 of a 1-2-3 impulse. Why? Because what you believe to be wave 2 doesn't have the personality of a corrective wave 2.

Prechter and Frost's *Elliott Wave Principle* describes the personality of each Elliott wave (see *EWP*, pp. 78-84). But here's a shortcut for starters: Before you memorize the personality of each Elliott wave, learn the overall personalities of impulse and corrective waves:

- **Impulse waves** always subdivide into five distinct waves, and they have an energetic personality that likes to cover a lot of ground in a short time. That means that prices travel far in a short period, and that the angle or slope of an impulse wave is steep.

- **Corrective waves** have a sluggish personality, the opposite of impulse waves. They are slow-moving affairs that seemingly take days and weeks to end. During that time, price tends not to change much. Also, corrective wave patterns tend to contain numerous overlapping waves, which appear as choppy or sloppy price action.

To apply this "wave personality" approach in real time, let's look at two daily price charts for Wheat, reprinted from the August and September 2005 issues of *Monthly Futures Junctures.*

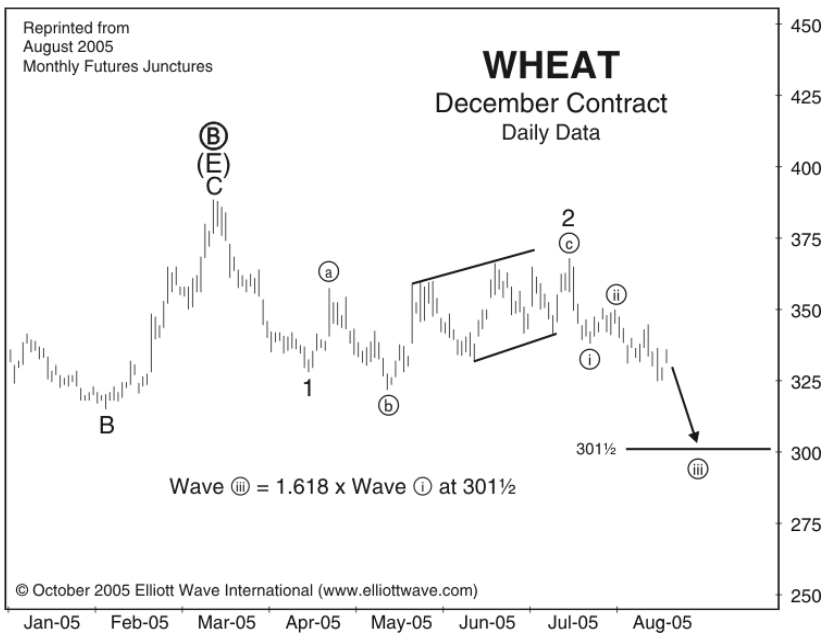


Figure 3-1

Figure 3-1 from August shows that I was extremely bearish on Wheat at that time, expecting a massive selloff in wave three-of-three. Yet during the first few weeks of September, the market traded lackadaisically. Normally this kind of sideways price action would have bolstered the bearish labeling, because it's typical of a

corrective wave pattern that's fighting the larger trend. However, given my overriding one-two, one-two labeling, we really should have been seeing the kind of price action that our wave count called for: sharp, steep selling in wave three-of-three.

It was precisely because I noticed that the personality of the price action didn't agree with the labeling that I decided to rework my wave count. You can see the result in Figure 3-2, which calls for a much different outcome from the one forecast by Figure 3-1. In fact, the labeling in Figure 3-2 called for a bottom to form soon, followed by a sizable rally. Even though the moderate new low I was expecting did not materialize, the sizable advance did: In early October 2005, Wheat rallied as high as 353.

So that's how I use personality types to figure out whether my wave labels are correct. If you follow the big picture of energetic impulse patterns and sluggish corrective patterns, it should help you match price action with the appropriate wave or wave pattern.

[OCTOBER 2005]

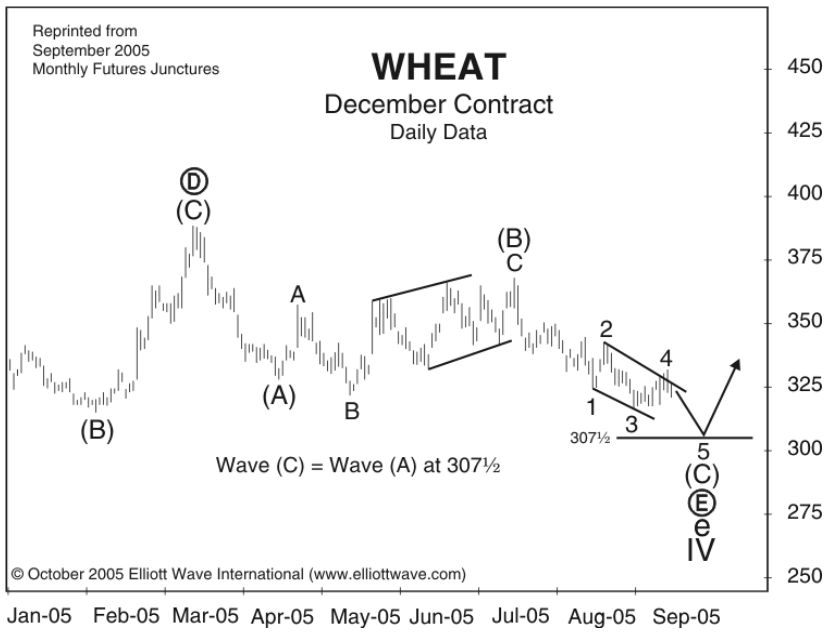


Figure 3-2

IV. How To Use the Wave Principle To Set Protective Stops

I've noticed that although the Wave Principle is highly regarded as an analytical tool, many traders abandon it when they trade in real-time – mainly because they don't think it provides the defined rules and guidelines of a typical trading system.

But not so fast – *although the Wave Principle isn't a trading "system," its built-in rules do show you where to place protective stops in real-time trading.* And that's what I'm going to show you in this lesson.

Over the years that I've worked with Elliott wave analysis, I've learned that you can glean much of the information that you require as a trader – such as where to place protective or trailing stops – from the three cardinal rules of the Wave Principle:

1. Wave two can never retrace more than 100% of wave one.
2. Wave four may never end in the price territory of wave one.
3. Wave three may never be the shortest impulse wave of waves one, three and five.

Let's begin with rule No. 1: Wave two will never retrace more than 100% of wave one. In Figure 4-1, we have a five-wave advance followed by a three-wave decline, which we will call waves (1) and (2). An important thing to remember about second waves is that they usually retrace more than half of wave one, most often a making a .618 Fibonacci retracement of wave one. So in anticipation of a third-wave rally – which is where prices normally travel the farthest in the shortest amount of time – you should look to buy at or near the .618 retracement of wave one.

Where to place the stop: Once a long position is initiated, a protective stop can be placed one tick below the origin of wave (1). If wave two retraces more than 100% of wave one, the move can no longer be labeled wave two.

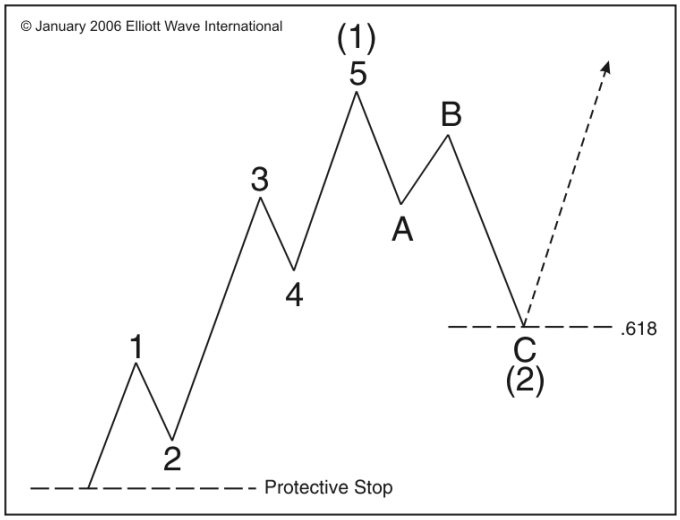


Figure 4-1

Now let's examine rule No. 2: Wave four will never end in the price territory of wave one. This rule is useful because it can help you set protective stops in anticipation of catching a fifth-wave move to new highs. The most common Fibonacci retracement for fourth waves is .382 of wave three. So after a sizable advance in price in wave three, you should look to enter long positions following a three-wave decline that ends at or near the .382 retracement of wave three.

Where to place the stop: As shown in Figure 4-2, the protective stop should go one tick below the extreme of wave (1). Something is wrong with the wave count if what you have labeled as wave four heads into the price territory of wave one.

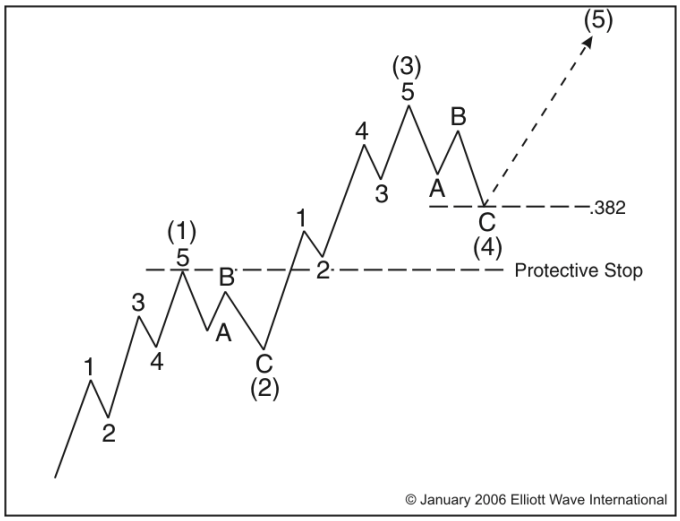


Figure 4-2

And, finally, rule No. 3: Wave three will never be the shortest impulse wave of waves one, three and five. Typically, wave three is the wave that travels the farthest in an impulse wave or five-wave move, but not always. In certain situations (such as within a Diagonal Triangle), wave one travels farther than wave three.

Where to place the stop: When this happens, you can consider a short position with a protective stop one tick above the point where wave (5) becomes longer than wave (3) (see Figure 4-3). Why? If you have labeled price action correctly, wave five will not surpass wave three in length; when wave three is already shorter than wave one, it cannot also be shorter than wave five. So if wave five does cover more distance in terms of price than wave three — thus breaking Elliott's third cardinal rule — then it's time to re-think your wave count.

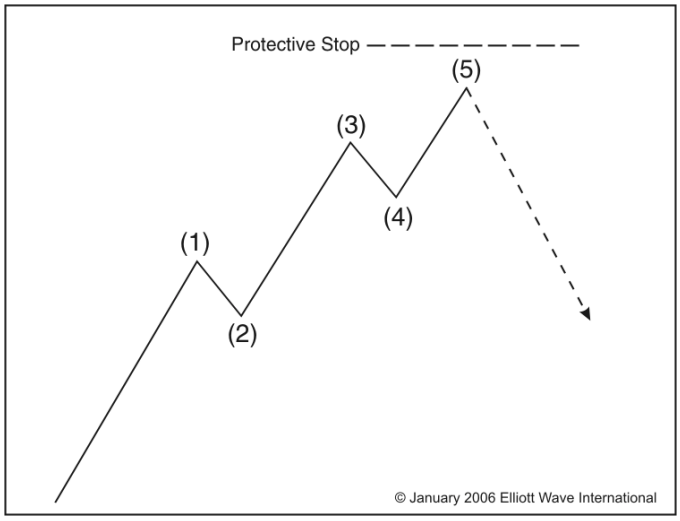


Figure 4-3

[January 2006]

V. Why Elliott's Guideline of Alternation Is Indispensable

In addition to the three cardinal rules of the Wave Principle, there are also a number of Elliott wave guidelines. These rules of thumb help to guide an Elliott wave practitioner through the complexities of a price chart and an unfolding wave pattern.

One of the most useful guidelines is *alternation*. The guideline of alternation tells us to expect a difference in the next expression of a similar wave. Specifically for impulse waves (five-wave moves), this guideline means that if wave two is sharp, wave four will often unfold in a sideways pattern, and vice versa. Sharp corrections are almost always zigzags. Sideways corrections include flats, triangles and double- and triple-three corrections. One easy way to tell the difference between a sharp correction and a sideways correction: sharp corrections never include a new price extreme, and sideways corrections often do.

While the guideline of alternation is usually applied to impulse waves, it's important to know that the guideline also applies to corrective waves: sometimes wave A alternates with wave B, and sometimes wave A alternates with wave C.

Figures 5-1 and 5-2 illustrate two different examples of A-B alternation. In Figure 5-1, notice that wave A is a flat correction (sideways), and wave B is a zigzag (sharp). Figure 5-2 shows the same tendency, but in reverse — wave A is a sharp correction, and wave B is a sideways correction.

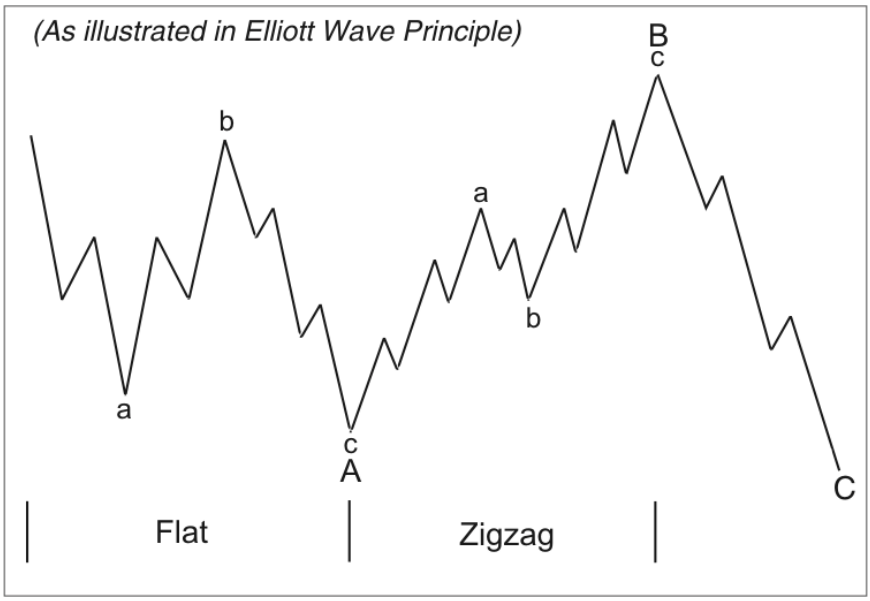


Figure 5-1

Note: Figures 5-1 through 5-3 come from Elliott Wave Principle*, pp. 65-66*

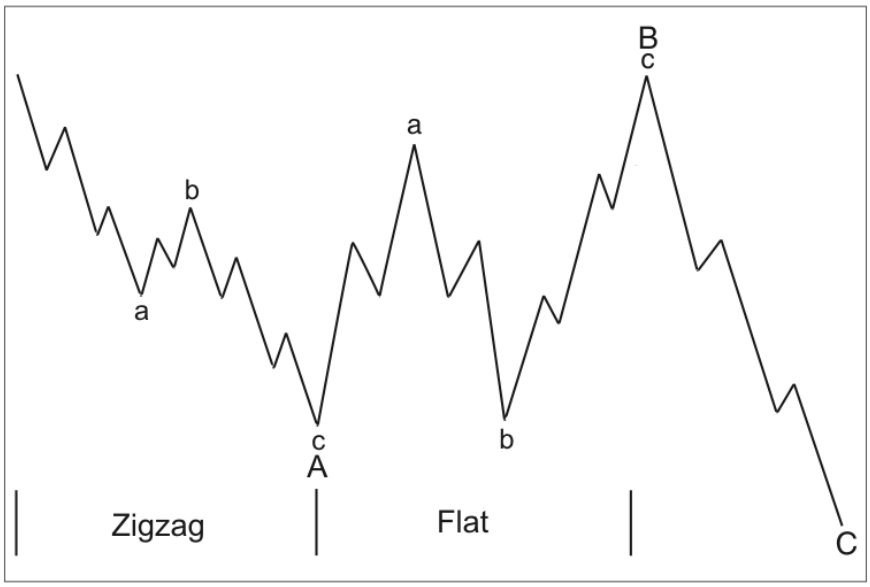


Figure 5-2

Figure 5-3 shows a more nuanced application of this guideline. Here, you'll see that wave A is simple, wave B is complex and wave C is even more complex. As the guideline states, expect a difference in the next expression of a similar wave, just as it is shown here.

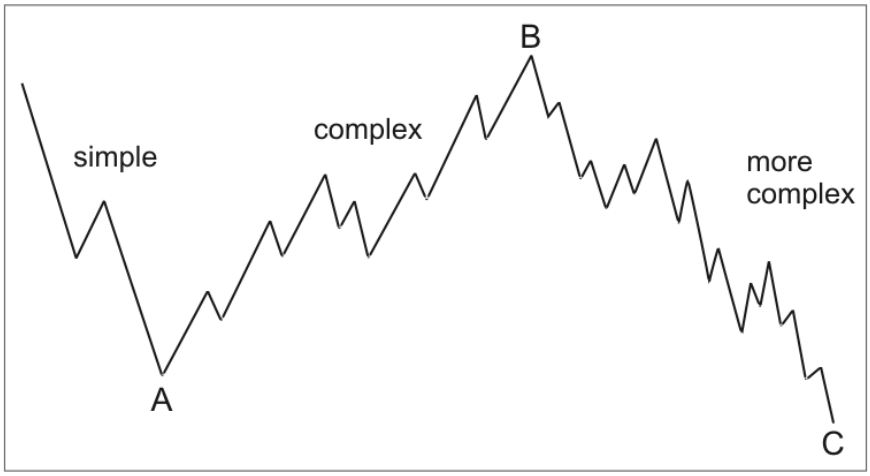


Figure 5-3

Figures 5-4 and 5-5 illustrate my favorite variation of this same theme — alternation between waves A and C. Notice that in Figure 5-4, wave A is simple, and wave C is complex. In Figure 5-5, just the opposite is shown: wave A is complex, and wave C is simple. I have seen this particular application of the guideline of alternation unfold real-time in many different markets and time frames. Simply observing how simple or complex wave A is at its completion can help you make a confident forecast about the way wave C will develop. I've found that this holds true on charts for all time frames.

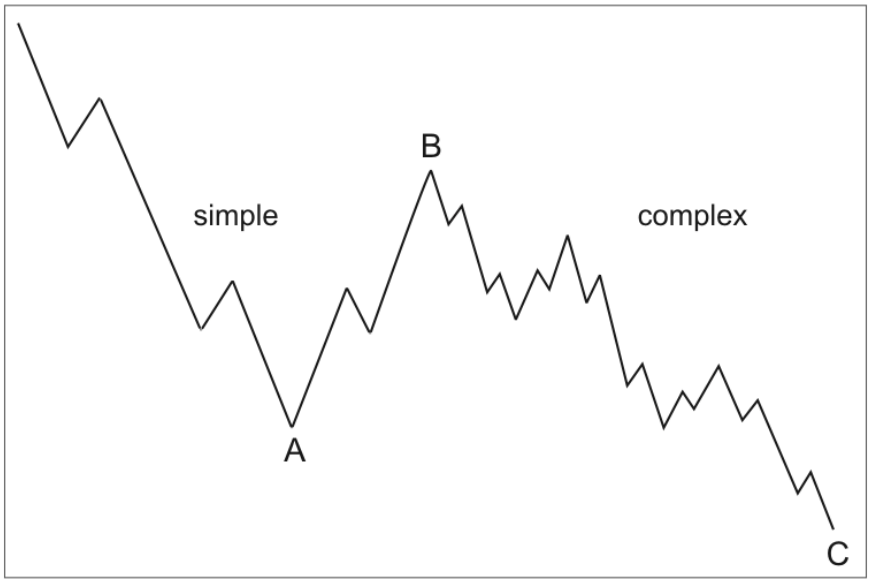


Figure 5-4

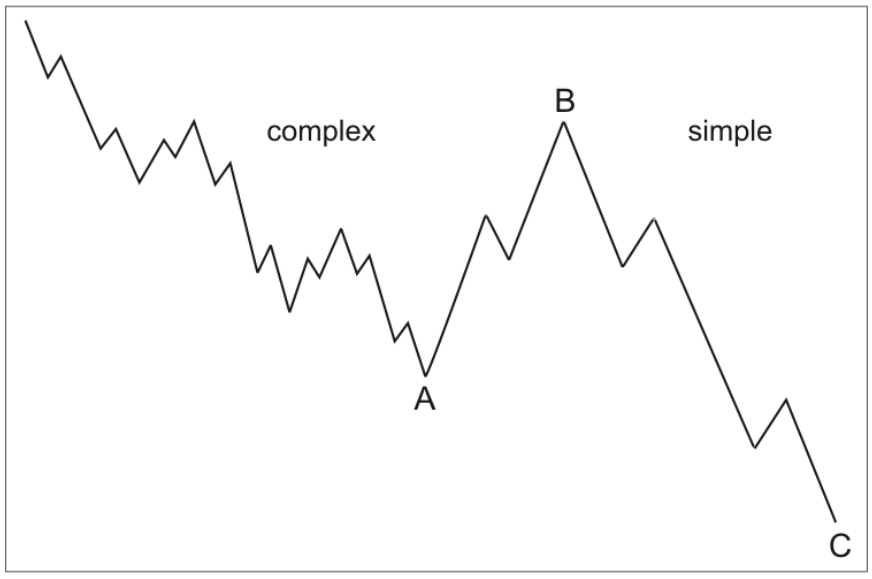


Figure 5-5



Figure 5-6

Figure 5-6 shows an excellent example of the guideline of alternation. Notice that wave A is a complex structure and that wave C is a simple structure. This three-wave move was wave B of a larger fourth wave contracting triangle illustrated in Figure 5-7.

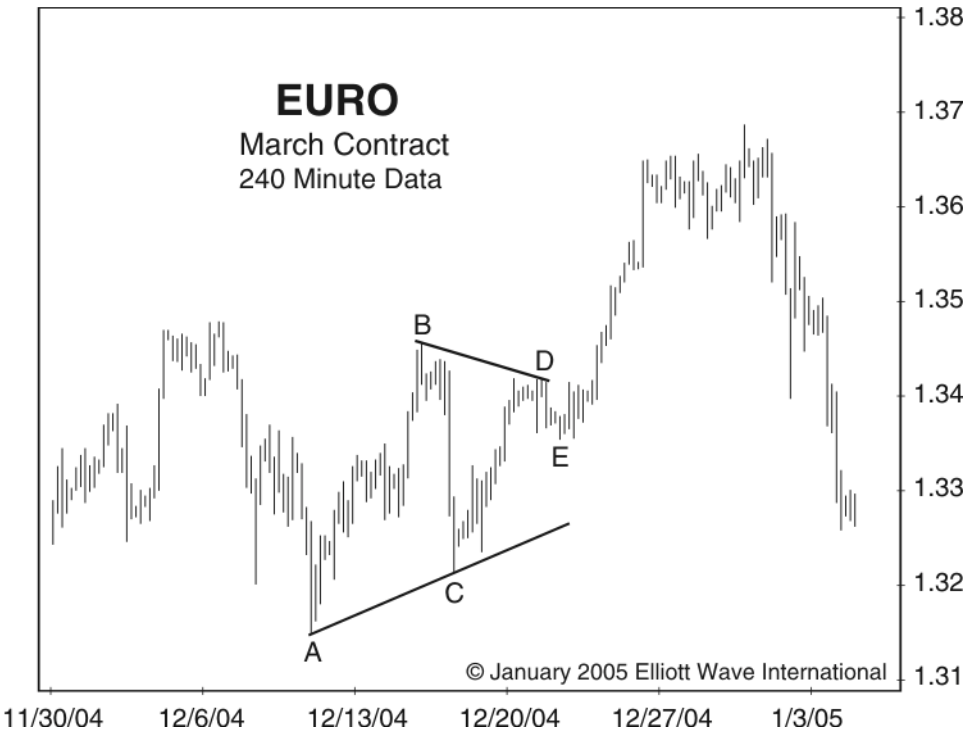


Figure 5-7

Sugar (Figure 5-8) provides us with another example of the guideline of alternation within corrective waves, as does UPL (Figure 5-9).

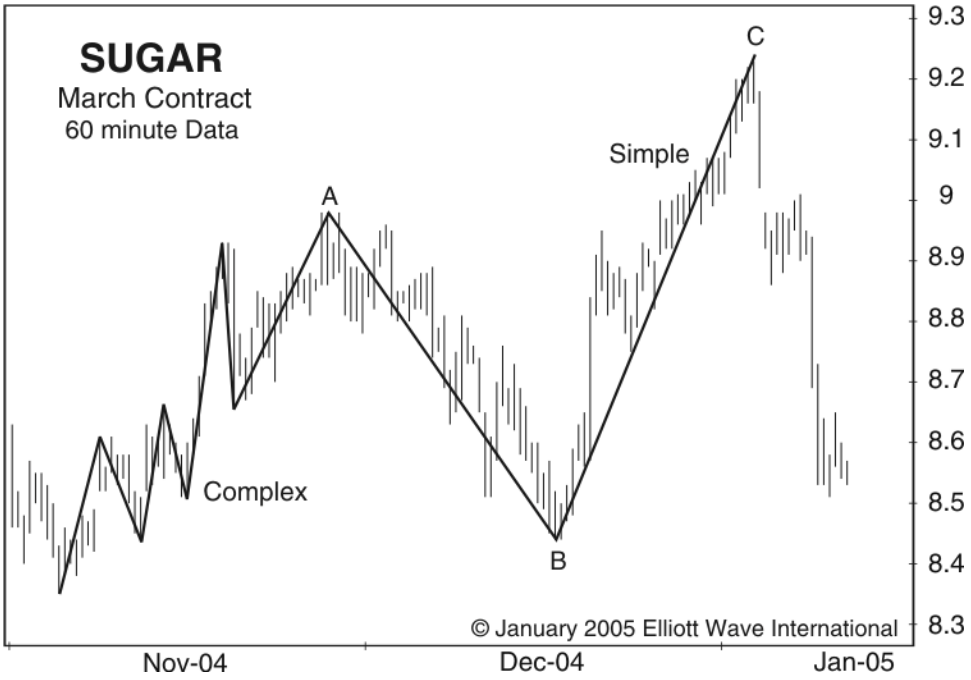


Figure 5-8

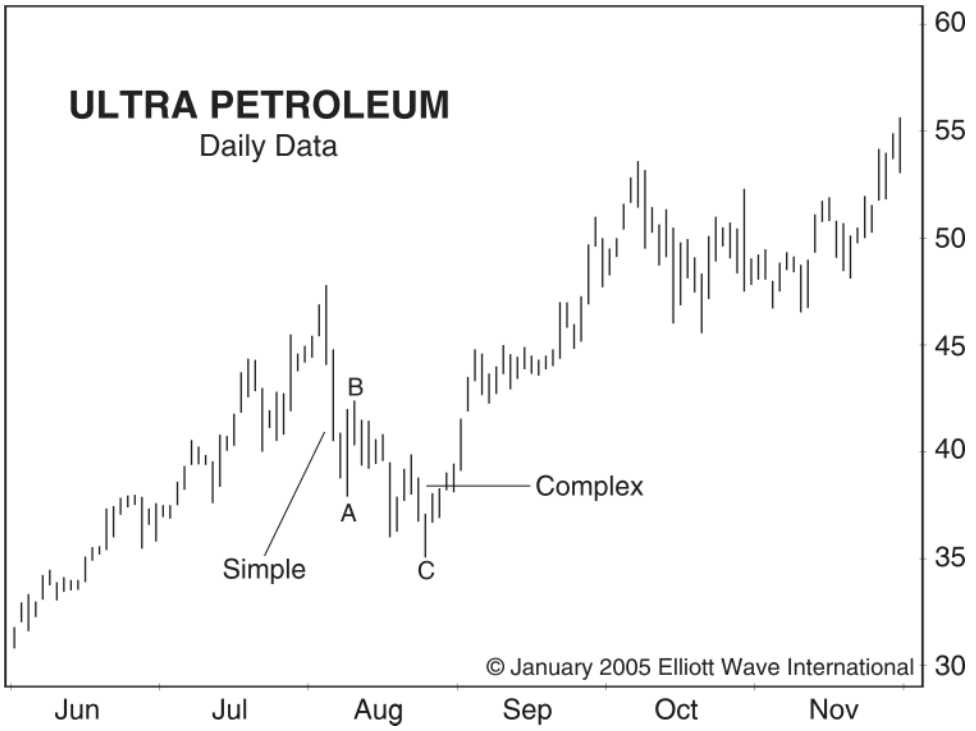


Figure 5-9

How does understanding the guideline of alternation help traders? It gives us a better idea of what to expect as a corrective wave pattern unfolds. I believe knowing how to put this guideline into practice also aids us in more accurately timing the end of corrective moves, which provides our best opportunity to rejoin the larger trend.

[JANUARY 2005]

VI. How "Diagonal Triangles" Can Expand Your Trading Opportunities

One of my favorite Elliott wave patterns to trade is the Diagonal Triangle. Why? Because Diagonal Triangles are terminating waves that introduce swift, tradable moves in price. Furthermore, they provide specific protective stop levels and trade objectives. Normally, once a Diagonal Triangle is complete, the end can act as a protective stop, while the origin of the pattern supplies a minimum objective for a trade.

The Converging Diagonal Triangle is the most common type. It consists of five waves that each subdivide into three smaller waves (Figure 6-1). The other variety, the Expanding Diagonal Triangle (Figure 6-2), is less common. Although it has the opposite shape of the Converging Diagonal Triangle, it is also made up of five waves that each subdivide into three smaller waves.

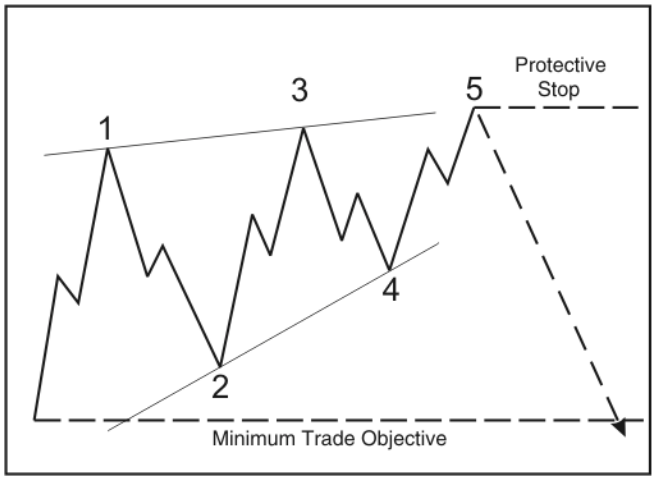


Figure 6-1

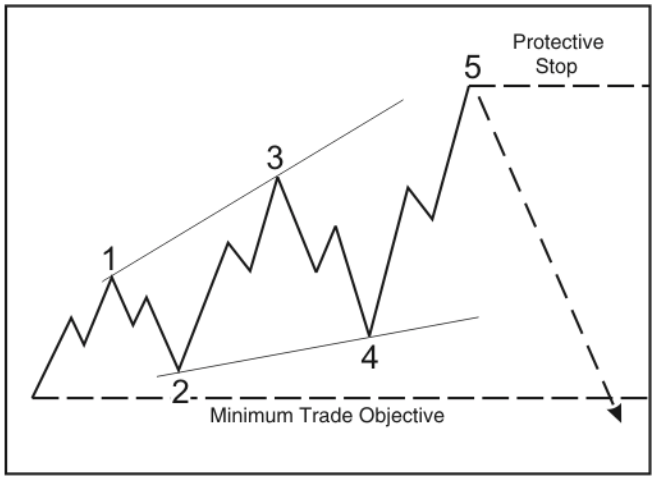


Figure 6-2

Figure 6-3 (Feeder Cattle) shows a textbook example of an Expanding Diagonal Triangle. As you can see, it resulted in a swift, tradable move down in price to below its origin.

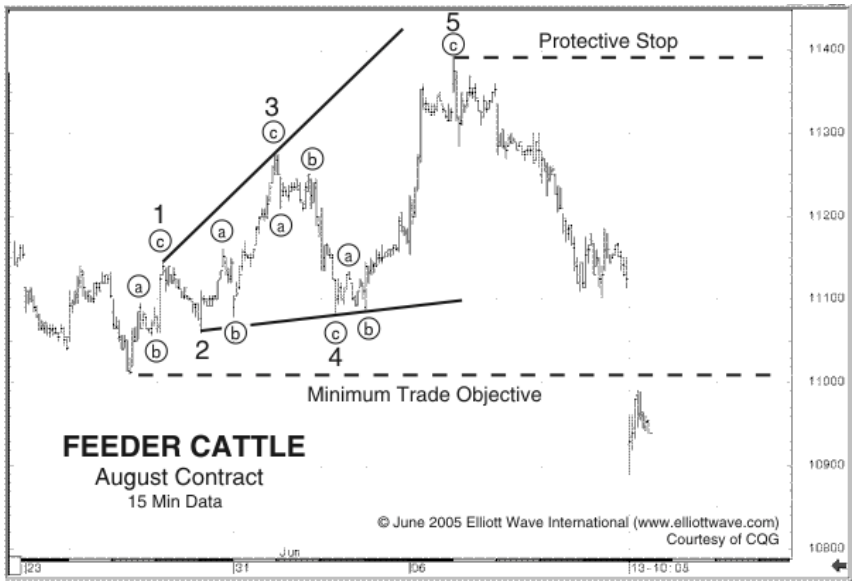


Figure 6-3

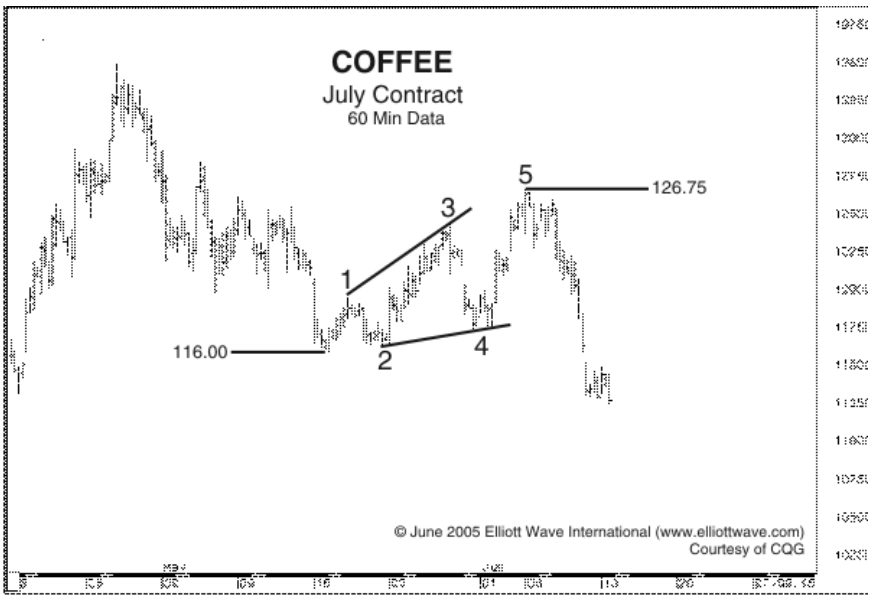


Figure 6-4

On occasion though, what may first appear to be a Diagonal Triangle cannot be labeled as such upon closer examination. For example, in Figure 6-4 (Coffee), the advance from 116.00 to 126.75 looks like an Expanding Diagonal Triangle. However, when labeled properly (Figure 6-5), this move up turns out to be a Zigzag pattern instead. And because Diagonal Triangles are terminating waves, they cannot occur in the wave B position of a corrective pattern.

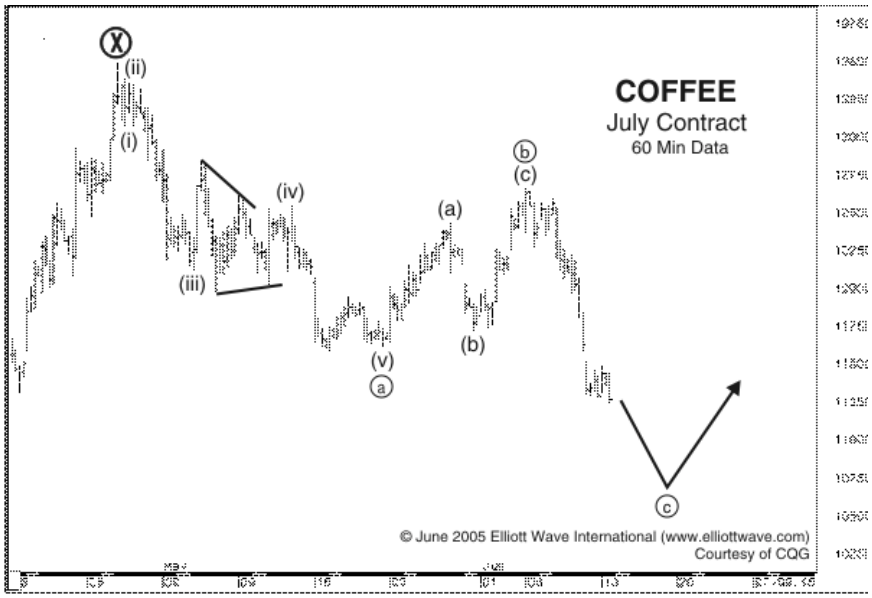


Figure 6-5

But notice the resolution of this particular formation: The swift, tradable move down in price to below the pattern's origin (116.00) is exactly what you would expect from a Diagonal Triangle . So here's the message: even if a five-wave overlapping move isn't a textbook Diagonal Triangle, I think it's still worthy of consideration as a potential trade.

Even though these uncommon Expanding Diagonal Triangles don't get written about much, I have focused on them because they still present high probability trade setups with definable risk and objectives.

[JUNE 2005]

VII. How To Apply Fibonacci Math to Real-World Trading

Have you ever given an expensive toy to a small child and watched while the child had less fun playing with the toy than with the box that it came in? In fact, I can remember some of the boxes I played with as a child that became spaceships, time machines or vehicles to use on dinosaur safaris.

In many ways, Fibonacci math is just like the box that kids enjoy playing with imaginatively for hours on end. It's hard to imagine a wrong way to apply Fibonacci ratios or multiples to financial markets, and new ways are being tested every day. Let's look at just some of the ways that I apply Fibonacci math in my own analysis.

• Fibonacci Retracements

Financial markets demonstrate an uncanny propensity to reverse at certain Fibonacci levels. The most common Fibonacci ratios I use to forecast retracements are .382, .500 and .618. On occasion, I find .236 and .786 useful, but I prefer to stick with the big three. You can imagine how helpful these can be: Knowing where a corrective move is likely to end often identifies high probability trade setups (Figures 7-1 and 7-2).



Figure 7-1

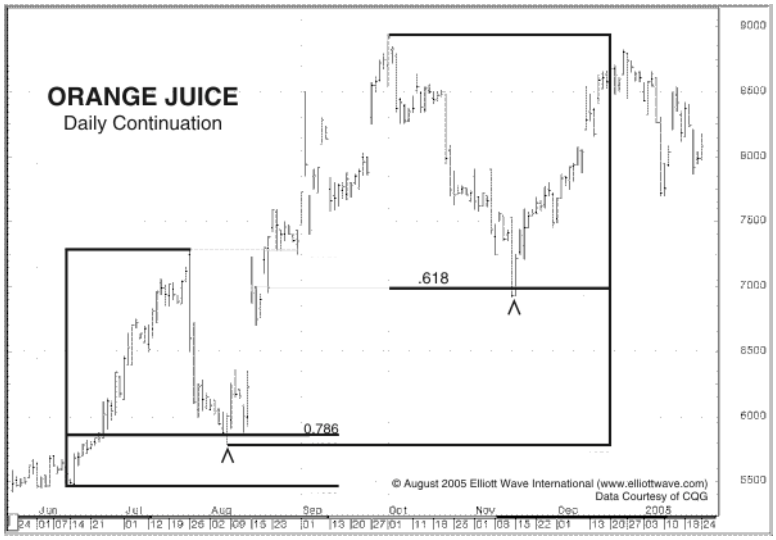


Figure 7-2

• Fibonacci Extensions

Elliotticians often calculate Fibonacci extensions to project the length of Elliott waves. For example, third waves are most commonly a 1.618 Fibonacci multiple of wave one, and waves C and A of corrective wave patterns often reach equality (Figures 7-3 and 7-4).

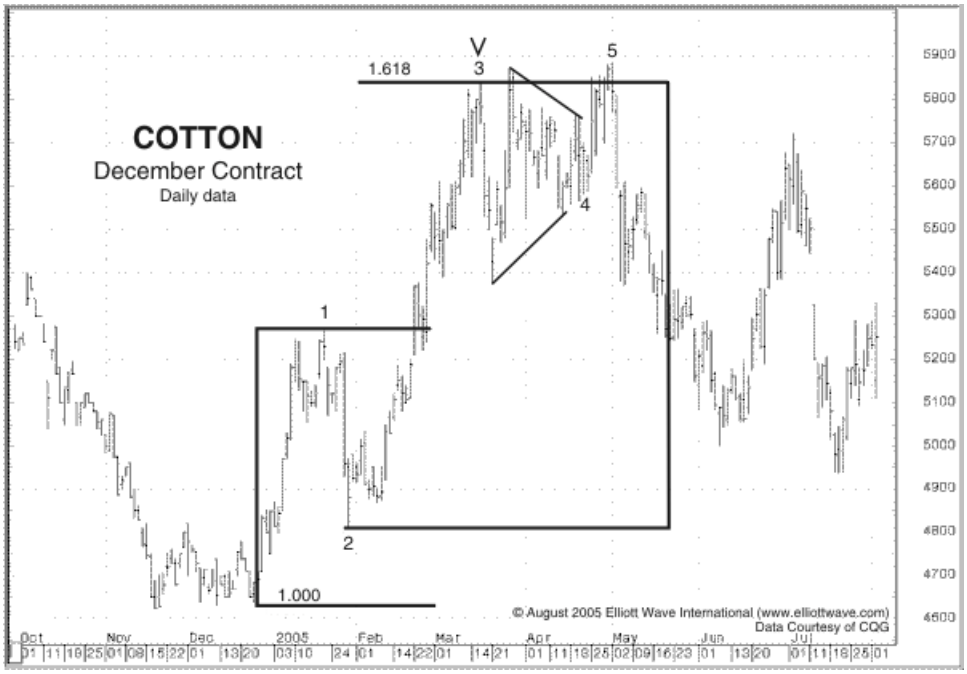


Figure 7-3

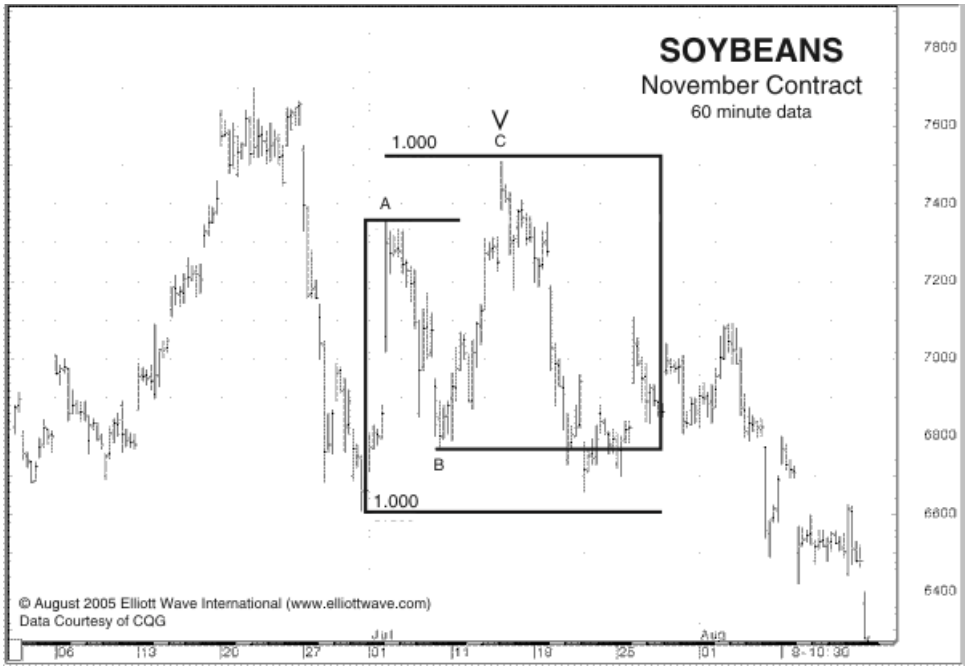


Figure 7-4

One approach I like and have used for a number of years is a "reverse Fibonacci" application, which uses primarily 1.382 and 2.000 multiples of previous swings to project a price target for the current wave (see Figure 7-5). I have found that this method has a lot of value, especially when it comes to identifying trade objectives.

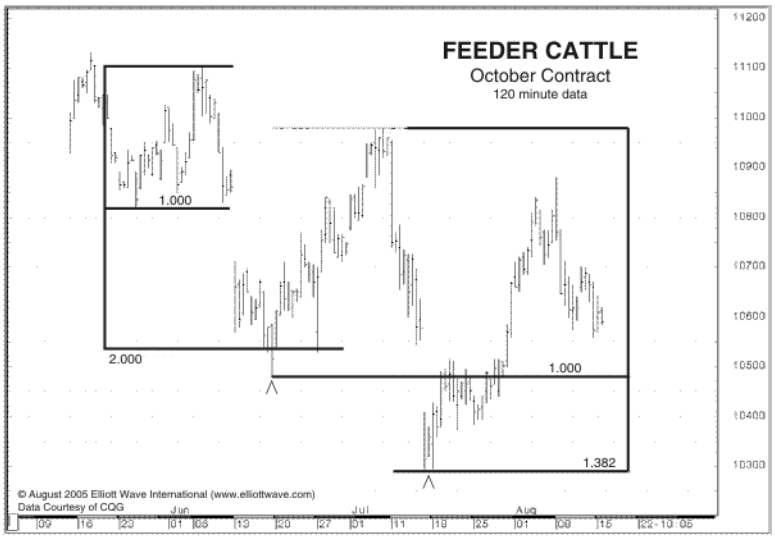


Figure 7-5

• Fibonacci Circles

Fibonacci circles are an exciting way to use Fibonacci ratios, because they take into account both linear price measurements and time. Notice in Figure 7-6 how the January 2005 advance in Cotton ended right at the 2.618 Fibonacci circle or multiple of the previous swing. Again in Figure 7-7, we see how resistance created by the 2.618 multiple of a previous swing provided excellent resistance for the February rally in Wheat. Moreover, the arc created by this Fibonacci circle provided solid resistance for price action during July and August of that year as well.

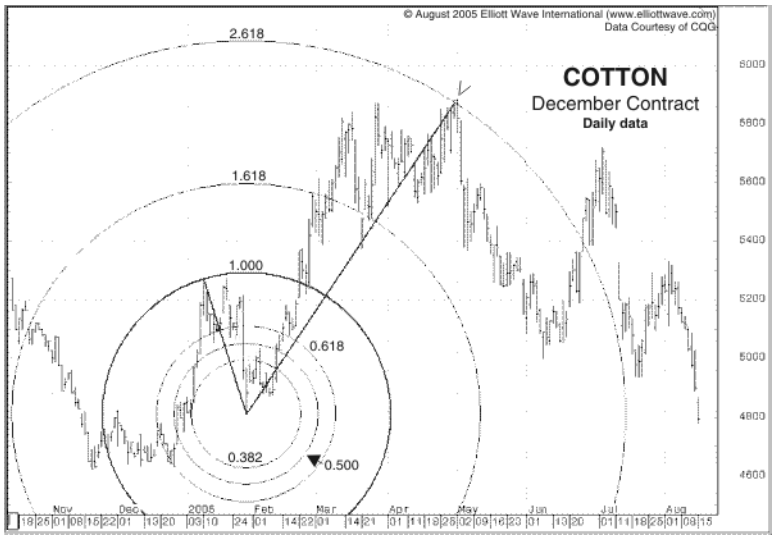


Figure 7-6

Fibonacci circles are an exciting way to use Fibonacci ratios, but they come with a word of warning: because this technique introduces time into the equation, it is scale-sensitive, meaning that compression data will sometimes distort the outcome.

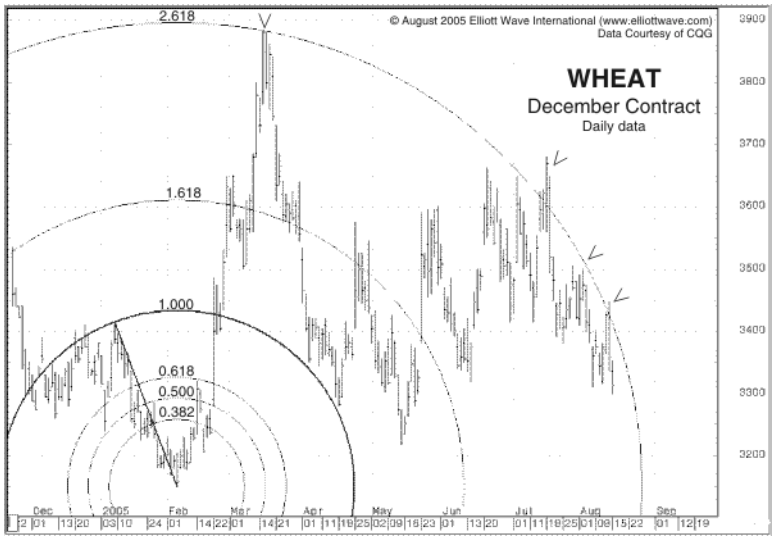


Figure 7-7

• Fibonacci Fan

The Fibonacci fan is another exciting approach using Fibonacci retracements and multiples that involve time. Notice how the .500 Fibonacci fan line in Figure 7-8 identified formidable resistance for Cocoa in June 2005. A Fibonacci fan line drawn from the March and June peaks came into play in July and again in August by identifying support and resistance (i.e., 1.618 and 1.000) (Figure 7-9).

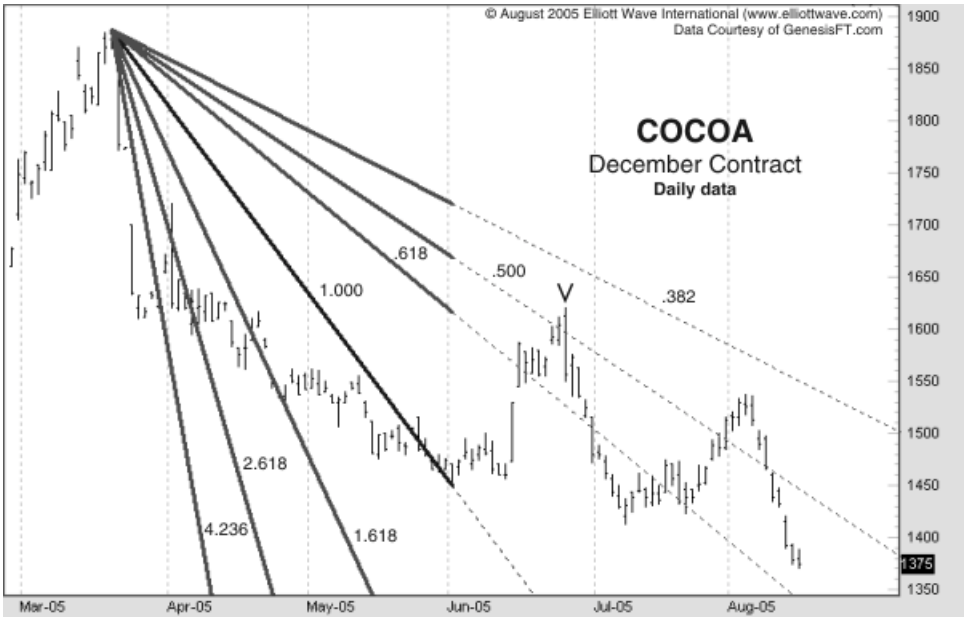


Figure 7-8

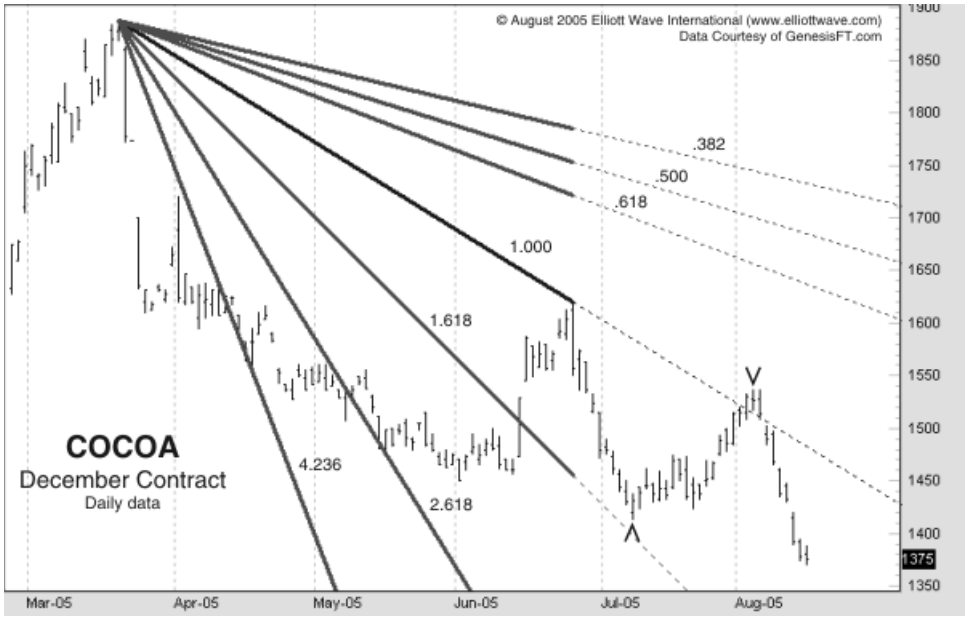


Figure 7-9

• Fibonacci Time

And, finally, there is Fibonacci time. Figure 7-10 illustrates probably the most common approach to using Fibonacci ratios to identify turning points in financial markets. As you can see, it simply requires multiplying the distance in time between two important extremes by Fibonacci ratios and projecting the results forward in time. This timing approach identified two excellent selling points in Pork Bellies, one of which was the market's all-time high, which occurred at 126.00 in May of 2004.

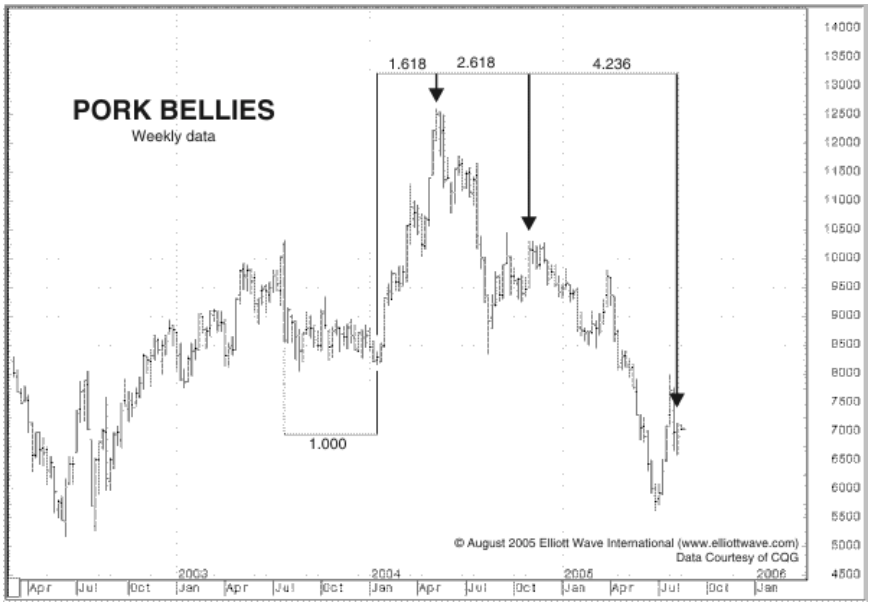


Figure 7-10

Another way to time potential turns in financial markets is to use the Fibonacci sequence itself (i.e., 1, 1, 2, 3, 5, 8, 13, 21, etc.). In Wheat, beginning on March 15, 2005 it is easy to see how this approach successfully identified several significant turns in price (Figure 7-11). Also notice how this methodology points to early October as potentially important. [Editor's note: Wheat prices made two-month highs with a double top on September 30 and October 12, then fell 14% into late November.]

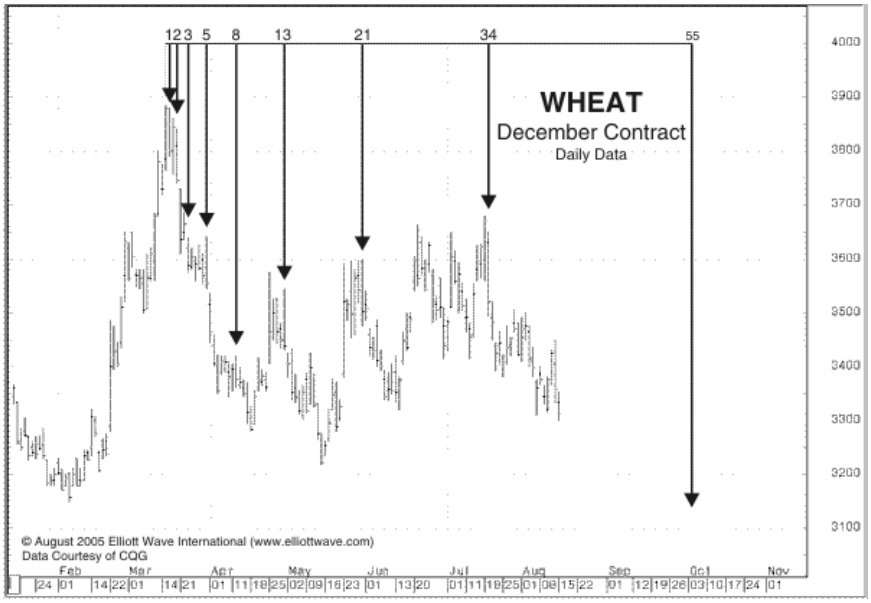


Figure 7-11

A pioneer in the research of Fibonacci relationships in time is Christopher Carolan of Calendar Research. To acquaint yourself with his ground-breaking research into this field, check out his website, www.calendarresearch.com.

Conclusion

In the end, just as there is no wrong way to play with a box, there is no wrong way to apply Fibonacci analysis to financial markets. What is even more exciting, there are ways of applying Fibonacci to market analysis that haven't been revealed or discovered yet. So take your Fibonacci box and have fun, and, remember, you are limited only by your imagination. If you find something new, let me know.

[AUGUST 2005]

Who Was Fibonacci and Why Is He Famous?

For a brief history on the Fibonacci sequence, here's an excerpt from Section V of *Trader's Classroom Collection: Volume 1* (pp. 20-21):

> "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.
>
> "The ratio between consecutive numbers in this set approaches the popular .618 and 1.618, the Fibonacci ratio and its inverse. (Other ratios that can be derived from non-consecutive numbers in the sequence are: .146, .236, .382, 1.000, 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 proved 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, comprising five fingers with each finger consisting of three bones. [Editor's note: In fact, the August 2005 issue of *Science* magazine discusses Fibonacci realtionships on the micro- and nano- level.]
>
> "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."

Note:

Find the rest of this lesson in Volume 1 of *Trader's Classroom Collection*: www.elliottwave.com/subscribers/traders_classroom/

VIII. How January Price Data Determines Support and Resistance for the Whole Year

1. HOW THE METHOD WORKS: JANUARY 2005 AS A CASE STUDY

I'd like to focus on how to use Fibonacci ratios of January price ranges to determine support and resistance levels for the whole year.

In the August 2004 Trader's Classroom, I wrote about the importance of "firsts," such as the first hour of a trading session, the first session of the week and the first month of the year. (You can find this article reprinted in section XI of *Trader's Classroom Collection: Volume I*). In that article, I pointed out that:

> "Often, the high or low of the week will occur within the first few hours of trading Monday. Similarly, the high or low of the month will 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 these bars make tend to act as significant support or resistance levels for price action later in the week, month or year."

As an Elliottician, I extensively use Fibonacci ratios like .382, .618, 1.000, 1.618 and 2.618, because the Fibonacci sequence is the mathematical basis of the Wave Principle. Fibonacci ratios are most often used to identify wave retracements and projections, but let me show you a different way to use them to mark probable highs and lows for the upcoming year.

In Figure 8-1 (Soybeans), you can see a number of horizontal lines that represent Fibonacci ratios of January's trading range. In 1999, notice how prices turned up from the 1.618 multiple of January's range. In 2002 and 2003, Soybeans reached 4.236 multiples of January's range. In 2004, Soybeans rallied to a 2.618 multiple of January's range and then sold off to almost a 4.236 multiple of January's range.

I skipped over Soybean price action in 2000 and 2001, because these two years portray a special situation. Let me explain. January's price range added to January's high and subtracted from January's low identifies the breakout levels for the rest of the year. As you can see in 2000, Soybeans were unable to rally above or fall below the 1.000 multiple of January's price range, which resulted in a sideways market for that year. The same thing occurred in 2001.

When using this technique, I have noticed that once prices exceed the 1.000 multiple of January's range (up or down), they will continue on to higher or lower Fibonacci ratios. Until this break above or below the 1.000 multiple occurs, odds strongly favor a sideways trading year or a range-bound market.

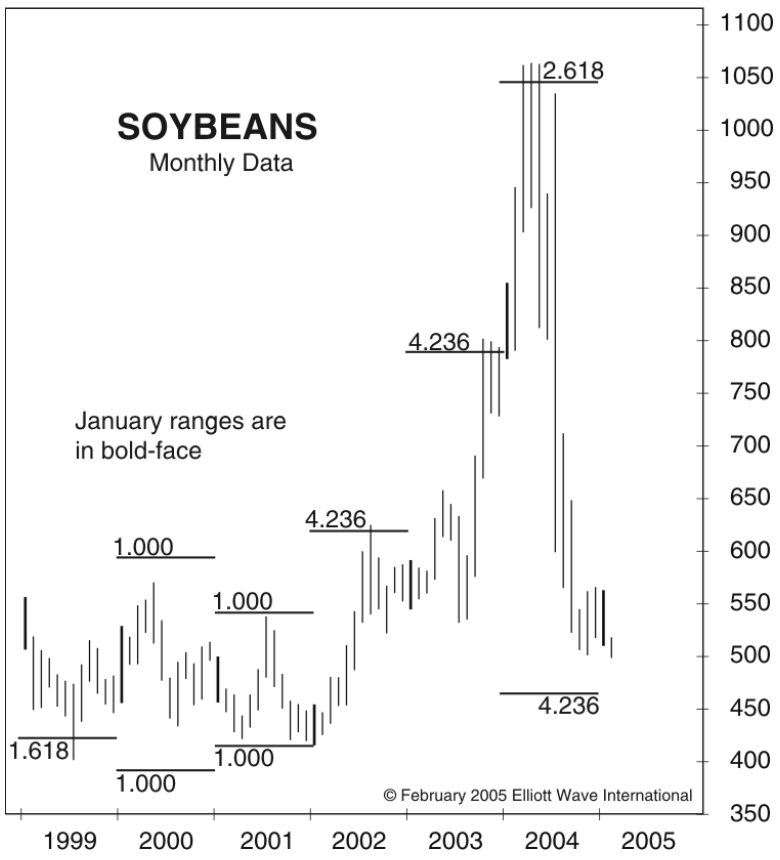


Figure 8-1

In Figure 8-2, Coffee prices were contained by 1.000 multiples of January's trading range in 1999 and 2003. While 1999 was volatile, these levels were still significant, as you can see in this chart. Coffee sold off, tried and failed to penetrate the lower boundary line and then reversed sharply, targeting the upper boundary line. In 2003, price action was much less volatile, but was still contained by the 1.000 multiples of January's price range, denoting a sideways year.

Figure 8-3 illustrates the Fibonacci levels that were significant for Coffee in 2000, 2001, 2002 and 2004, as well as my calculations for support and resistance levels for 2005, based on the price range of January's trading. I show you the same kind of technical analysis for Cotton in Figure 8-4. For a complete list of significant Fibonacci levels for each of the commodities I follow, see Table 8-1 on the next page.

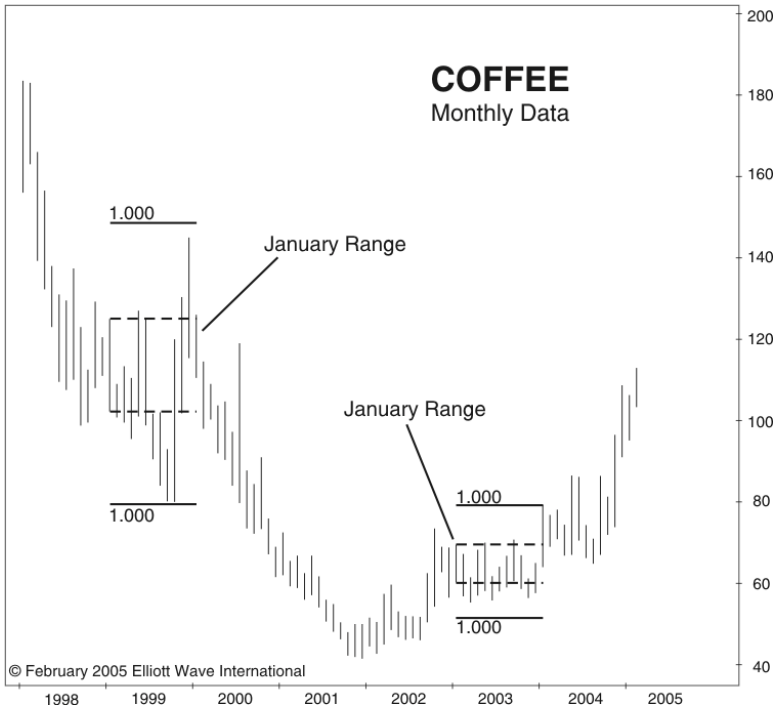


Figure 8-2

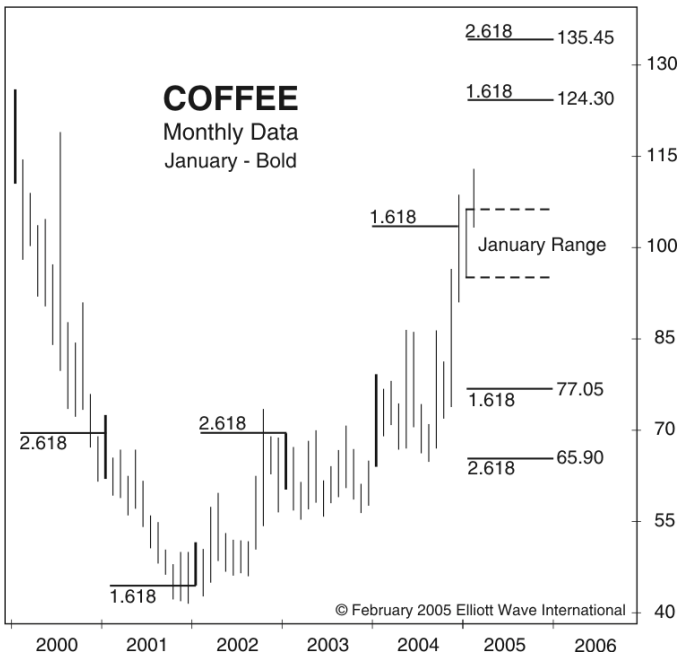


Figure 8-3

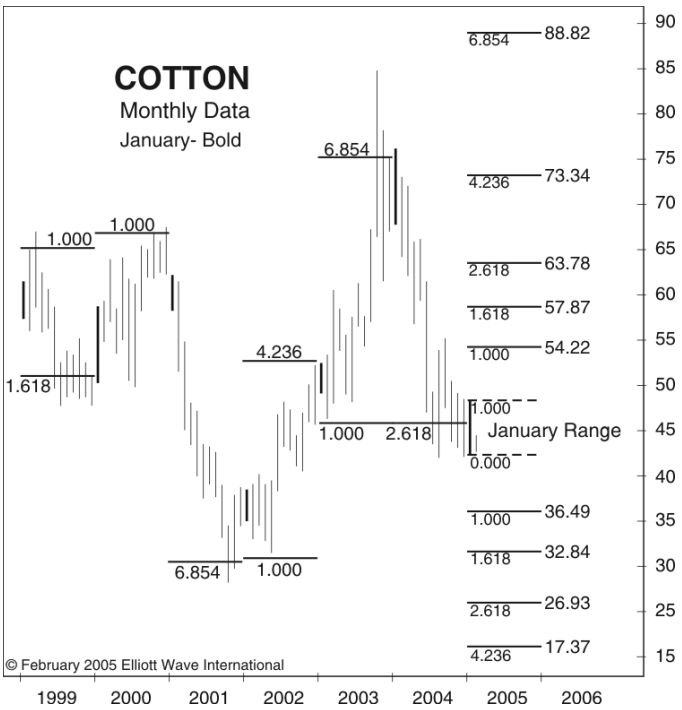


Figure 8-4

PROJECTED 2005 RESISTANCE AND SUPPORT

	January High	January Low	Resistance 1	1.618	2.618	4.236	6.854
Coffee	106.25	95.1	117.4	124.29	135.44	153.48	182.67
Cocoa	1596	1464	1728	1809.58	1941.58	2155.15	2500.73
Sugar	9.33	8.51	10.15	10.66	11.48	12.8	14.95
Cotton	48.31	42.4	54.22	57.87	63.78	73.34	88.82
Orange Juice	86.5	77	96	101.87	111.37	126.74	151.61
Lumber	388.3	344	432.6	459.98	504.28	575.95	691.93
Copper	147.75	132.35	163.15	172.67	188.07	212.98	253.3
Soybeans	563	510	616	648.75	701.75	787.51	926.26
Soybean Meal	168	152	184	193.89	209.89	235.78	277.66
Soybean Oil	20.4	19.65	21.15	21.61	22.36	23.58	25.54
Corn	209.75	195.25	224.25	233.21	247.71	271.17	309.13
Wheat	312	287.5	336.5	351.64	376.14	415.78	479.92
Oats	173	152	194	206.98	227.98	261.96	316.93
Pork Bellies	98.25	92.65	103.85	107.31	112.91	121.97	136.63
Lean Hogs	77.35	73.45	81.25	83.66	87.56	93.87	104.08
Feeder Cattle	107.27	99.45	115.09	119.92	127.74	140.4	160.87
Live Cattle	92.75	87.4	98.1	101.41	106.76	115.41	129.42
CRB Index	288.42	277.07	299.77	306.78	318.13	336.5	366.21

	January High	January Low	Support 1	1.618	2.618	4.236	6.854
Coffee	106.25	95.1	83.95	77.06	65.91	47.87	18.68
Cocoa	1596	1464	1332	1250.42	1118.42	904.85	559.27
Sugar	9.33	8.51	7.69	7.18	6.36	5.04	2.89
Cotton	48.31	42.4	36.49	32.84	26.93	17.37	1.89
Orange Juice	86.5	77	67.5	61.63	52.13	36.76	11.89
Lumber	388.3	344	299.7	272.32	228.02	156.35	40.37
Copper	147.75	132.35	116.95	107.43	92.03	67.12	26.8
Soybeans	563	510	457	424.25	371.25	285.49	146.74
Soybean Meal	168	152	136	126.11	110.11	84.22	42.34
Soybean Oil	20.4	19.65	18.9	18.44	17.69	16.47	14.51
Corn	209.75	195.25	180.75	171.79	157.29	133.83	95.87
Wheat	312	287.5	263	247.86	223.36	183.72	119.58
Oats	173	152	131	118.02	97.02	63.04	8.07
Pork Bellies	98.25	92.65	87.05	83.59	77.99	68.93	54.27
Lean Hogs	77.35	73.45	69.55	67.14	63.24	56.93	46.72
Feeder Cattle	107.27	99.45	91.63	86.8	78.98	66.32	45.85
Live Cattle	92.75	87.4	82.05	78.74	73.39	64.74	50.73
CRB Index	288.42	277.07	265.72	258.71	247.36	228.99	199.28

Table 8-1

They say "there is more than one way to skin a cat." Likewise, I believe that there is more than one way to use Fibonacci ratios. I've found that you can often predict how a commodity will do all year by applying Fibonacci analysis to January's trading range, just as I've shown here.

[FEBRUARY 2005]

2. HOW WELL THE METHOD WORKED IN 2005

In February 2005, I claimed that a trader could use Fibonacci ratios of January price ranges to determine support and resistance levels in any commodity for the rest of the year. At the end of 2005, I thought it would be interesting to show you how the Fibonacci levels identified in the February Trader's Classroom did indeed prove significant.

Before we begin looking at charts, let me review the technique again so that you can use it yourself next year: To identify annual levels of Fibonacci resistance and support for any commodity, simply multiply January's trading range by 1.000, 1.618, 2.618 and 4.236, and add those sums to January's high to identify resistance; subtract those sums from January's low to identify support. Now that we're all on the same page, let's examine a few of the more notable examples.

As you can see in Coffee's chart (Figure 8-5), once prices broke out of their January price range, the market rallied right to 135.45 — the 2.618 multiple of its January trading range. In fact on a closing basis, the high was 134.45, just one point away from 135.45. After reaching this significant level of Fibonacci resistance, Coffee began a months long decline to 84.45, again, less than a point away from 83.95, the 1.000 multiple of its January trading range.

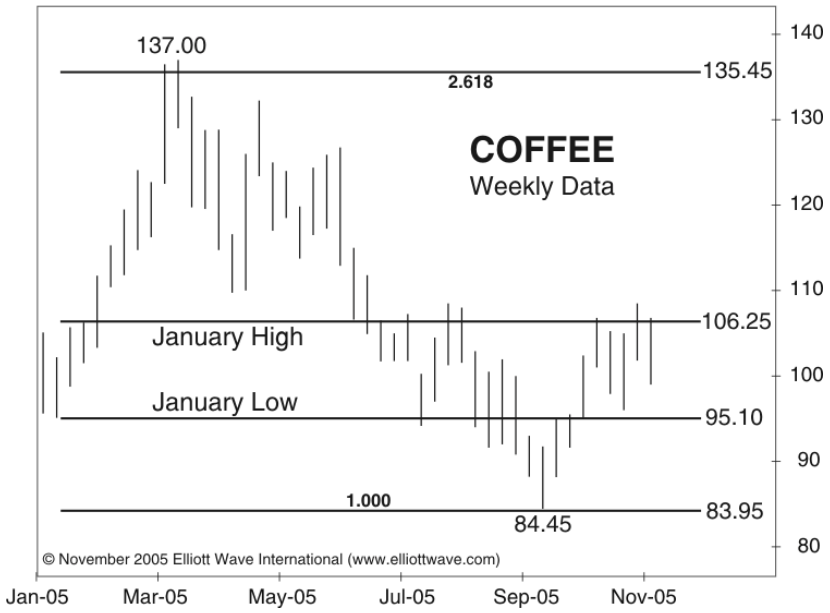


Figure 8-5

Cotton's chart (Figure 8-6) shows just how effective this technique is for projecting the annual range of Fibonacci resistance and support levels. When Cotton broke out of its January price range, it rallied directly to the 1.618 multiple of its January trading range at 57.87. Even though the high of the year in Cotton (basis the weekly chart) is 60.50 so far, on a closing basis it is 58.00 — less than a point away from Fibonacci resistance at 57.87. Also notice that the 1.000 and 1.618 multiples of January's trading range in Cotton proved to be formidable resistance both in July and October. And in both instances, the difference between the actual highs and the projected Fibonacci resistance levels was less than a point.

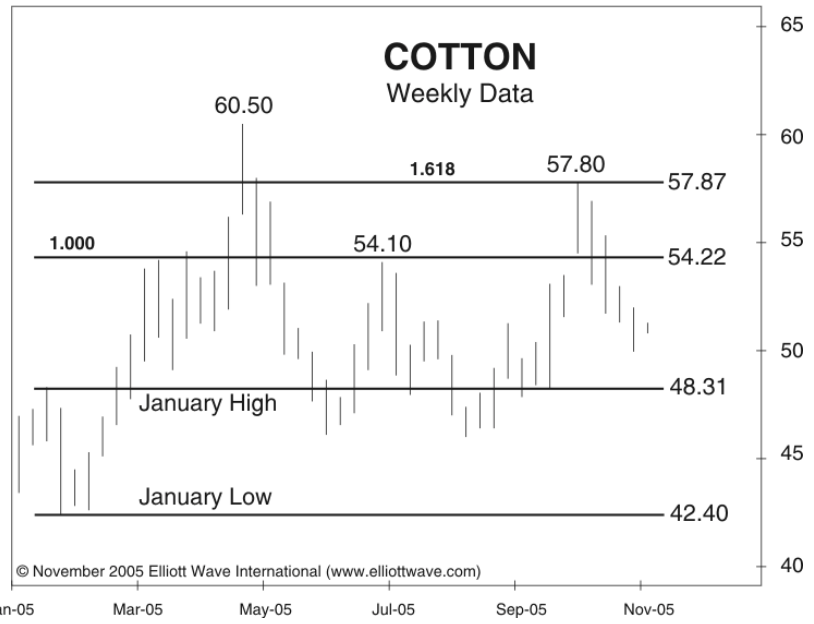


Figure 8-6

Finally, let's examine Wheat's chart (Figure 8-7). The 1.618 multiple of January's price range identified Fibonacci resistance at 352.50. And on three separate occasions — in March, July and September — Wheat reacted strongly to the 352.50 level by selling off for a number of weeks.

Figures 8-5 through 8-7 (Coffee, Cotton and Wheat) provide excellent evidence of the effectiveness of this technique. But they are certainly not the only examples, so I have included more charts for Cocoa, Sugar, Orange Juice, Soybeans, Corn, Pork Bellies, Lean Hogs, Live Cattle and Feeder Cattle (Figures 8-8 to 8-16). In each one of these charts, you'll find that Fibonacci multiples of January's trading range proved significant throughout the year, often more than once.

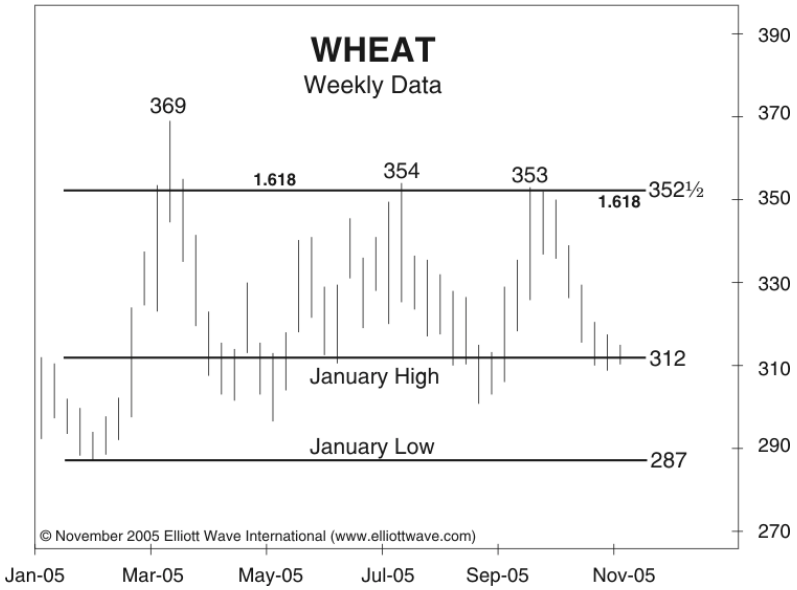


Figure 8-7

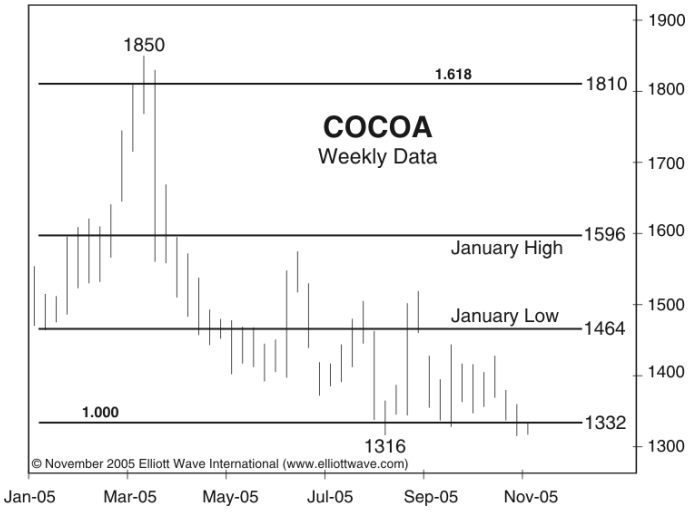


Figure 8-8

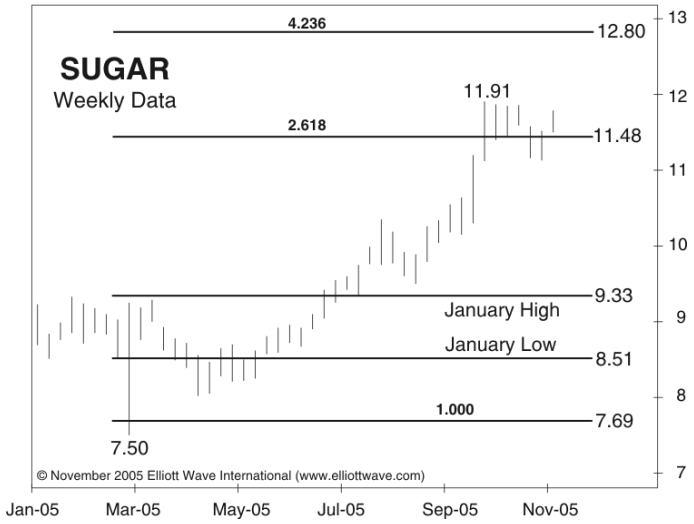


Figure 8-9

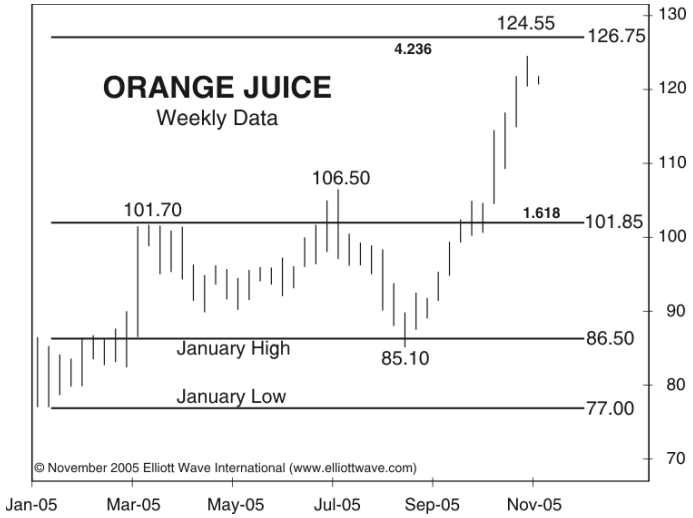


Figure 8-10

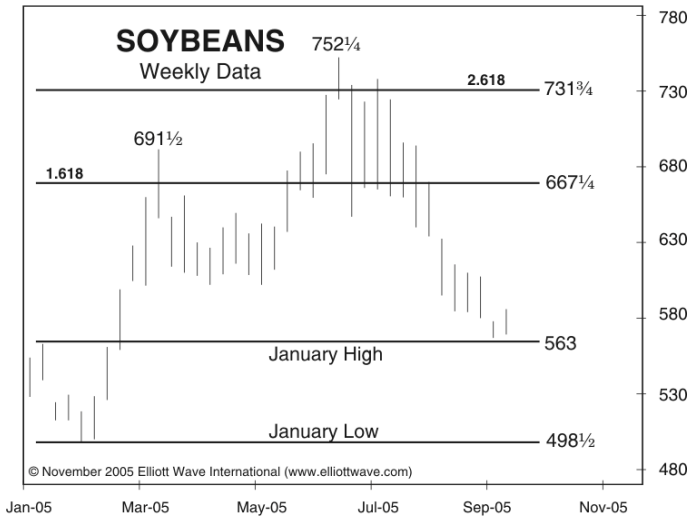


Figure 8-11

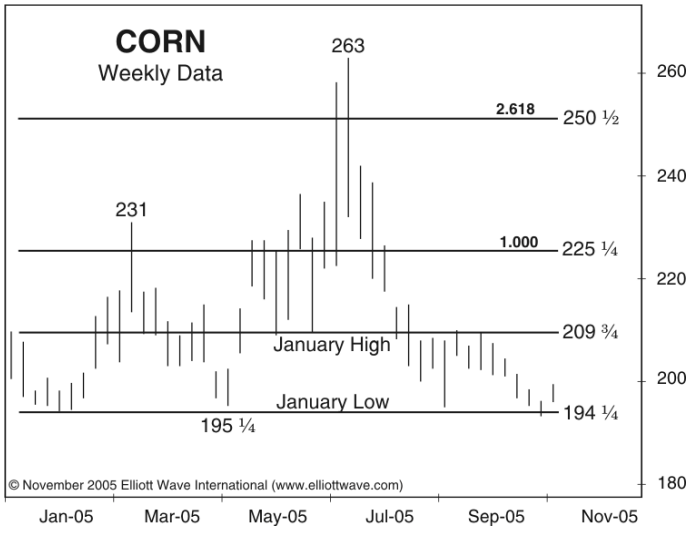


Figure 8-12

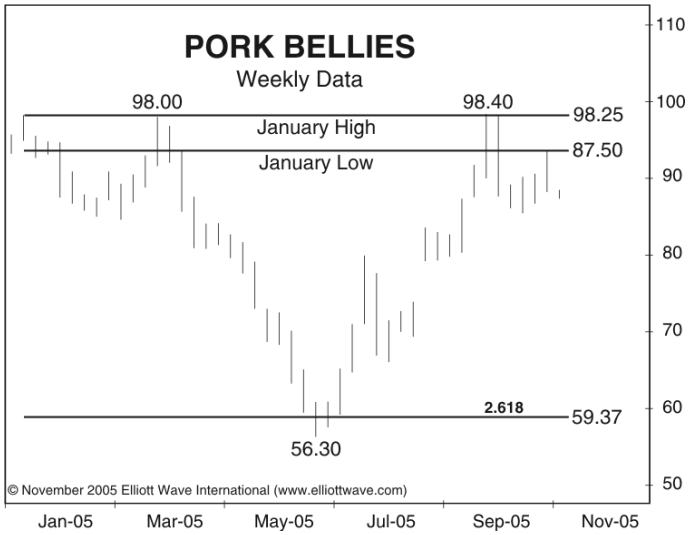


Figure 8-13

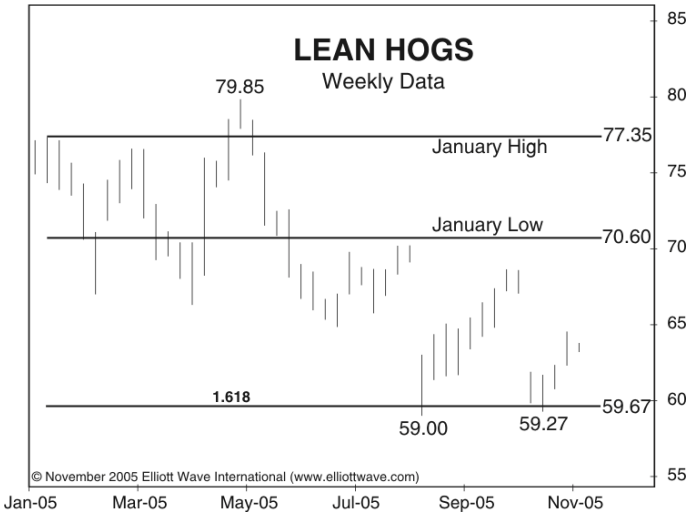


Figure 8-14

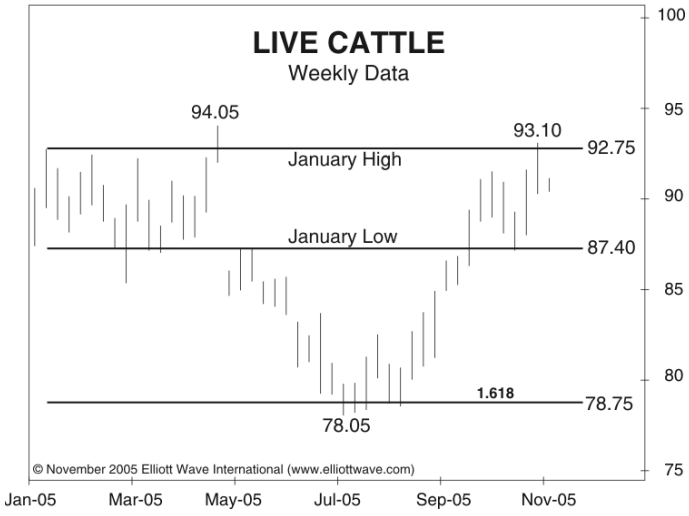


Figure 8-15

And here are two final thoughts about using Fibonacci multiples to forecast markets:

- Smaller Fibonacci ratios like .382, .500 and .618 are useful, especially in a range-bound market.

- This technique applies equally well to Currencies, Bonds, Metals, Energy and Stocks, both indices and individual issues.

[NOVEMBER 2005]

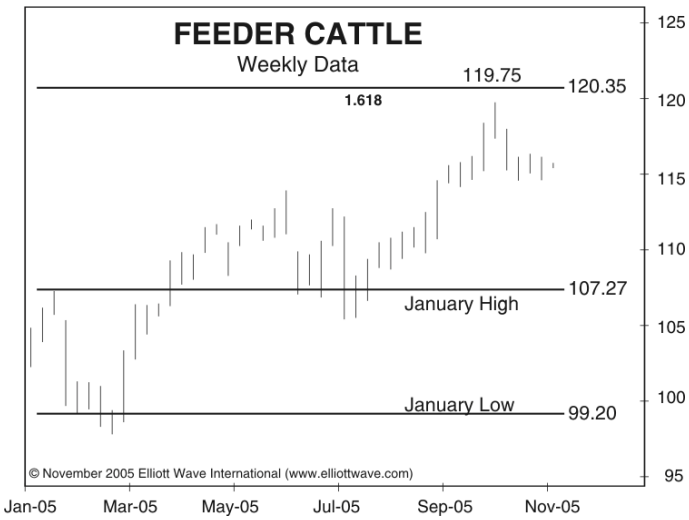


Figure 8-16

IX. How To Identify Fibonacci "Double 8" Trade Setups

If you have ever been to Las Vegas and played the slot machines (something I'm probably too inclined to do), you're familiar with triple sevens, 777. Triple sevens is a jackpot-winning combination that results in that oh-so-sweet sound of coins hitting the coin tray.

Let me tell you about another winning combination that works in the world of market forecasting: It's called double eights, 88. What is a Double 8? It is the name I have given to a specific Fibonacci trade setup that refers to the last digit of the relevant Fibonacci ratio — .618. When the setup occurs, which is more often than triple sevens in Vegas but less often than triple bars, it usually has a very nice payout.

Specifically, a Double 8 trade setup occurs when there are two consecutive tests of .618 retracements. Let's examine Figure 9-1 (Cocoa) to see what I mean. Notice that both the November 2004 advance and the December 2004 advance retraced right up to (or just beyond) the .618 retracements of their previous declines. The first test of the .618 retracement is our first eight and the second test is our second eight. As this chart shows, this Double 8 Fibonacci setup would have provided a nice payout for a trader. Figure 9-2 (Soybeans) shows another Double 8 formation that also resulted in a sizable selloff.

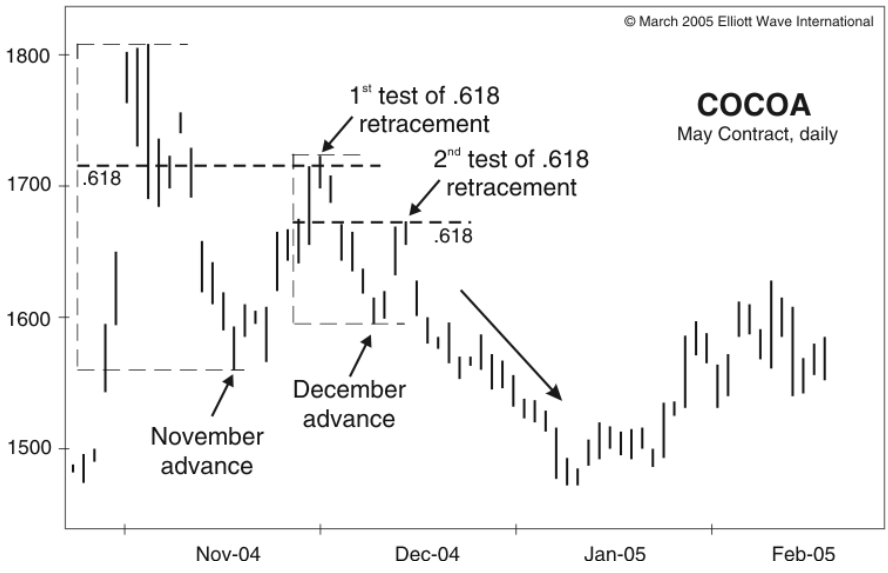


Figure 9-1

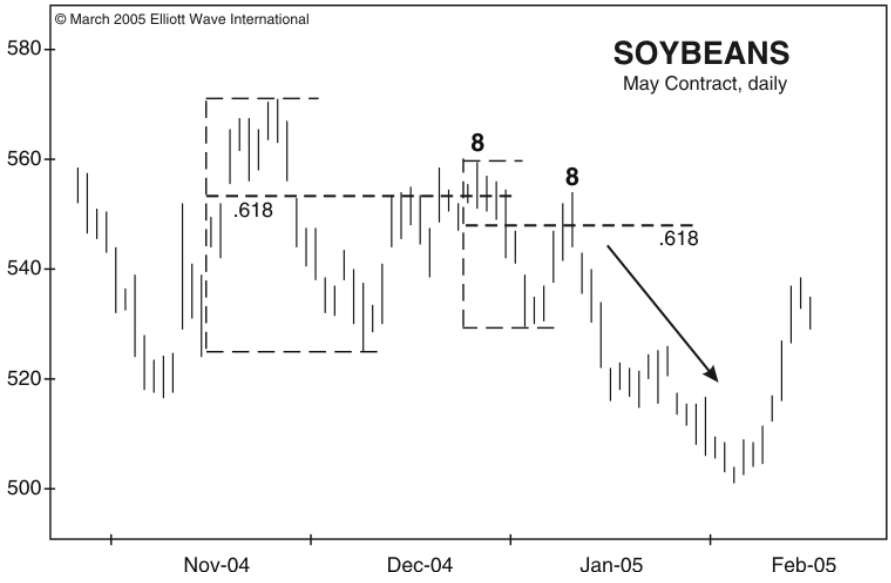


Figure 9-2

As I have said many times in Trader's Classroom, I won't use a tool if it doesn't work on every market and every timeframe. As you can see in Figure 9-3 (Coffee), the Double 8 trade setup is equally effective on the weekly chart level.

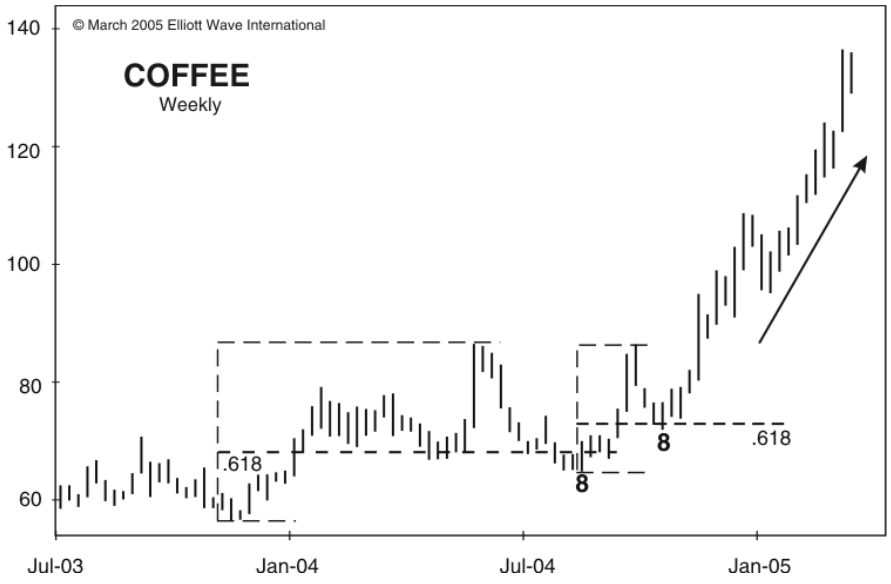


Figure 9-3

Even in a 5-minute chart like Figure 9-4 (Wheat), this setup is dynamic. What's most notable about Figure 9-4 is that we had a triple-eight setup, .61**8**, .61**8**, .61**8**.

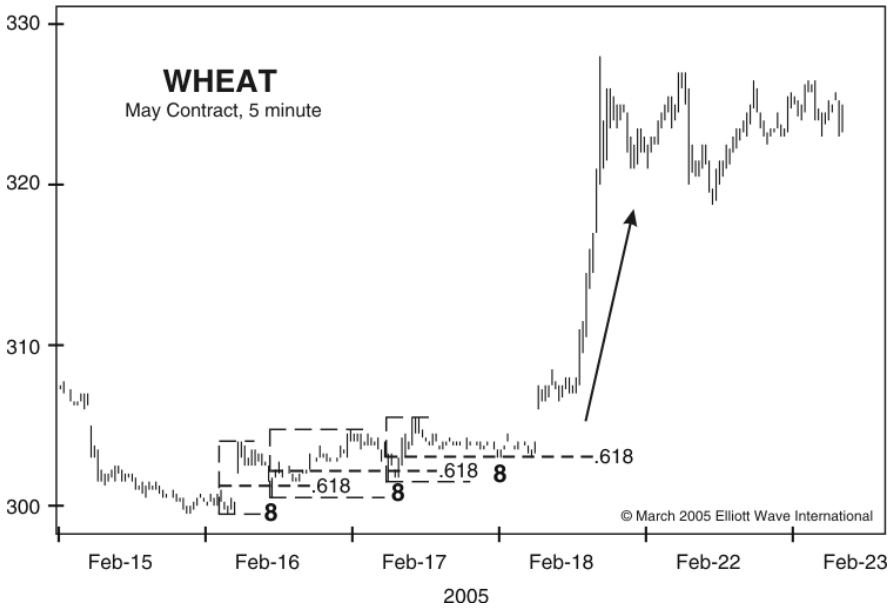


Figure 9-4

So how does the Wave Principle fit into all this? Simple. This Fibonacci trade setup tends to position traders in front of wave three of C, a third-of-a-third wave, or wave E of a contracting triangle. Each of these positions is significant because prices travel the farthest in the shortest amount of time in wave three, especially in wave three-of-three, and the resolution of a triangle is normally swift.

If you ever go to Vegas, I really hope you hit triple sevens. The feeling you get winning a great big jackpot is the thrill of a lifetime. If you can't make it to Vegas any time soon, simply look for Double 8s on your price charts, and see if you experience the same kind of thrill.

[MARCH 2005]

X. How To Integrate Technical Indicators Into an Elliott Wave Forecast

1. HOW ONE TECHNICAL INDICATOR CAN IDENTIFY THREE TRADE SETUPS

I love a good love-hate relationship, and that's what I've got with technical indicators. Technical indicators are those fancy computerized studies that you frequently see at the bottom of price charts that are supposed to tell you what the market is going to do next (as if they really could). The most common studies include MACD, Stochastics, RSI and ADX, just to name a few.

The No. 1 (and Only) Reason To Hate Technical Indicators

I often hate technical studies because they divert my attention from what's most important – PRICE.

Have you ever been to a magic show? Isn't it amazing how magicians pull rabbits out of hats and make all those things disappear? Of course, the "amazing" is only possible because you're looking at one hand when you should be watching the other. Magicians succeed at performing their tricks to the extent that they succeed at diverting your attention.

That's why I hate technical indicators; they divert my attention the same way magicians do. Nevertheless, I *have* found a way to live with them, and I *do* use them. Here's how: Rather than using technical indicators as a means to gauge momentum or pick tops and bottoms, I use them to identify potential trade setups.

Three Reasons To Learn To Love Technical Indicators

Out of the hundreds of technical indicators I have worked with over the years, my favorite study is MACD (an acronym for Moving Average Convergence-Divergence). MACD, which was developed by Gerald Appel, uses two exponential moving averages (12-period and 26-period). The difference between these two moving averages is the MACD line. The trigger or Signal line is a 9-period exponential moving average of the MACD line (usually seen as 12/26/9…so don't misinterpret it as a date). Even though the standard settings for MACD are 12/26/9, I like to use 12/25/9 (it's just me being different). An example of MACD is shown in Figure 10-1 (Coffee).

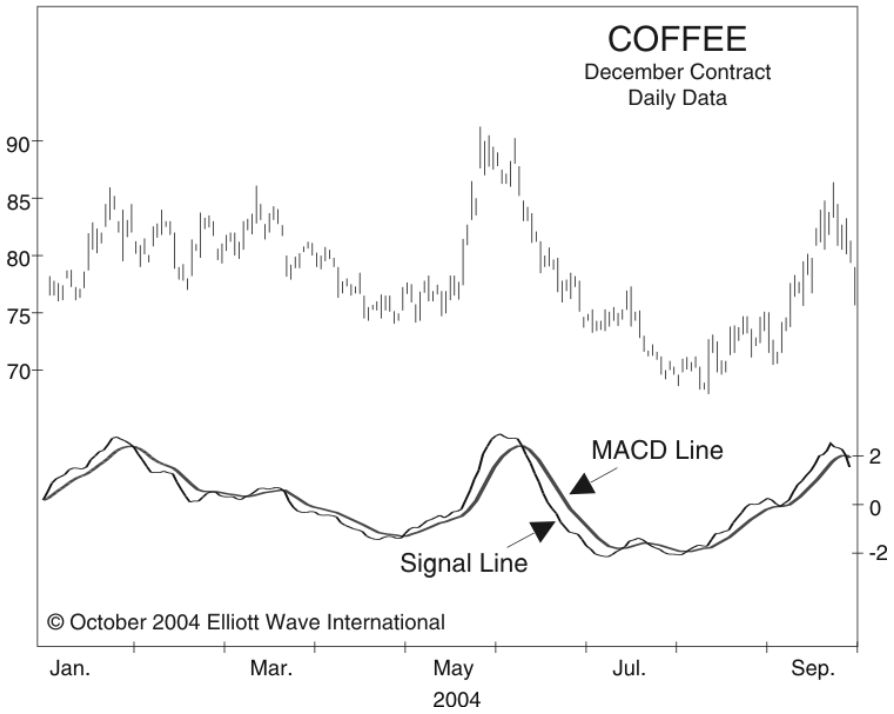


Figure 10-1

The simplest trading rule for MACD is to buy when the Signal line (the thin line) crosses above the MACD line (the thick line), and sell when the Signal line crosses below the MACD line. Some charting systems (like Genesis or CQG) may refer to the Signal line as MACD and the MACD line as MACDA. Figure 10-2 (Coffee)

highlights the buy-and-sell signals generated from this very basic interpretation.

Although many people use MACD this way, I choose not to, primarily because MACD is a trend-following or momentum indicator. An indicator that follows trends in a sideways market (which some say is the state of markets 80% of time) will get you killed. For that reason, I like to focus on different information that I've observed and named: Hooks, Slingshots and Zero-Line Reversals. Once I explain these, you'll understand why I've learned to love technical indicators.

• *Hooks*

A Hook occurs when the Signal line penetrates, or attempts to penetrate, the MACD line and then reverses at the last moment. An example of a Hook is illustrated in Figure 10-3 (Coffee).

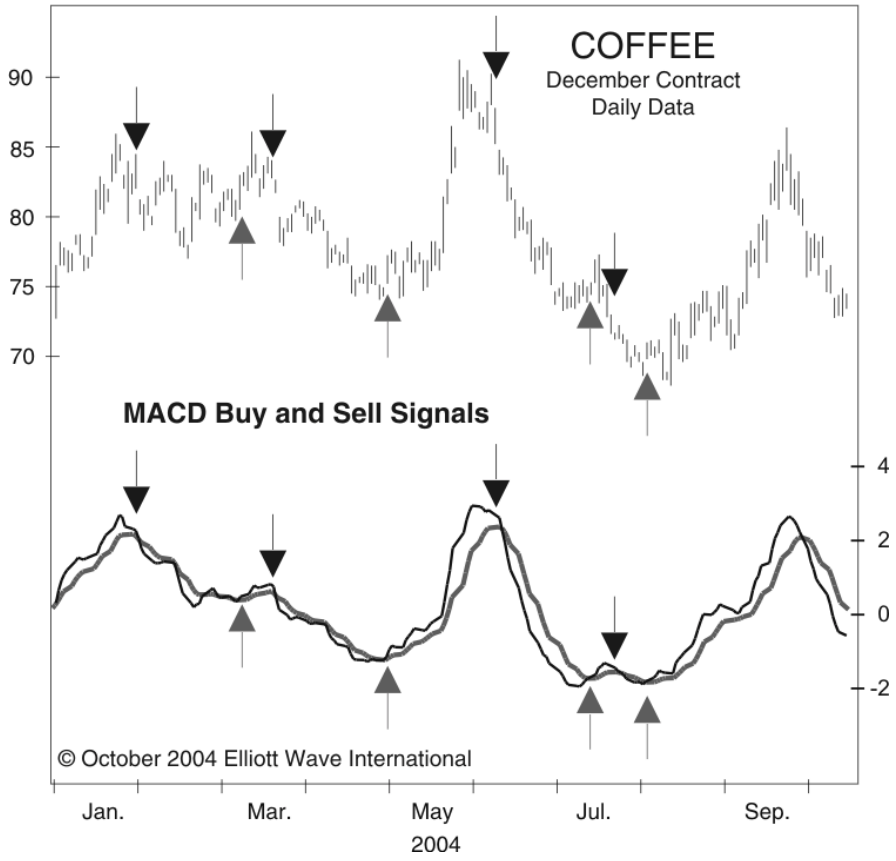


Figure 10-2

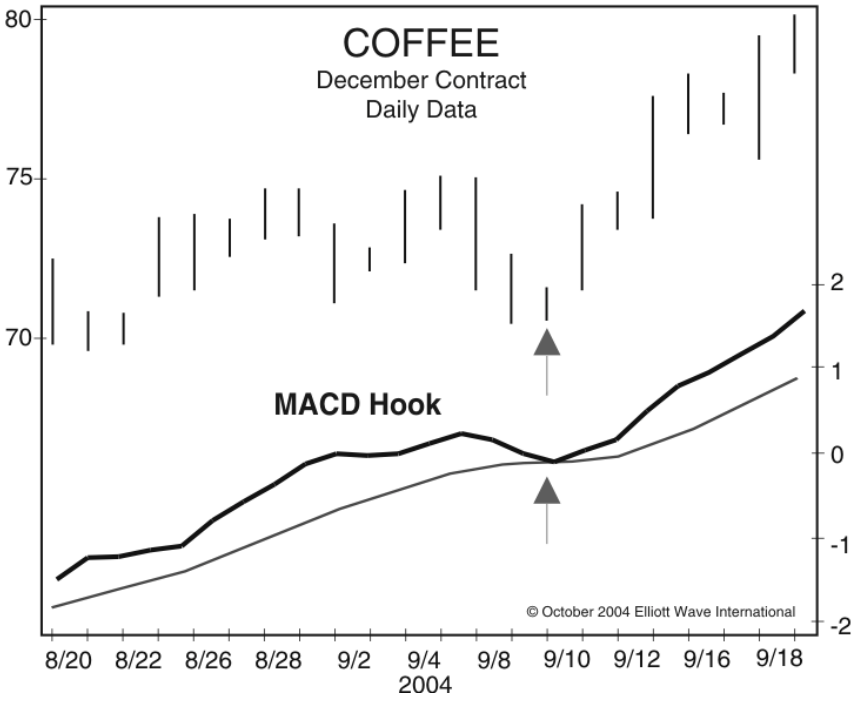


Figure 10-3

I like Hooks because they fit my personality as a trader. As I have mentioned before, I like to buy pullbacks in uptrends and sell bounces in downtrends (See p. 5 of *Trader's Classroom Collection: Volume I*). And Hooks do just that – they identify countertrend moves within trending markets.

In addition to identifying potential trade setups, you can also use Hooks as confirmation. Rather than entering a position on a cross-over between the Signal line and MACD line, wait for a Hook to occur to provide confirmation that a trend change has indeed occurred. Doing so increases your confidence in the signal, because now you have two pieces of information in agreement.

Figure 10-4 (Live Cattle) illustrates exactly what I want this indicator to do: alert me to the possibility of rejoining the trend. In Figure 10-5 (Soybeans), I highlight two instances where the Hook technique worked and two where it didn't.

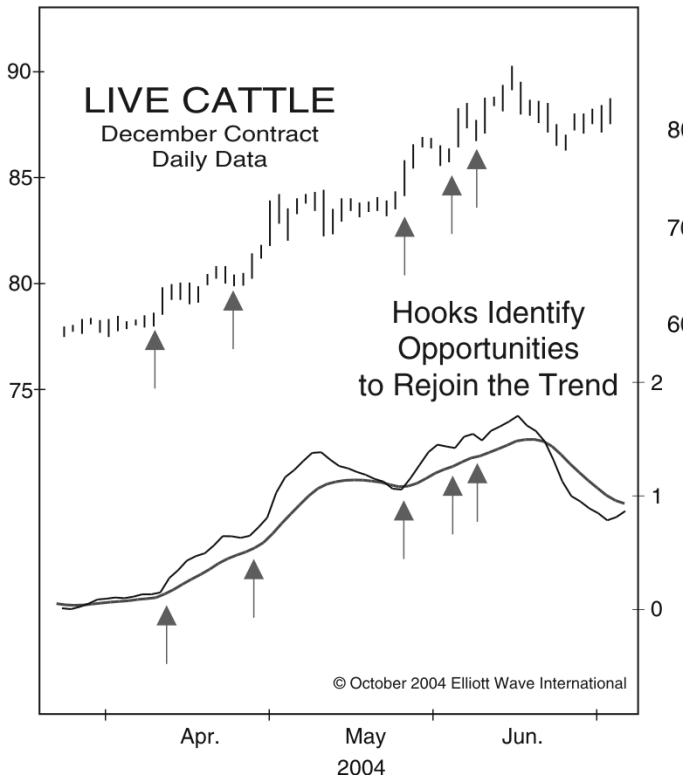


Figure 10-4

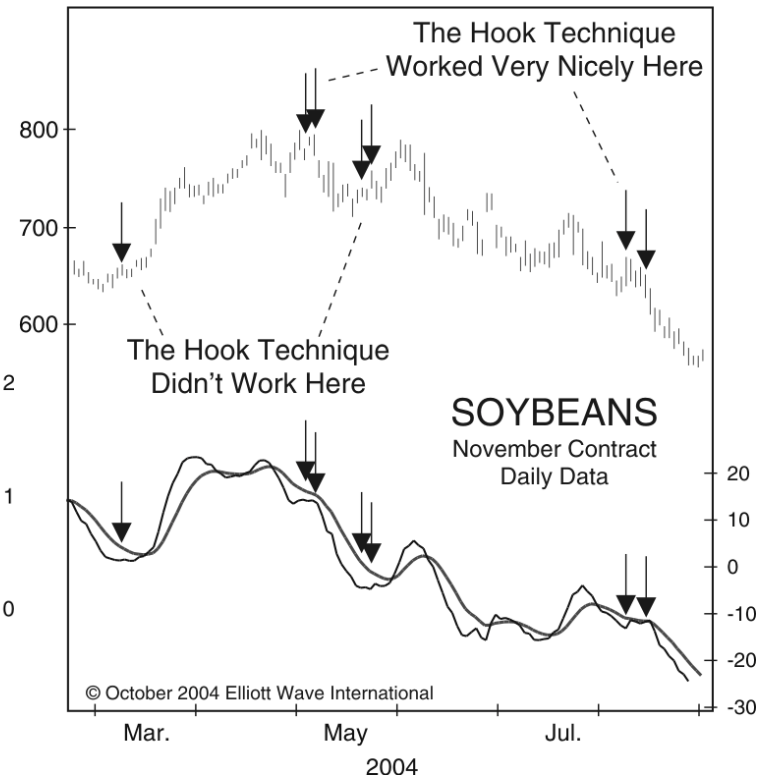


Figure 10-5

But is it really fair to say that the signal didn't work? Probably not, because a Hook should really just be a big red flag, saying that the larger trend may be ready to resume. It's not a trading system that I blindly follow. All I'm looking for is a heads-up that the larger trend is possibly resuming. From that point on, I am comfortable making my own trading decisions. If you use it simply as an alert mechanism, it does work 100% of the time.

• *Slingshots*

Another pattern I look for when using MACD is called a Slingshot. To get a mental picture of this indicator pattern, think the opposite of divergence. Divergence occurs when prices move in one direction (up or down) and an indicator based on those prices moves in the opposite direction.

A bullish Slingshot occurs when the current swing low is above a previous swing low (swing lows or highs are simply previous extremes in price),while the corresponding readings in MACD are just the opposite. Notice in Figure 10-6 (Sugar) how the May low was above the late March swing low. However, in May, the MACD reading fell below the level that occurred in March. This is a bullish Slingshot, which usually identifies a market that is about to make a sizable move to the upside (which Sugar did).

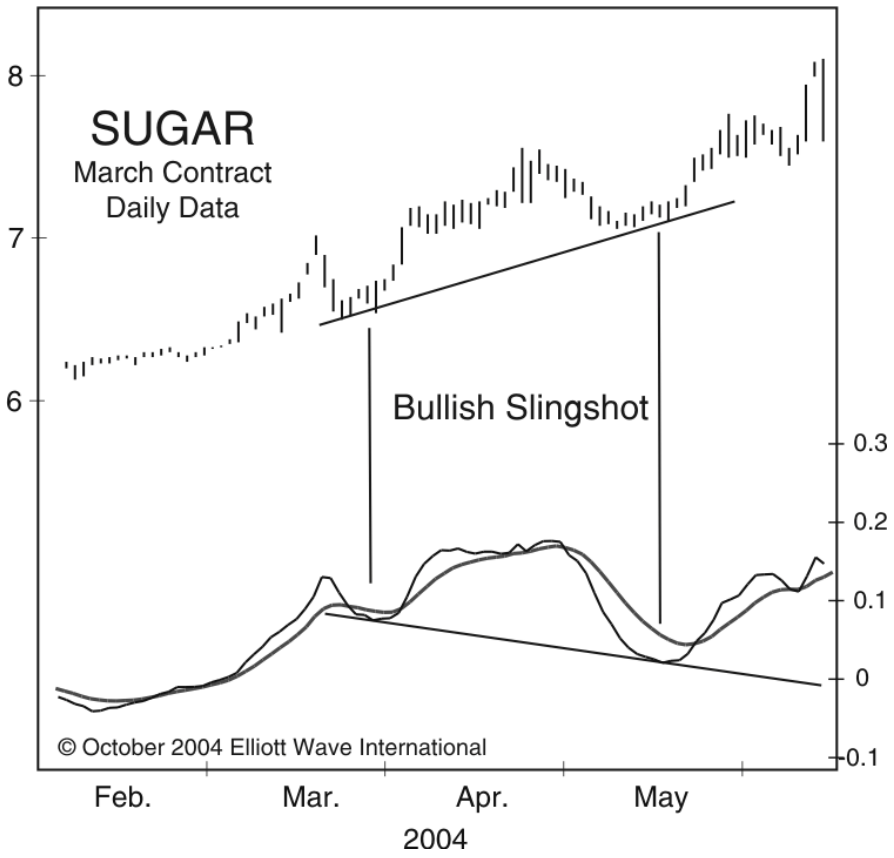


Figure 10-6

A bearish Slingshot is just the opposite: Prices make a lower swing high than the previous swing high, but the corresponding extreme in MACD is above the previous extreme. Figure 10-7 (Soybeans) shows an example of a bearish Slingshot.

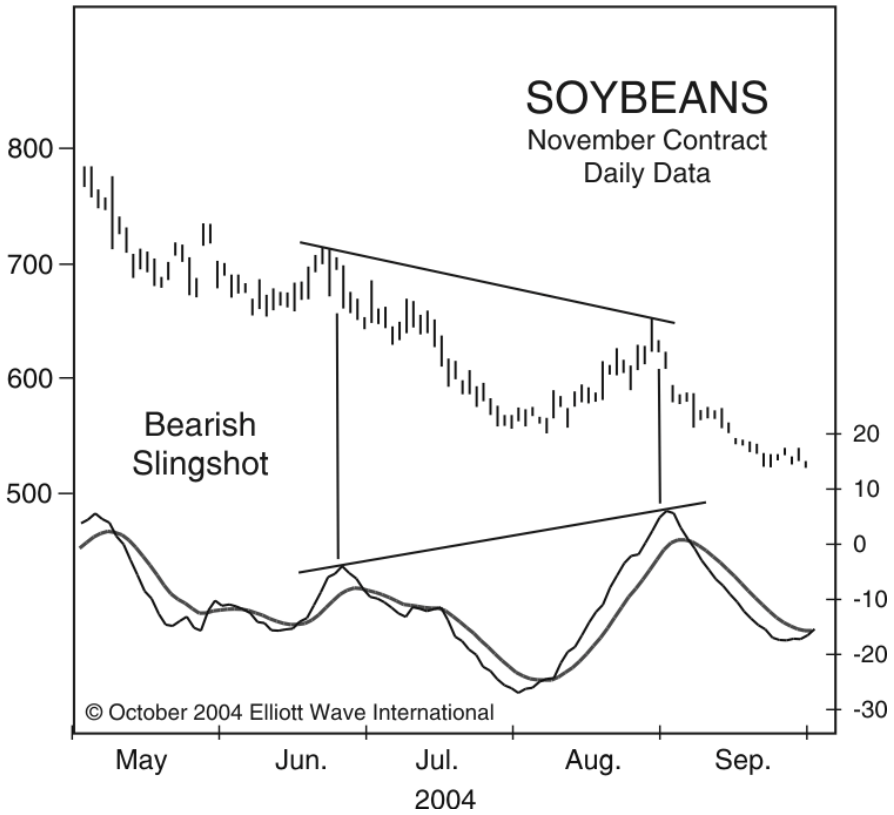


Figure 10-7

• *Zero-Line Reversals*

The final trade setup that MACD provides me with is something I call a Zero-Line Reversal(ZLR). A Zero-Line Reversal occurs when either the Signal line or the MACD line falls (or rallies) to near zero, and then reverses. It's similar in concept to the hook technique described above. The difference is that instead of looking for the Signal line to reverse near the MACD line, you're looking for reversals in either the Signal line or the MACD line near zero. Let's look at some examples of Zero-Line Reversals and I'm sure you'll see what I mean.

In Figure 10-8 (Sugar), you can see two Zero-Line Reversals. Each time, MACD reversed above the zero-line, which means they were both bullish signals. When a Zero-Line Reversal occurs from below, it's bearish. Figure 10-9 (Soybeans) shows an example of one bullish ZLR from above, and three bearish reversals from below. If you recall what happened with Soybeans in September 2005, the bearish ZLR that occurred early that month was part of our bearish Slingshot from Figure 10-7. These combined signals were a great indication that the August advance was merely a correction within the larger sell-off that began in April. That meant that lower prices were forthcoming, as forecast in the August and September issues of *Monthly Futures Junctures*.

So there you have it, a quick rundown on how I use MACD to alert me to potential trading opportunities (which I love). Rather than using MACD as a mechanical buy-sell system or using it to identify strength or weakness in a market, I use MACD to help me spot trades. And the Hook, Slingshot and Zero-Line Reversal are just a few trade setups that MACD offers.

[OCTOBER 2004]

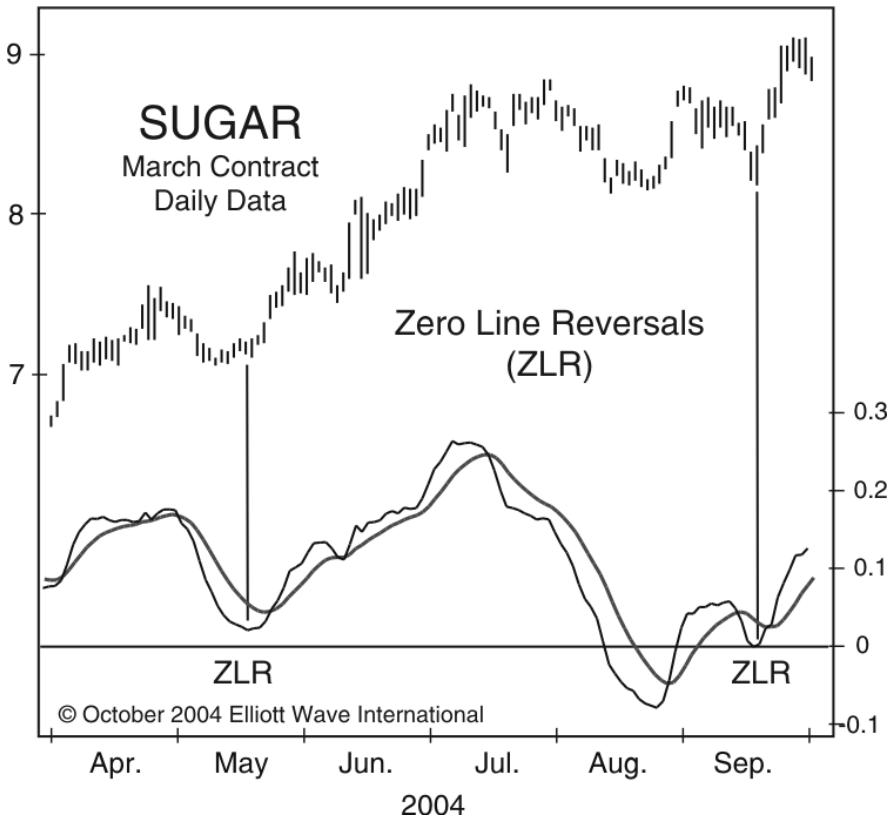


Figure 10-8

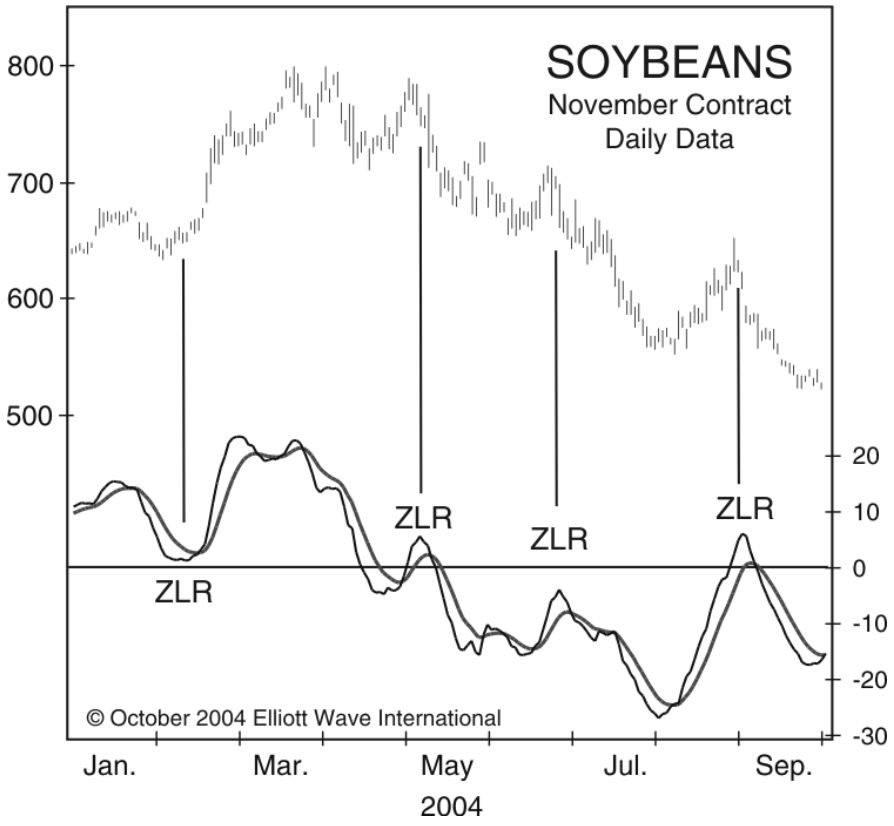


Figure 10-9

2. HOW TO USE TECHNICAL INDICATORS TO CONFIRM ELLIOTT WAVE COUNTS

Top Reason To Love Technical Indicators

The previous lesson points out one of the redeeming features of technical studies: You can identify potential trade setups using MACD to find Hooks, Slingshots and Zero-Line Reversals (ZLR). In this lesson, I'm going to continue our examination of MACD, and I've saved the best for last. The No. 1 reason to love technical indicators is that you can use one like MACD to count Elliott waves. Let me count the ways (and the waves):

You Can Count Impulse Waves and Identify Wave 3 Extremes

Often, an extreme reading in MACD will correspond to the extreme of wave three. This correlation appears when MACD tests zero in wave four, prior to the development of wave five. During a typical wave five, the MACD reading will be smaller in magnitude than it was during wave three, creating what is commonly referred to as divergence. An example is illustrated in Figure 10-10 (Sugar).

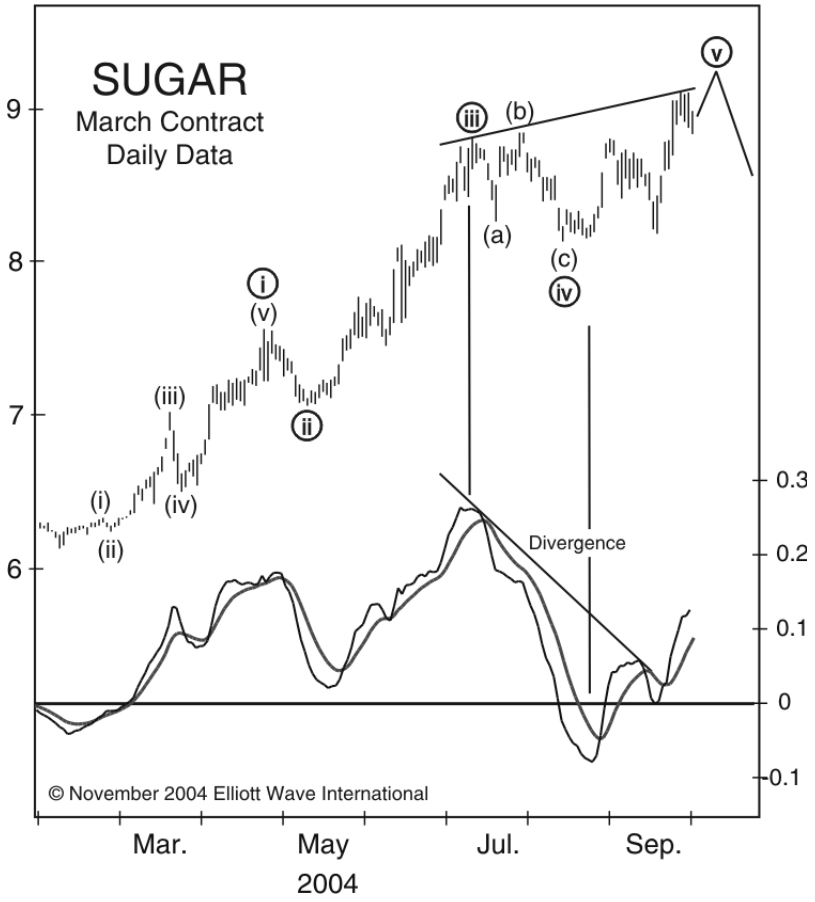


Figure 10-10

In this chart, you can see how the extreme reading in MACD is in line with the top of wave three, which occurred in July. MACD pulled back to zero in wave four before turning up in wave five. And though sugar prices were higher at the end of wave ⓥ than at the end of wave ⓘⓘⓘ, MACD readings during wave ⓥ fell far short of their wave ⓘⓘⓘ peak.

So remember that within a five-wave move, there are three MACD signals to look for:

1. Wave three normally corresponds to an extreme reading in MACD.
2. Wave four accompanies a test of zero.
3. Wave five pushes prices to a new extreme while MACD yields a lower reading than what occurred in wave three.

Figures 10-11 and 10-12 (Pork Bellies and Soybeans) show important variations on the same theme. Notice how wave four in Pork Bellies coincided with our Zero-Line Reversal, which I discussed in the previous lesson. Figure 10-12 (Soybeans), shows a five-wave decline that's similar to the five-wave rallies shown in Figures 10-10 and 10-11. Together, these charts should give you a good sense of how MACD can help you count Elliott impulse waves on a price chart.

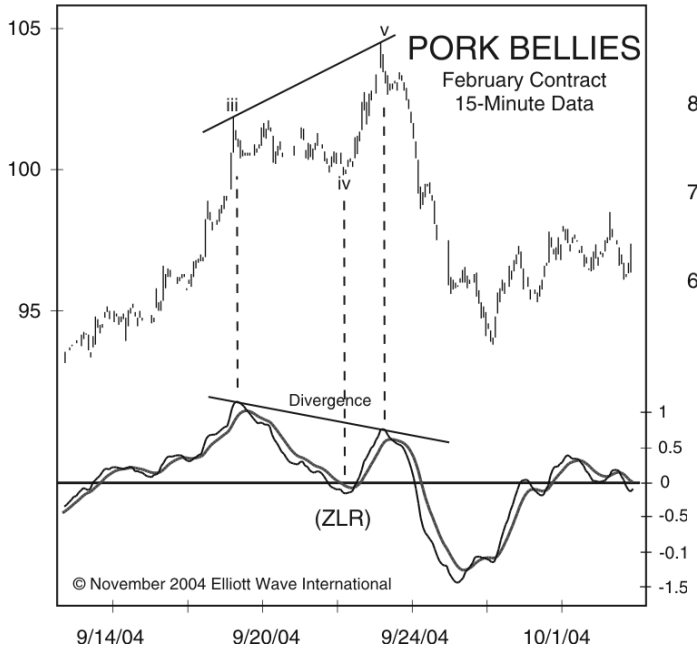


Figure 10-11

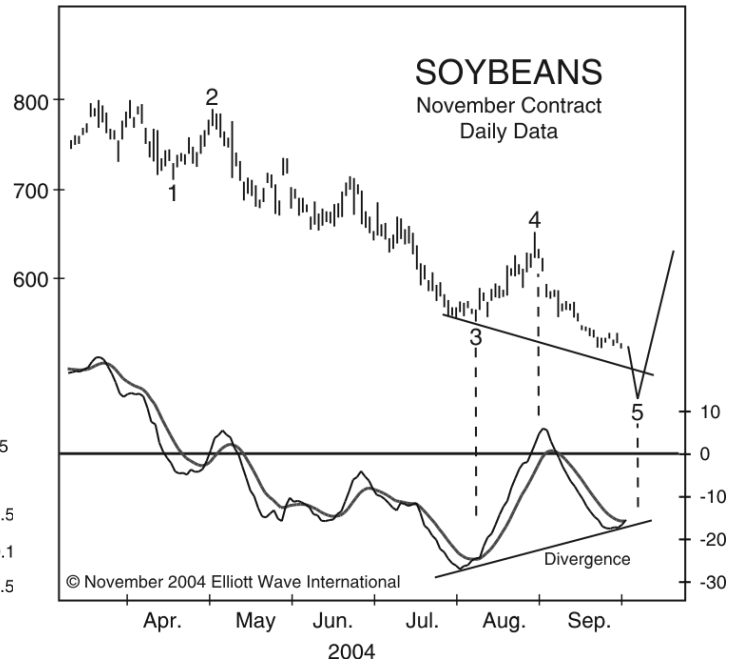


Figure 10-12

You Can Count Corrective Waves and Time Reversals

MACD also helps to identify the end of corrective waves. In Figure 10-13 (Live Cattle), you can see a three-wave decline. If you examine MACD, you'll see that although wave C pushed below the extreme of wave A in price, the MACD reading for wave C was above the wave A level.

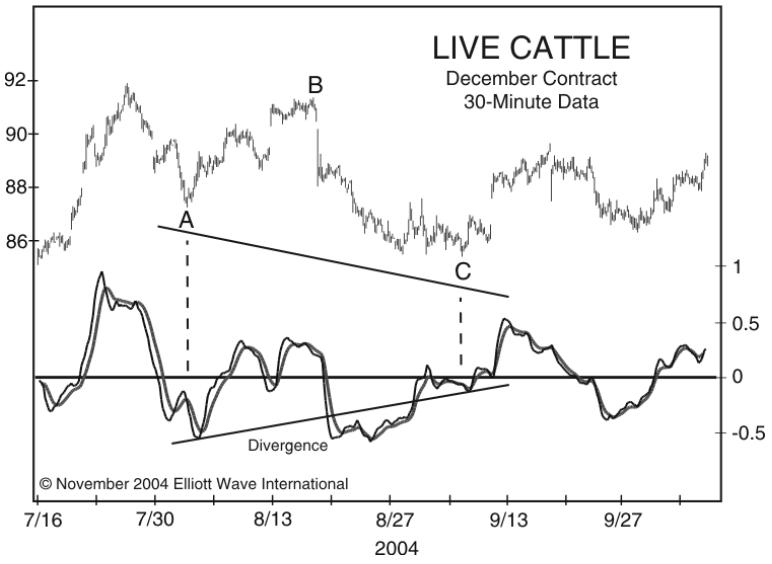


Figure 10-13

Figure 10-14 (Corn) illustrates another example. As you can see, the MACD reading for wave C is below that which occurred in wave A, creating a small but significant divergence. Since it can be difficult to see corrective waves while they're happening, it helps to use MACD as a back up.

You Can Identify Triangles

MACD can also help you identify triangles. In Figures 10-15 and 10-16 (Pork Bellies and Sugar) you'll see contracting triangle wave patterns. MACD traces out similar patterns that are concentrated around the zero-line. In other words, triangles in price often correspond to a flattened MACD near zero.

Overall, my love-hate relationship with technical indicators like MACD has worked out well, so long as I've remembered not to get too caught up in using them. I hope that you will find some of your own reasons to love them, too, but I do want to caution you that you can get burned if you become too enamored with them. Remember, it's price that brought you to this dance, and you should always dance with the one that brung you.

[NOVEMBER 2004]

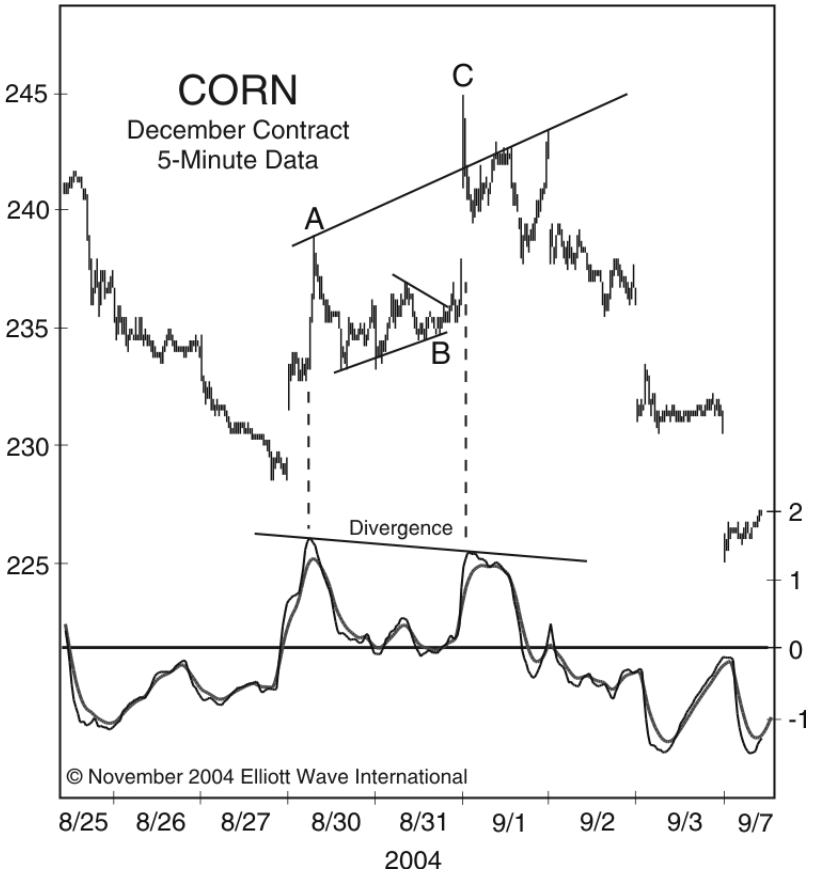


Figure 10-14

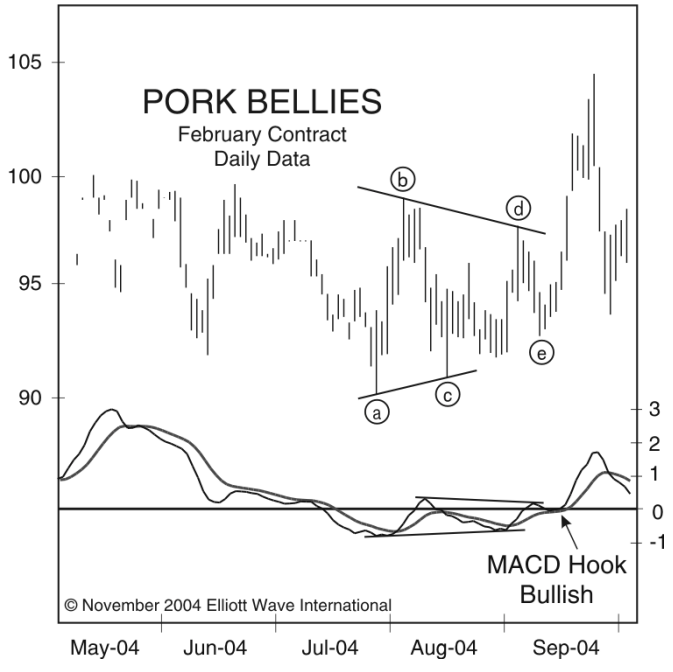


Figure 10-15

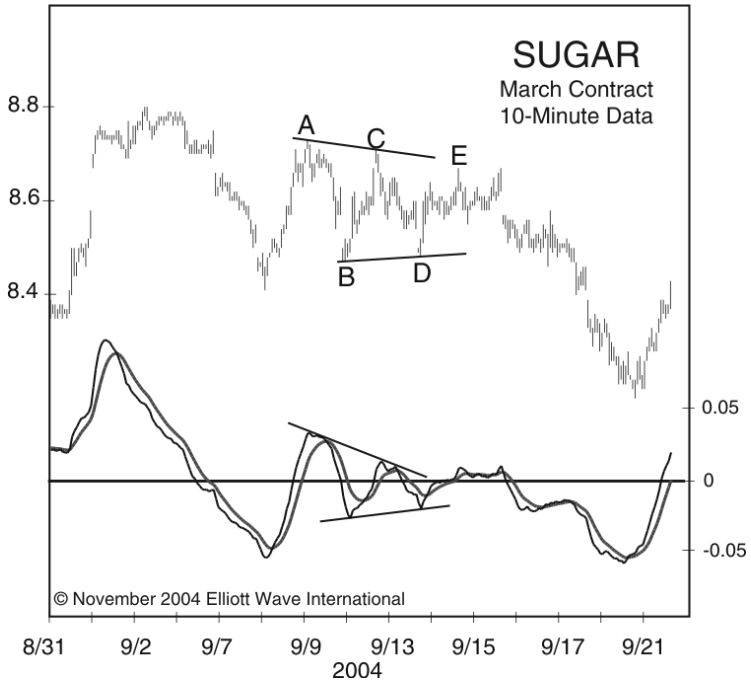


Figure 10-16

3. HOW MOVING AVERAGES CAN ALERT YOU TO FUTURE PRICE EXPANSION

I want to share with you one of my favorite trade set-ups, called Moving Average Compression (MAC). I like it because it consistently works, and you can customize it to your individual trading style and time frame.

MAC is simply a concentration of moving averages with different parameters, and when it occurs on a price chart, the moving averages appear knotted like tangled strands of Christmas tree lights.

Let's look at Figure 10-17 (Live Cattle). Here, you can see three different simple moving averages, which are based on Fibonacci numbers (13, 21 and 34). The points where these moving averages come together and seemingly form one line for a period of time is what I refer to as Moving Average Compression.

Moving Average Compression works so well in identifying trade set-ups because it represents periods of market *contraction*. As we know, because of the Wave Principle, after markets expand, they contract (when a five-wave move is complete, prices retrace a portion of this move in three waves). MAC alerts you to those periods of price contraction. And since this state of price activity can't be sustained, MAC is also precursor to *price expansion.*

Notice early April in Figure 10-17 (Live Cattle), when the three simple moving averages I'm using formed what appears to be a single line and did so for a number of trading days. This kind of compression shows us that a market has contracted, and therefore will soon expand — which is exactly what Live Cattle did throughout the months of April and May.

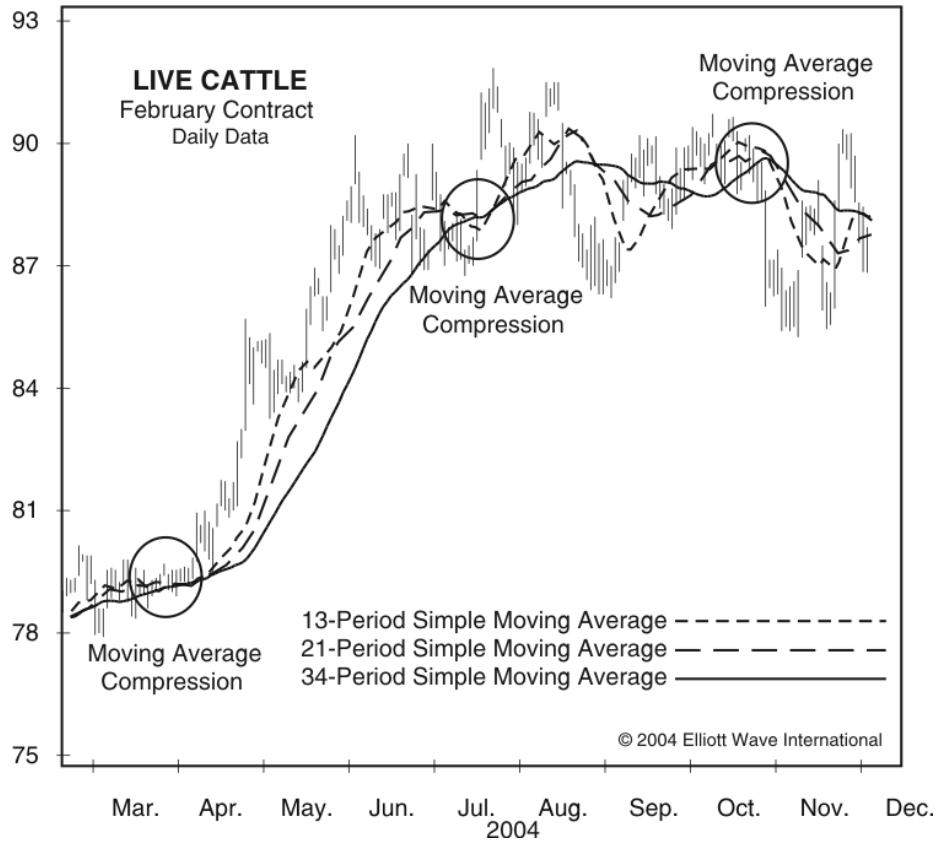


Figure 10-17

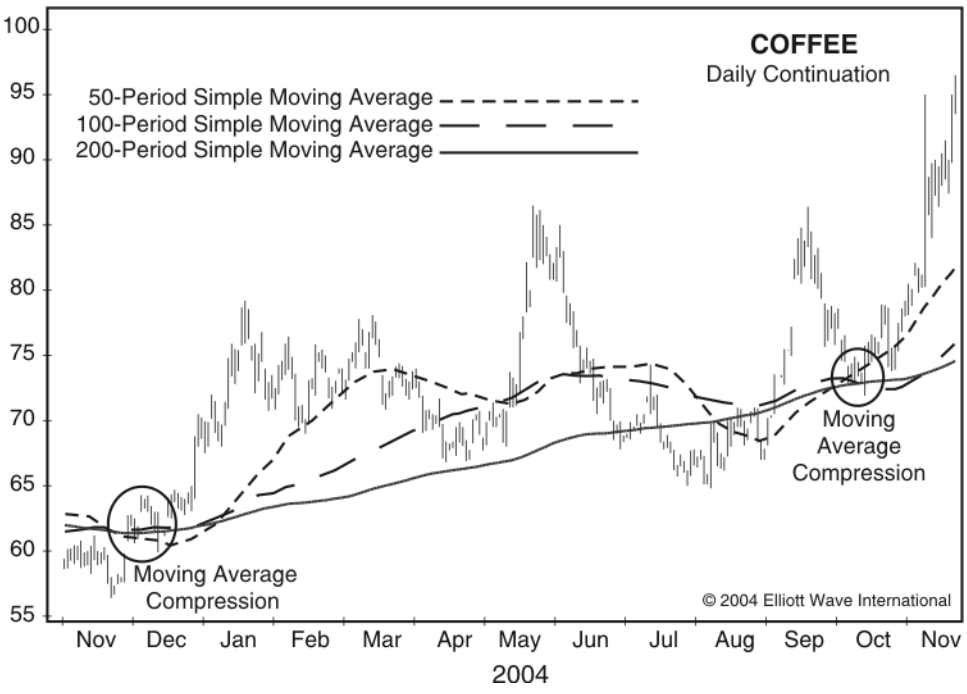


Figure 10-18

I also like MAC because it is such a flexible tool — it doesn't matter what parameters you use. You can use very long-period moving averages as shown in Figure 10-18 (Coffee) or multiple moving averages as shown in Figure 10-19 (Feeder Cattle), and you will still find MAC signals.

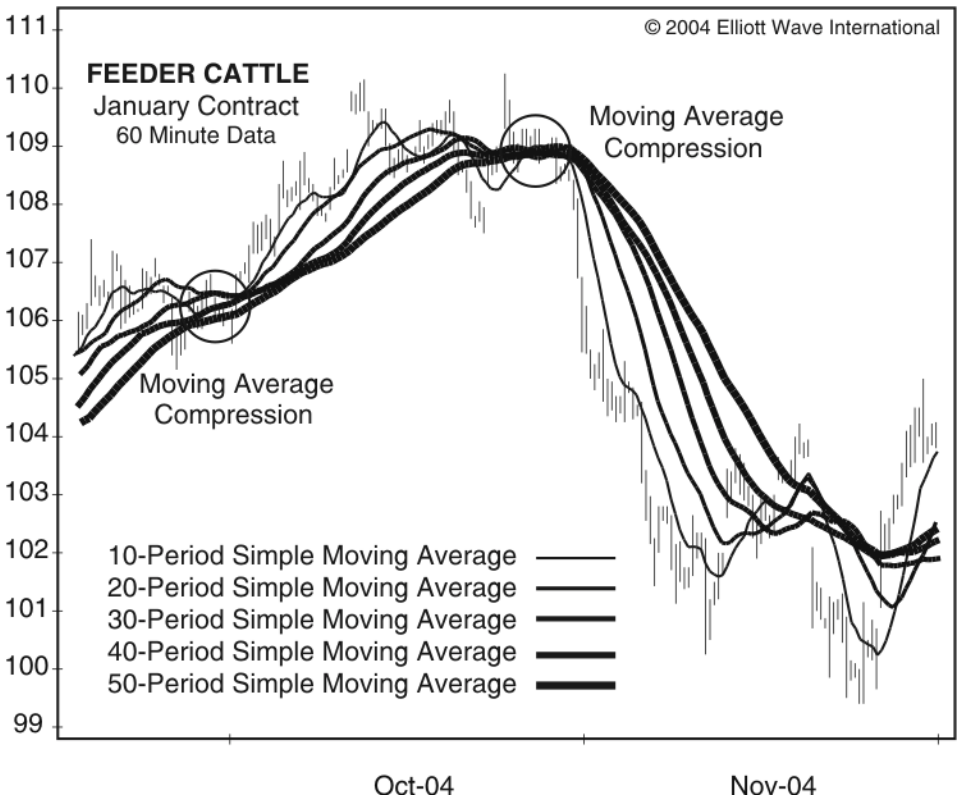


Figure 10-19

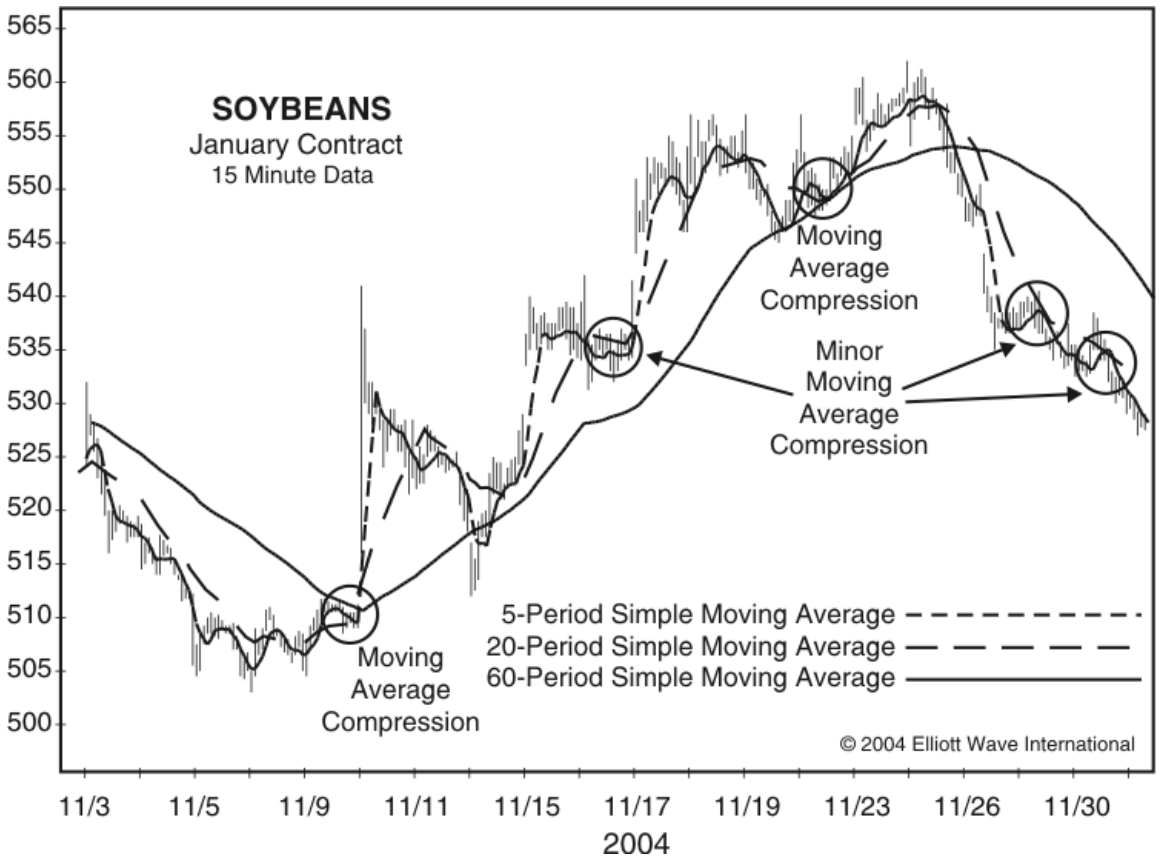


Figure 10-20

It also doesn't matter whether you use simple, exponential, weighted or smoothed moving averages. The end result is the same: the averages come together during periods of market contraction and move apart when the market expands. As with all my tools, this one works regardless of time frame or market. Figure 10-20 (Soybeans) is a 15-minute chart, where the moving averages compressed on a number of occasions prior to sizable moves in price.

I would love to say the concept of Moving Average Compression is my original idea, but I can't. It is actually my variation of Daryl Guppy's Multiple Moving Average indicator. His indicator is visually breathtaking, because it uses 12 exponential moving averages of different colors. I first encountered Guppy's work in the February 1998 issue of *Technical Analysis of Stocks and Commodities* magazine. I highly recommend the article.

[DECEMBER 2004]

XI. How To Use Bar Patterns To Spot Trade Setups

1. "DOUBLE INSIDE BARS"

While many of my co-workers jog, bicycle or play in bands for a hobby, I amuse myself by looking through old price charts of stocks and commodities. I try to limit the time I spend on my hobby to about a half-day on the weekends, but often it encompasses the whole weekend, especially if it's raining. Over the years I've made many observations and notes, a few of which I like to share here in Trader's Classroom. Let's look at a bar pattern that I call a "double inside day."

Many of you who subscribe to *Daily Futures Junctures* have seen me mention this bar pattern. Although this price formation is nothing new or groundbreaking, it is so important that I think everyone should be familiar with it. Why? Because it often introduces sizable moves in price – always a good reason for a trader to pay attention.

So let's begin with a basic definition: A double inside day, or bar, occurs when two inside bars appear in a row. An inside bar is simply a price bar with a high below the previous high and a low above the previous low. Figure 11-1 illustrates what a double inside bar pattern looks like. Notice that the range of price bar number two encompasses price bar number one, and price bar number three encompasses price bar number two.

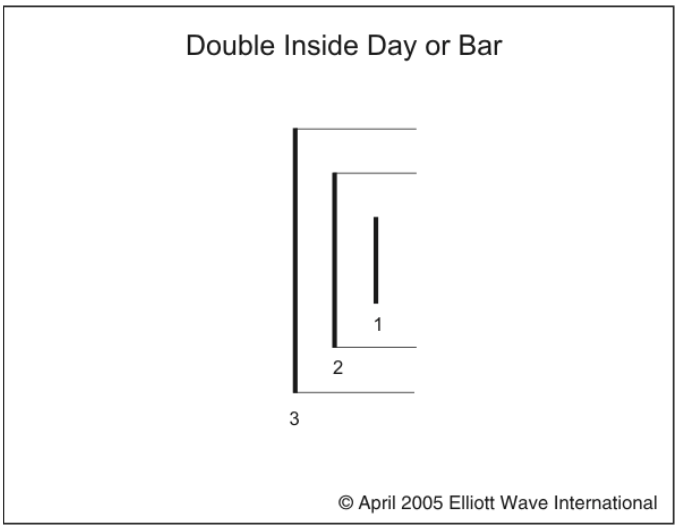


Figure 11-1

Figures 11-2 through 11-5 (Wheat, Orange Juice, Feeder Cattle and Soybean Oil) show examples of double inside days and the price moves that followed. In each instance, I believe these formations introduced tradable moves.

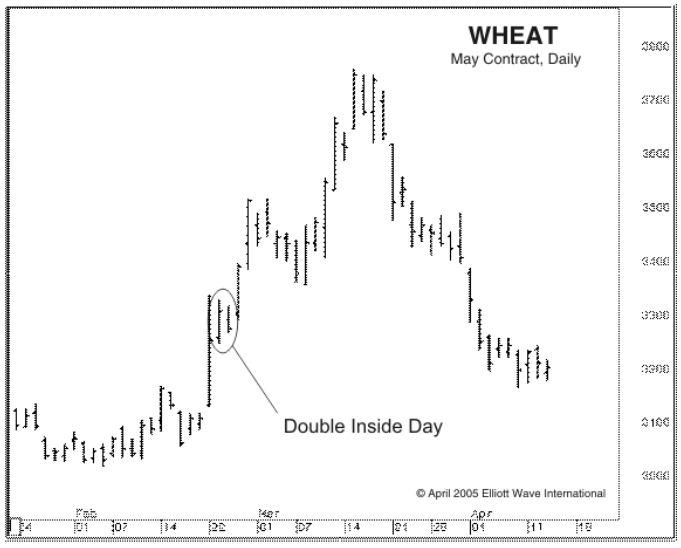


Figure 11-2

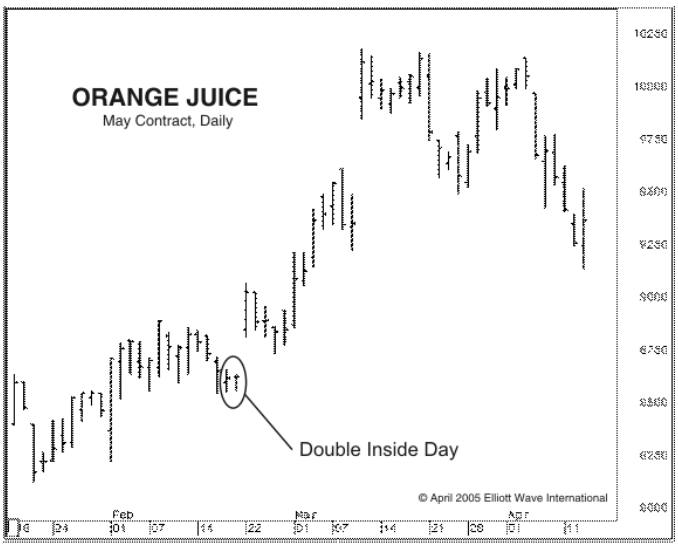


Figure 11-3

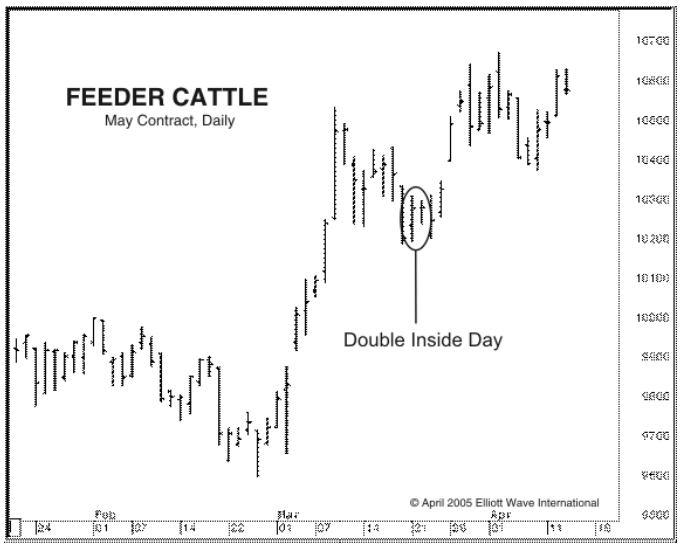


Figure 11-4

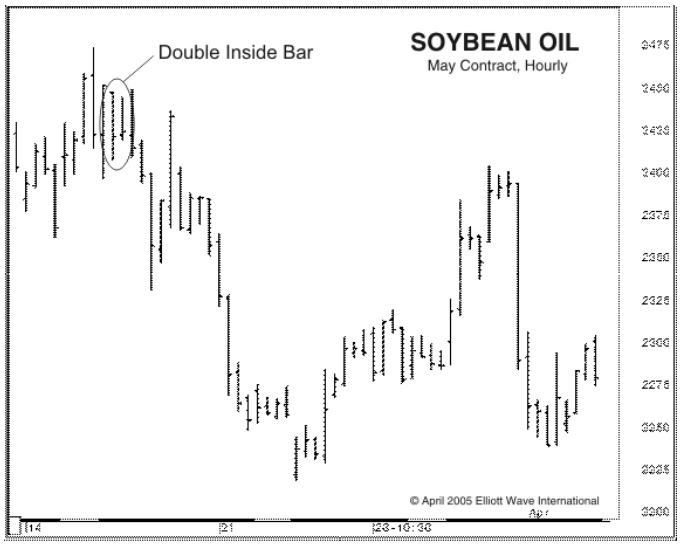


Figure 11-5

2. "ARROWS"

Now that we are all on the same side of the fence, let me introduce you to another price pattern that I call the "arrow." An arrow is simply a modified double inside day formation. Instead of using three price bars, it requires four. In Figure 11-6, you can see that price bar number one is an inside bar and that price bar number two is an inside bar in relation to bars three and four.

- The high of bar two is below the high of bar three.
- The low of bar two is above the low of bar four.

Now let's look at some examples. In Figures 11-7 through 11-9 (Cotton, Coffee and Soybeans), it's easy to see that each arrow introduced a tradable move much like our double in-

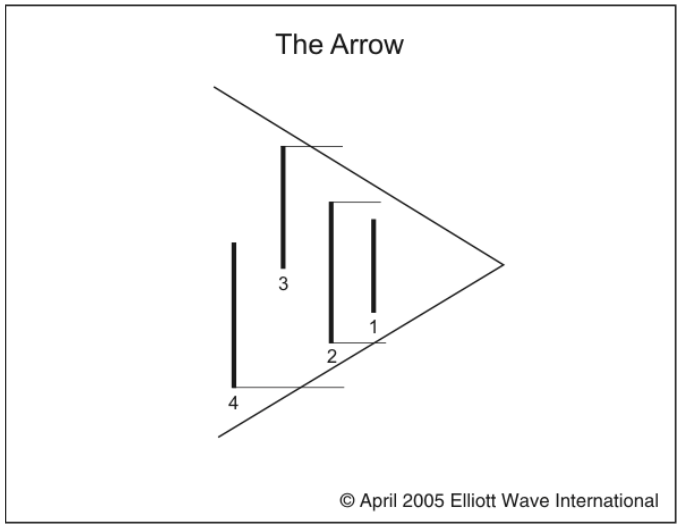


Figure 11-6



Figure 11-7

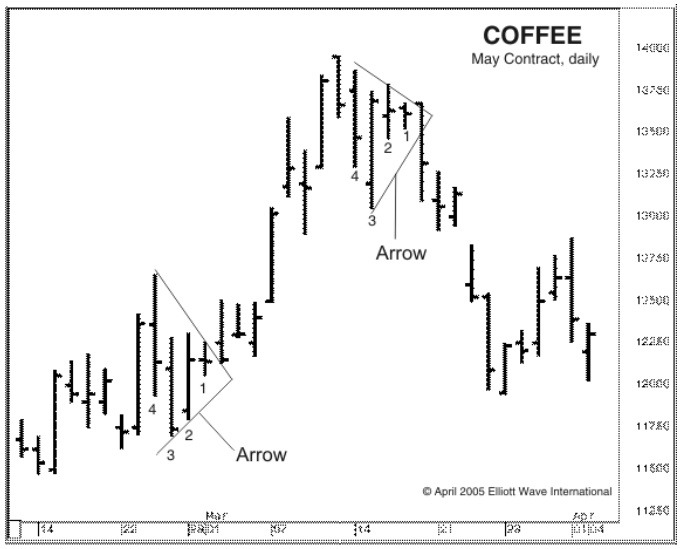


Figure 11-8

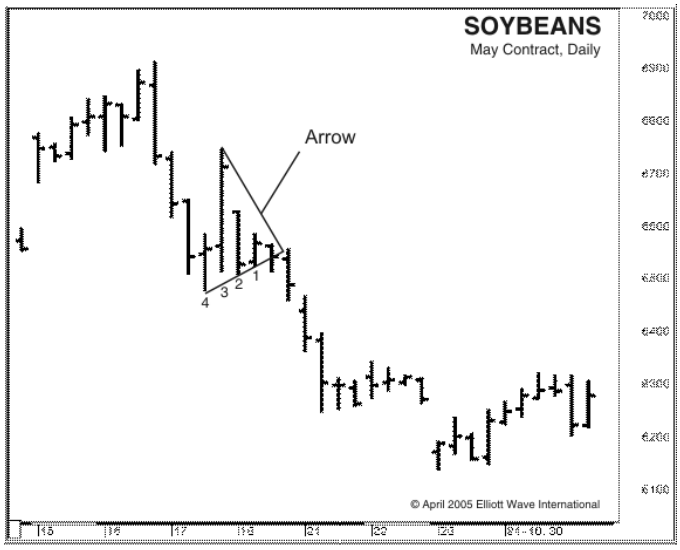


Figure 11-9

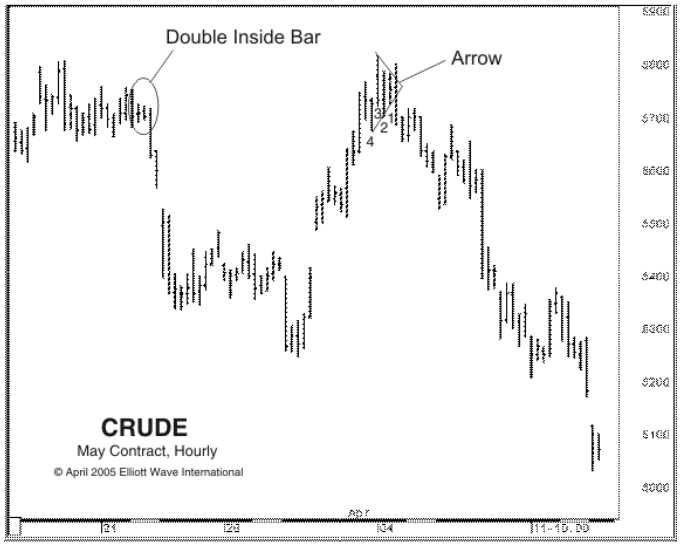


Figure 11-10

side day formation did. One way to think of an arrow is that it is simply a *hidden* double inside day, or bar. I've saved the best for last. On the left hand side of Figure 11-10 (Crude Oil), you can see a double inside bar that introduced a selloff in just a few short hours from 57.08 to 53.40. On the right hand side of the chart, you can see an arrow formation that included the (then) all-time high in Crude Oil at 58.20 and led to about an $8 drop in prices soon after. That's what I mean by a sizable move in price.

[APRIL 2005]

3. "POPGUNS"

I'm no doubt dating myself, but when I was a kid, I had a popgun – the old-fashioned kind with a cork and string (no fake Star Wars light saber for me). You pulled the trigger, and the cork popped out of the barrel attached to a string. If you were like me, you immediately attached a longer string to improve the popgun's reach. Why the reminiscing? Because "Popgun" is the name of a bar pattern I would like to share with you this month. And it's the path of the cork (out and back) that made me think of the name for this pattern.

The Popgun is a two-bar pattern composed of an outside bar preceded by an inside bar, as you can see in Figure 11-11. (Quick refresher course: An outside bar occurs when the range of a bar encompasses the previous bar and an inside bar is a price bar whose range is encompassed by the previous bar.) In Figure 11-12 (Coffee), I have circled two Popguns.

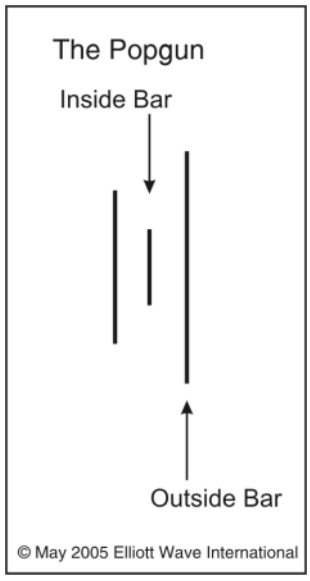


Figure 11-11

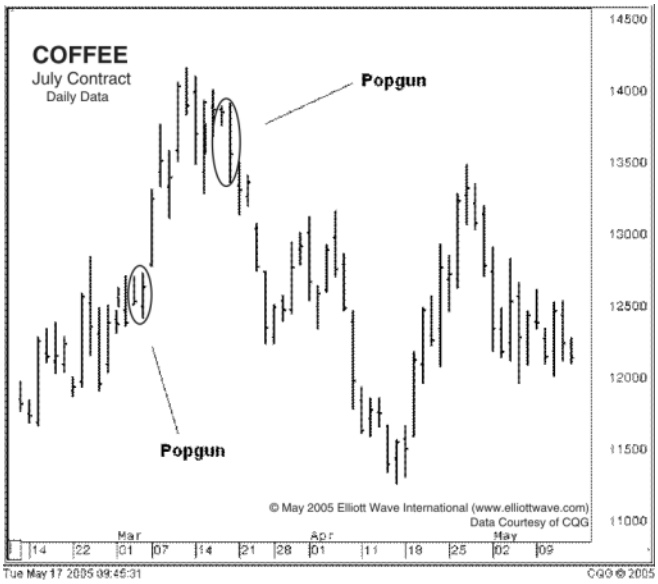


Figure 11-12

So what's so special about the Popgun? It introduces swift, tradable moves in price. More importantly, once the moves end, they are significantly retraced, just like the popgun cork going out and back. As you can see in Figure 11-13 (Coffee), prices advance sharply following the Popgun, and then the move was significantly retraced. In Figure 11-14 (Coffee), we see the same thing again but to the downside: prices fall dramatically after the Popgun, and then a sizable correction develops.

How can we incorporate this bar pattern into our Elliott wave analysis? The best way is to understand where Popguns show up in the wave patterns. I have noticed that Popguns tend to occur prior to impulse waves – waves one, three and five. But, remember, waves A and C of corrective wave patterns are also technically impulse waves. So Popguns can occur prior to those moves as well.

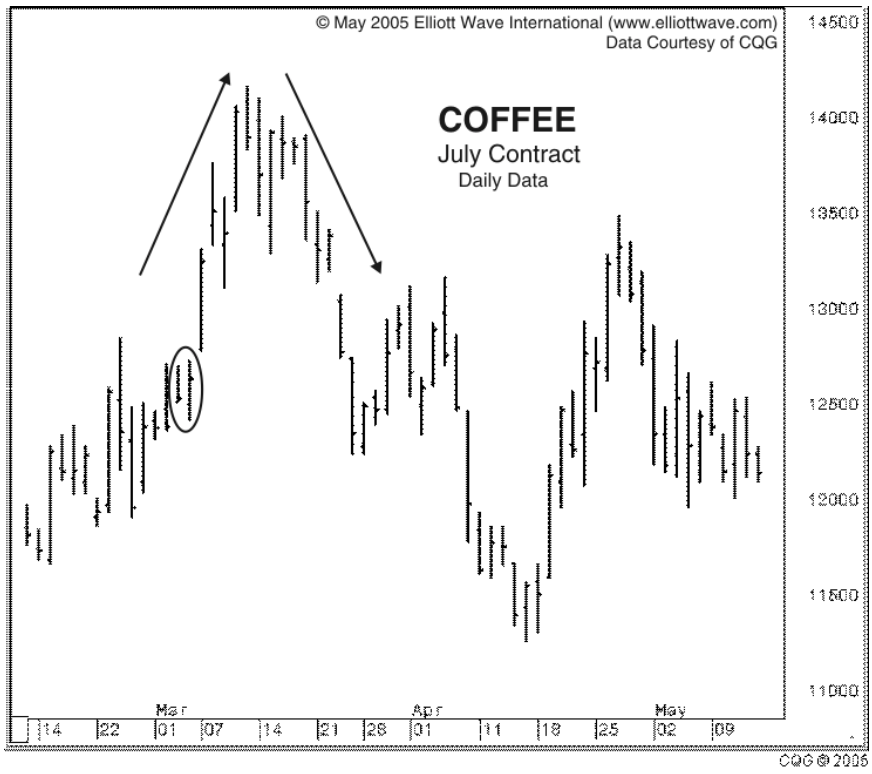


Figure 11-13



Figure 11-14

As with all my work, I rely on a pattern only if it applies across all time frames and markets. To illustrate, I have included two charts of Sirius Satellite Radio (SIRI) that show this pattern works equally well on 60-minute and weekly charts. Notice that the Popgun on the 60-minute chart (Figure 11-15) preceded a small third wave advance. Now look at the weekly chart (Figure 11-16) to see what three Popguns introduced (from left to right): wave C of a flat correction, wave 5 of (3) and wave C of (4).

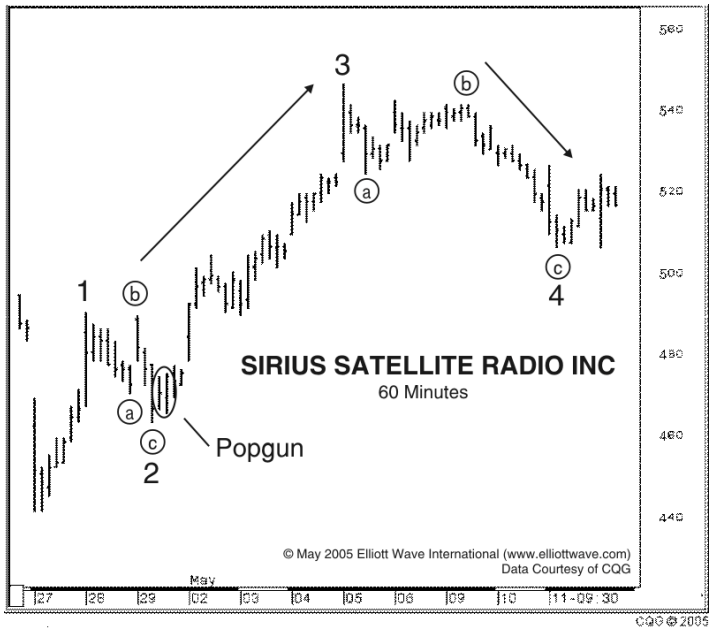


Figure 11-15

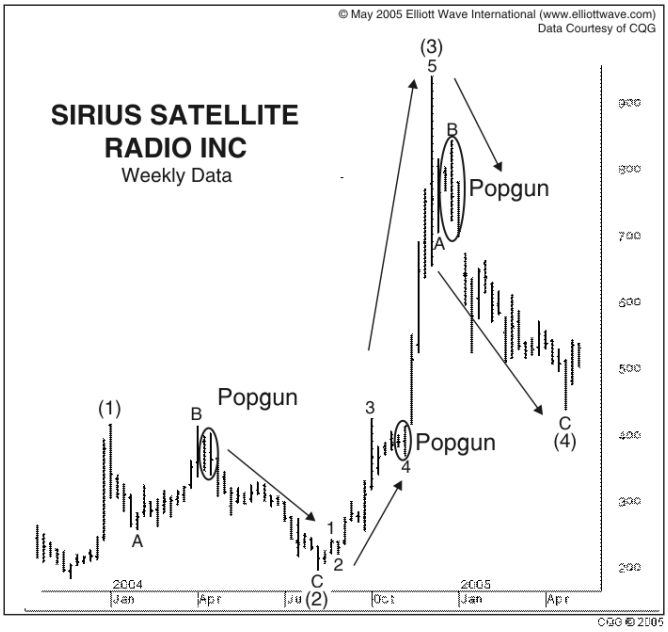


Figure 11-16

There's only one more thing to know about using this Popgun trade setup: Just be careful and don't shoot your eye out, as my mom would say.

[MAY 2005]

XII. How To Use Price Gaps as Trade Setups: The Double Tap

When I first began my career as a technical analyst, it seemed that everything about financial markets and technical analysis had already been discovered. I remember feeling disappointed that I was beginning my career in such a dynamic profession so late in its maturity.

But in recent years, I have found myself believing just the opposite. I think what we collectively know as technicians and traders is like a child's understanding of how a car works. In other words, we have only begun to discover the many secrets that financial markets and successful trading hold.

So as a perpetual student of financial markets, I spend many long weekends and hours poring over price charts and studying price action. As a result, I've made some fascinating and intriguing discoveries. One such discovery is a trade setup I call the Double Tap.

What is a Double Tap?

I have found that it is often the *second* test of a price gap which introduces swift, sizable moves in price. A Double Tap occurs when prices test a previous price gap on two separate occasions, as if they were tapping you on the shoulder to point out an opportunity. If the two taps or tests are against resistance, then prices are likely setting up for a selloff. Conversely, if the two taps or tests are against support, then prices are most likely gearing up for a rally.

Before I show you examples of this Double Tap setup, let me first explain what I mean by "price gap" to be sure that we are using the same definition. A price gap occurs when the *range* of the current bar fails to include the *close* of the previous bar. The result often appears as a blank space on a price chart. And it is the *close of the previous bar* prior to the move up or down in prices that I consider to be the "gap" that we want to use as our measure. (Also see Section X of *Trader's Classroom Collection: Volume 1*, pp. 54-56.)

What It Looks Like

So now let's look at a few examples of the Double Tap on 60-minute charts. The three horizontal lines in Figure 12-1 (Soybeans) show the closes of three price bars that preceded gaps in price. As you can see, Soybean prices tested this area on two separate occasions. And it was the second test of these price gaps that resulted in the recent selloff in Soybeans down to 553 (basis March).

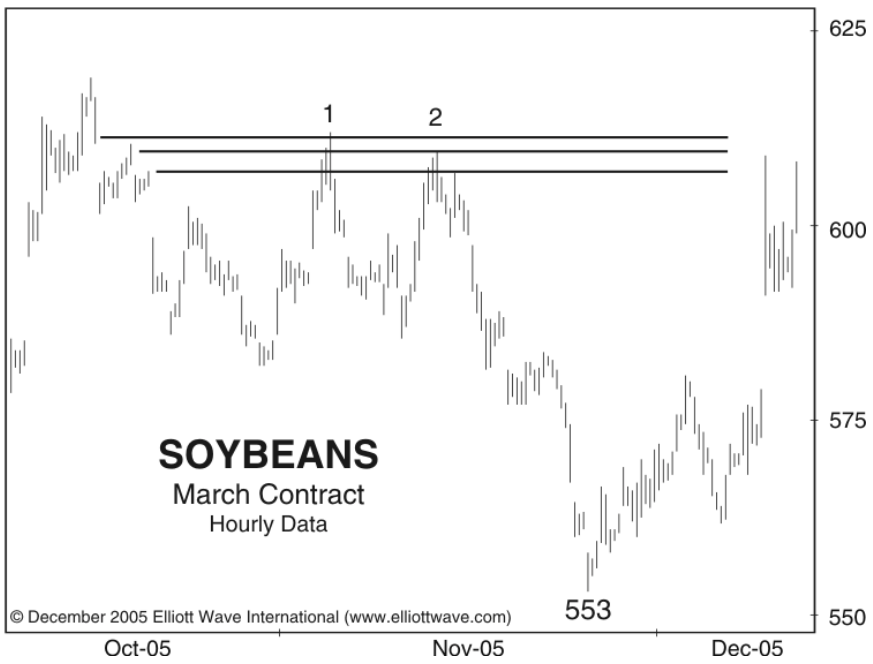


Figure 12-1

Figure 12-2 (Feeder Cattle) identifies two small previous price gaps by horizontal lines on the price chart. And again, it wasn't the first test of this area that resulted in a tradable move in price but the second test of this area, after which prices moved swiftly to 117.90.

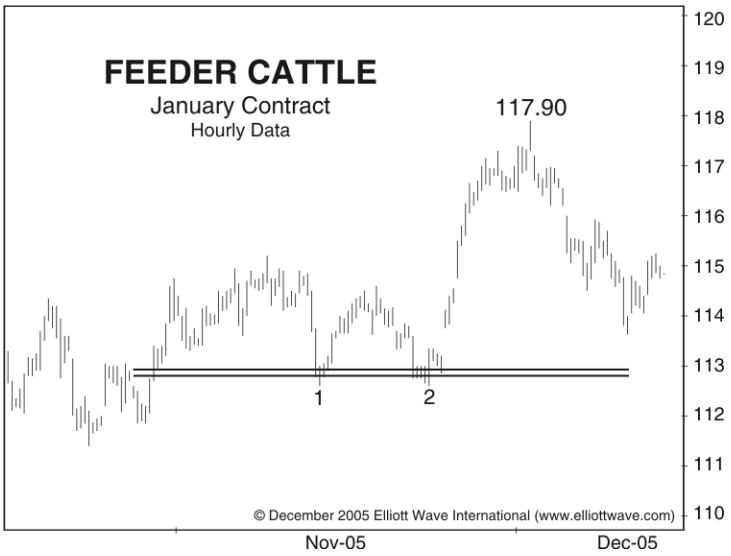


Figure 12-2

Another example of a Double Tap recently occurred in Lean Hogs (Figure 12-3). This time, rather than two previous price gaps, there was only one, which is identified by the horizontal line. Notice again that it is the second test of the price gap that results in a swift, sizable move down in price to 65.12.

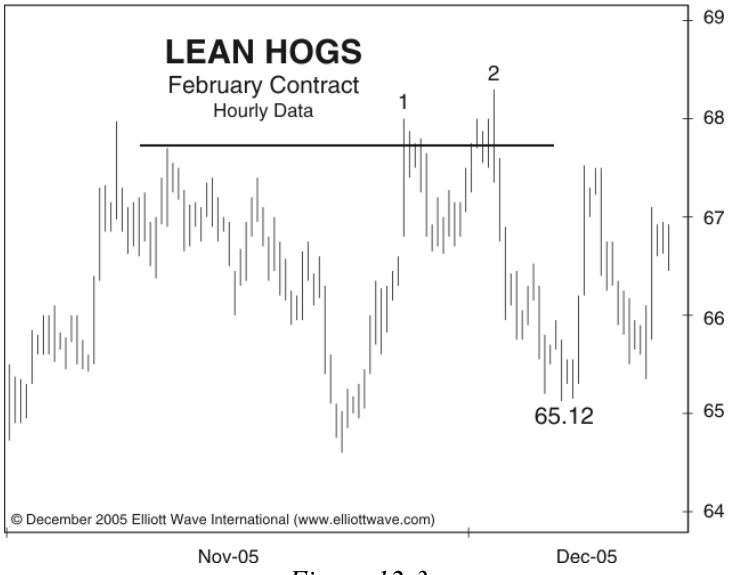


Figure 12-3

The Cocoa chart (Figure 12-4) shows two Double Taps: The first led to a rally to 1467; the second resulted in a selloff to 1344. This example is exciting because it illustrates a smaller Double Tap formation within a larger Double Tap. As you can see, the resulting price moves are proportional to the size of the patterns.

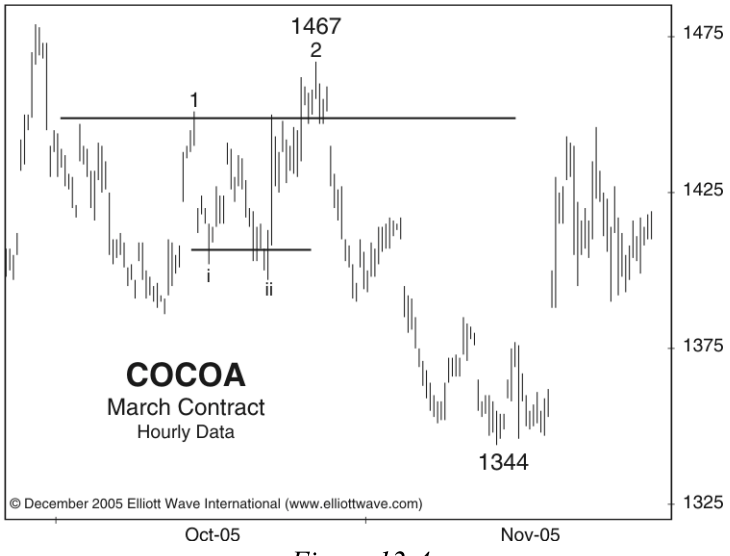


Figure 12-4

In my experience, the Double Tap occurs more frequently on intraday time frames of 60 minutes, 30 minutes, 15 minutes, etc., than on daily or weekly time frames. Nevertheless, the last two charts for Coffee and Soybean Meal (Figures 12-5 and 12-6) show that it can work just as well on daily charts. In Coffee (Figure 12-5), the second test of the identified price gap resulted in a selloff to ultimately 93.50. And in Soybean Meal (Figure 12-6), we have a situation similar to that which we saw in Cocoa (Figure 12-4), a Double Tap within a Double Tap. As you can see in Figure 12-6, the interior Double Tap trade setup introduced a decline from 186.2 to 169.0, and the larger secondary Double Tap yielded a proportional move to a high of 196.5.

Some say that "...third time's a charm." Well, in the case of the Double Tap, it's the second time that's a charm.

[DECEMBER 2005]

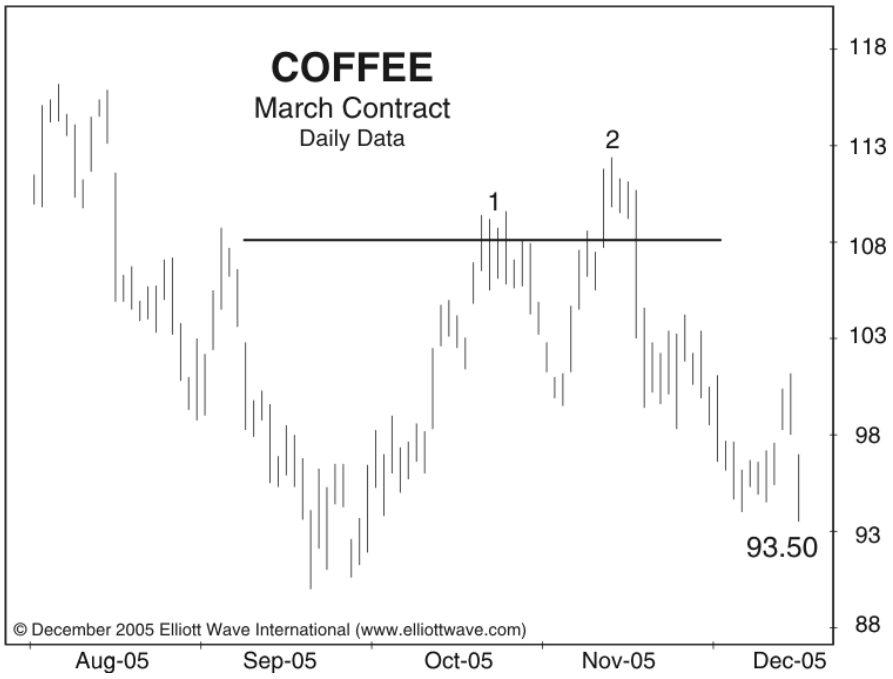


Figure 12-5

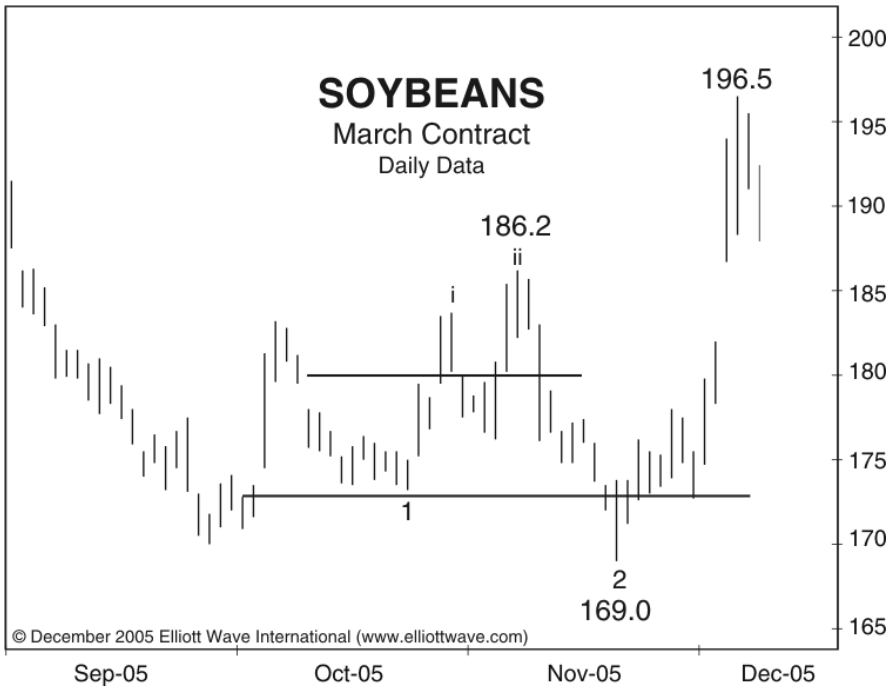


Figure 12-6

Appendix: 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 A-1 shows, these basic patterns link to form five- and three-wave structures of increasingly larger size (larger "degree" in Elliott terminology).

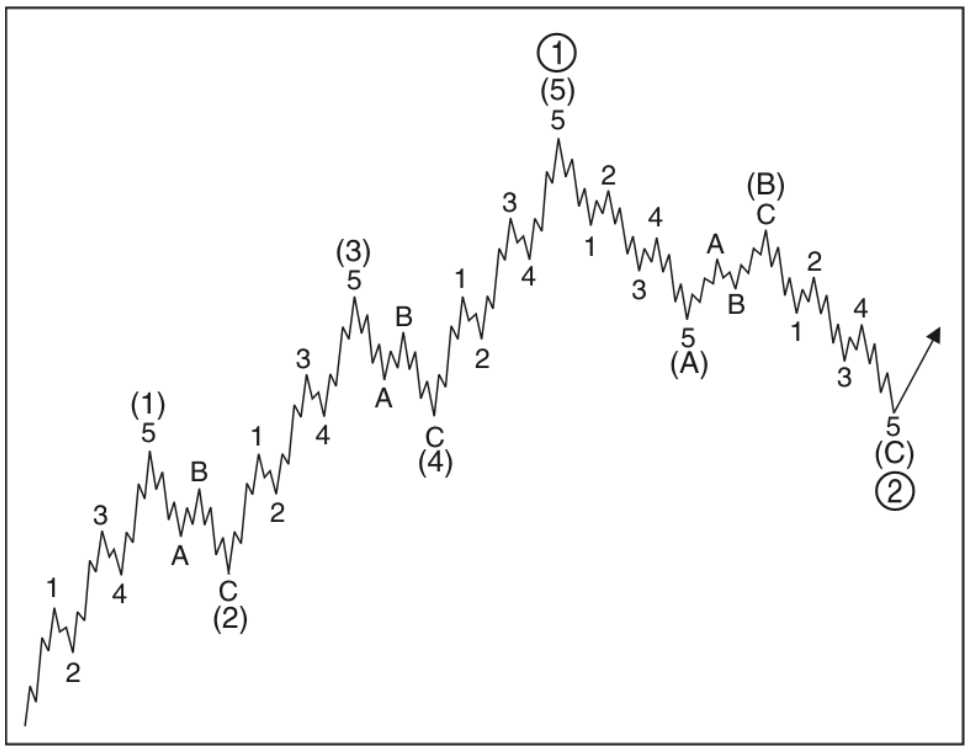


Figure A-1

In Figure A-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 A-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	ⓘ	ⓘⓘ	ⓘⓘⓘ	ⓘⓥ	ⓥ	ⓐ	ⓑ	ⓒ
Minuette	(i)	(ii)	(iii)	(iv)	(v)	(a)	(b)	(c)
Subminuette	i	ii	iii	iv	v	a	b	c

Figure A-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 OF TERMS

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.

February 2006 – April 2007 Volume 3

Trader's Classroom Collection



More Lessons from Futures Junctures

Editor Jeffrey Kennedy

elliottwave

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THE TRADER'S CLASSROOM COLLECTION

Volume 3

Lessons from *Futures Junctures* Editor Jeffrey Kennedy

Published by

Elliott Wave International

www.elliottwave.com

THE TRADER'S CLASSROOM COLLECTION: Volume 3

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Elliott Wave International, Inc.

For information, address the publisher:

Elliott Wave International

Post Office Box 1618

Gainesville, Georgia 30503 USA

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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.*

A Note from Jeffrey Kennedy about Volume III…

June 2008

I enjoy analyzing price charts and making forecasts here at Elliott Wave International, but what I enjoy even more is providing each of you with insights I've learned over the years. I do that in my monthly column, called Trader's Classroom.

It turns out that many of my subscribers like the column as much as I like writing it. That's what gave us the idea to collect my columns and publish them for new subscribers as *The Trader's Classroom Collection*. Now we've produced a third volume that includes 13 columns I wrote from February 2006 to April 2007, on topics like Trading in the Zone, The Only Technical Trade Setup You'll Ever Need and my Annual Fibonacci Support and Resistance Levels.

Recent years have seen some of the most historically volatile times for commodities and, in turn, have provided some of the clearest wave patterns. It has been the perfect environment to offer real-life, real-time trading lessons via the Trader's Classroom column in *Monthly Futures Junctures*. The advances in grains in 2007 offered several examples of how important the Wave Principle and my other techniques are in identifying high-probability trading opportunities in any financial market.

Why do I to write these columns each month? ***To supply you with simple tools and methods that work on any timeframe and in any financial market, which you can apply yourselves.*** And remember, although I mostly use commodity charts, you can apply these lessons to your favorite markets.

I hope you enjoy Volume III of *The Trader's Classroom Collection*, which covers these four broad topics: 1) helping yourself to trade better, 2) using the Wave Principle to trade, 3) high-opportunity trade setups and 4) Fibonacci-related trading tips.

Welcome to the third edition of *The Trader's Classroom Collection*,



Jeffrey Kennedy
Chief Commodity Analyst and Editor of *Futures Junctures*
Elliott Wave International

P.S. I have beefed up our Futures Junctures Service to include webinars and video updates as well as Commitment of Traders data, Daily Sentiment Index data, the Futures Junctures Index of Crowd Psychology and a Trader's Toolbox. If you would like to receive these and the Trader's Classroom columns as I publish them, learn more about how to subscribe to our Futures Junctures service at http://www.elliottwave.com/wave/TCCFJ.

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

1. Trading in the Zone

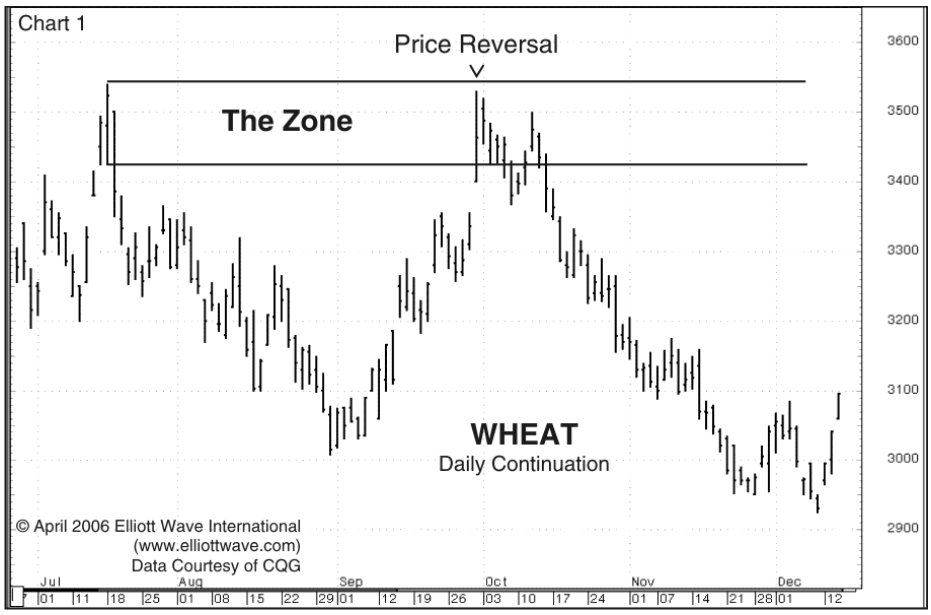
The Best Place for High-Opportunity Trade Setups
April 2006

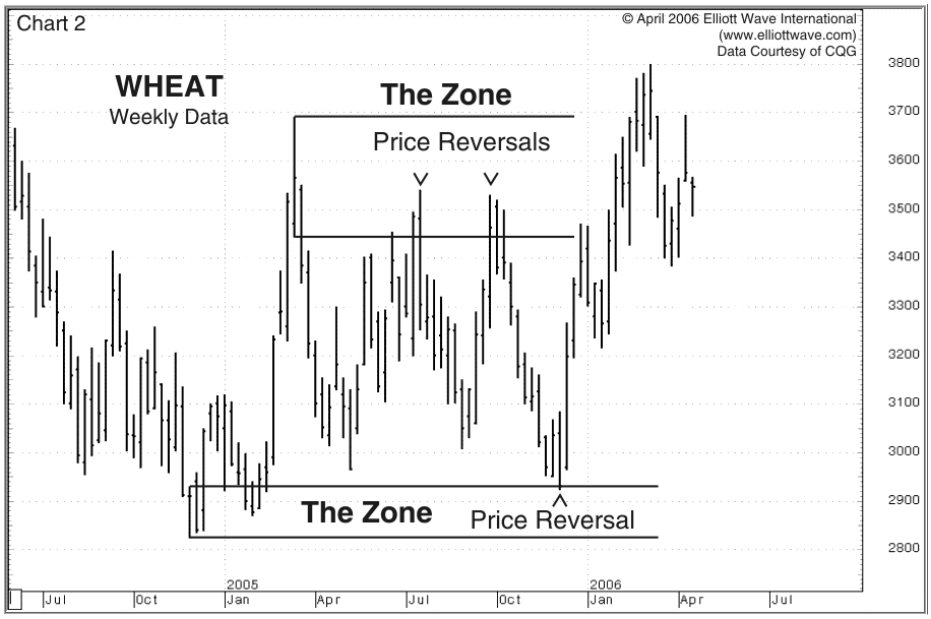
Have you ever had the experience of "being in the zone"? It's that special place of intense mental focus where it seems that nothing else exists and that you can seemingly do no wrong. Lots of athletes talk about "being in the zone" when they play at their peak. Some people encounter the zone while playing golf or skiing; others, while doing yard work or making a sales call. One of my first experiences with this almost magical place came when I was a kid playing the video game called Pac-Man. Some people talk about "being the ball" when they hit a great shot. Well, there were times when I wasn't just playing Pac-Man – I was the Pac-Man.

So what does the zone have to do with analysis? In my world, it's that special place on a price chart that seems to offer frequent high probability trade setups. I call it The Zone. Where do you find The Zone on a price chart? It is the range of the price bar that includes a long– standing price extreme.

Let's look at Chart 1 (Wheat, daily continuation) to see what I mean. Notice that I drew two horizontal lines from the high and low points of the bar in mid-July 2005. This range is what I call The Zone. The high of this bar, 354, was the highest high in Wheat in a six-month period. As you can see, when prices revisited The Zone between 354 and 343 in late-September 2005, a significant sell off resulted. This is why The Zone of a price chart is so important; it's where prices often reverse.

To show you how useful and reliable this technique is, I am including two more charts of Wheat on different time frames. In Chart 2, you can see that, once you draw in The Zones on your chart, they can prepare you for reversals. In this case, weekly Wheat offered three distinct trading opportunities (i.e., two shorts and one long).

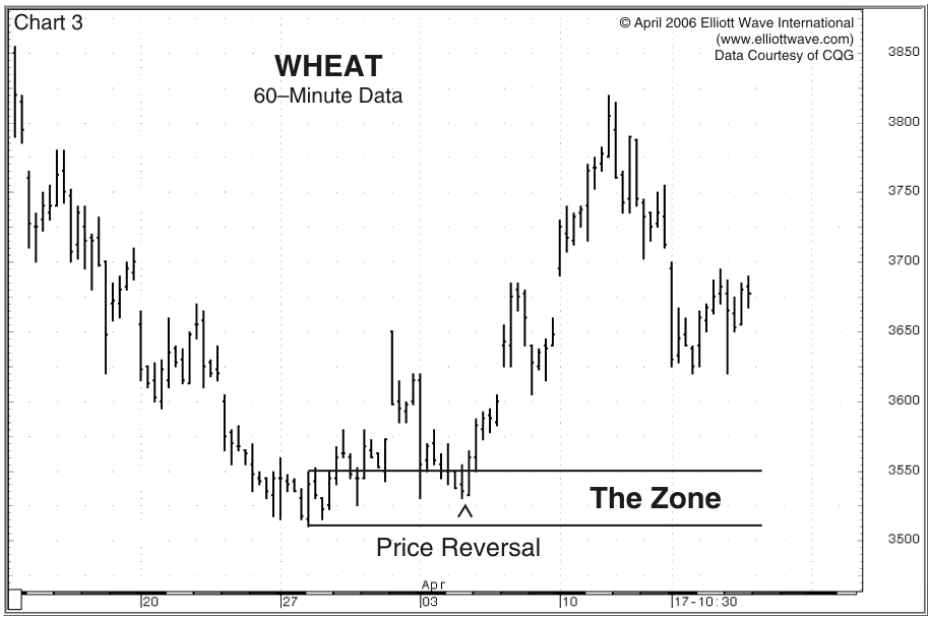


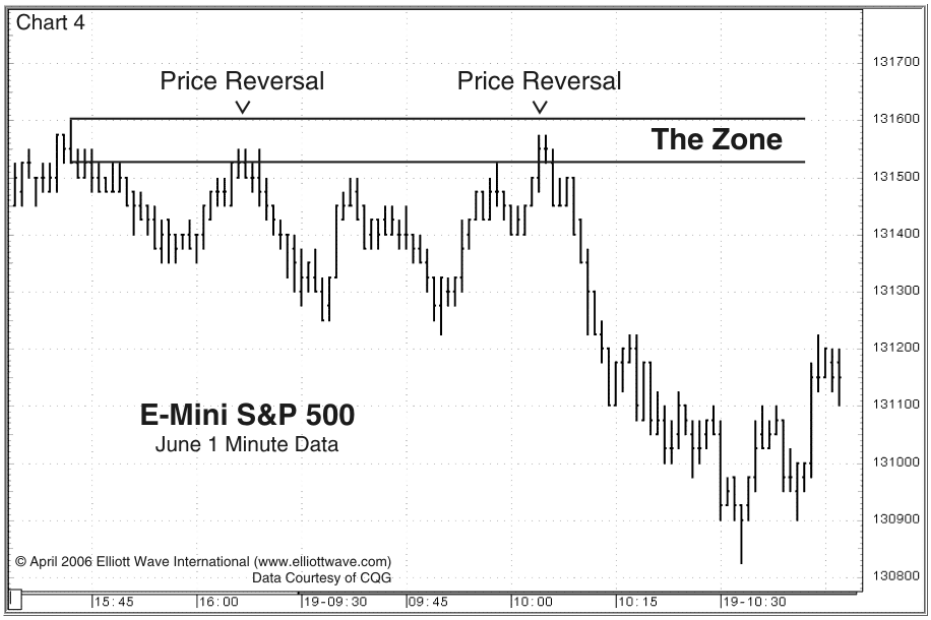


On the much smaller time frame of 60 minutes, Chart 3 shows that The Zone drawn from the lowest low provided a high probability buy side trade setup.

Chart 4 is even more exciting, because it demonstrates how The Zone applies even on a 1-minute chart. As you can see, The Zone identified two distinct trading opportunities on the 1-minute chart of the E-mini S&P.

Since this column is called Trader's Classroom, I've decided to give each of you some homework this month: Take your favorite market and identify its Zone on intraday, daily, weekly and monthly time frames. By doing this, you'll be able to identify for yourself where reversals in price are most likely to occur ... and you'll be in The Zone.





2. Why Do Traders Fail?

Because of Inadequate Trading Systems
June 2006

I think that, as a general rule, traders fail 95% of the time, regardless of age, race, gender or nationality. The task at hand could be as simple as learning to ride a bike for the first time or as complex as mapping the human genome. Ultimate success in any enterprise requires that we accept failure along the way as a constant companion in our everyday lives.

I didn't just pull this 95% figure from thin air either. I borrowed it from the work of the late, great Dr. W. Edward Deming, who is the father of Total Quality Management, commonly known as TQM. His story is quite interesting, and it actually has a lot to do with how to trade well.

Dr. Deming graduated with degrees in electrical engineering, mathematics and mathematical physics. Then, he began working with Walter A. Shewhart at Bell Telephone Laboratories, where he started applying statistical methods to industrial production and management. His early work with Shewhart resulted in a seminal book, Statistical Method from the Viewpoint of Quality Control.

Since American industry spurned many of his ideas, Deming went to Japan shortly after World War II to help with early planning for the 1951 Japanese Census. Impressed by Deming's expertise and his involvement in Japanese society, the Japanese Union of Scientists and Engineers invited him to play a key role in Japan's reconstruction efforts. Deming's work is largely responsible for why so many high quality consumer products come from Japan even to this day.

In turn, Japanese society holds Dr. W. Edward Deming in the highest regard. The Prime Minister of Japan recognized him on behalf of Emperor Hirohito in 1960. Even more telling, Deming's portrait hangs in the lobby at Toyota headquarters to this day, and it's actually larger than the picture of Toyota's founder.

So why do people fail? According to Deming, it's not because people don't try hard enough or don't want to succeed. People fail because they use inadequate systems. In other words, when traders fail, it's primarily because they follow faulty trading systems – or they follow no system at all.

So what is the right system to follow as a trader? To answer this question, I offer you what the trader who broke the all-time real-money profit record in the 1984 United States Trading Championship offered me. He told me that a successful trader needs five essentials:

1. A Method

> You must have a method that is objectively definable. This method should be thought out to the extent that if someone asks how you make decisions to trade, you can quickly and easily explain. Possibly even more important, if the same question is asked again in six months, your answer will be the same. This is not to say that the method cannot be altered or improved; it must, however, be developed as a totality before it is implemented.

2. The Discipline to Follow Your Method

> 'Discipline to follow the method' is so widely understood by true professionals that among them it almost sounds like a cliché. Nevertheless, it is such an important cliché that it cannot be ignored. Without discipline, you really have no method in the first place. And this is precisely why many consistently successful traders have military experience – the epitome of discipline.

3. Experience

It takes experience to succeed. Now, some people advocate "paper trading" as a learning tool. Paper trading is useful for testing methodologies, but it has no real value in learning about trading. In fact, it can be detrimental, because it imbues the novice with a false sense of security. "Knowing" that he has successfully paper-traded during the past six months, the novice believes that the next six months trading with real money will be no different. In fact, nothing could be farther from the truth. Why? Because the markets are not merely an intellectual exercise, they are an emotional one as well. Think about it, just because you are mechanically inclined and like to drive fast doesn't mean you have the necessary skills to win the Daytona 500.

4. The Mental Fortitude to Accept that Losses Are Part of the Game

The biggest obstacle to successful trading is failing to recognize that losses are part of the game, and, further, that they must be accommodated. The perfect trading system that allows for only gains does not exist. Expecting, or even hoping for, perfection is a guarantee of failure. Trading is akin to batting in baseball. A player hitting .300 is good. A player hitting .400 is great. But even the great player fails to hit 60% of the time! Remember, you don't have to be perfect to win in the markets. Practically speaking, this is why you also need an objective money management system.

5. The Mental Fortitude to Accept Huge Gains

To win the game, make sure that you understand why you're in it. The big moves in markets come only once or twice a year. Those are the ones that will pay you for all the work, fear, sweat and aggravation of the previous 11 months or even 11 years. Don't miss them for reasons other than those required by your objectively defined method. Don't let yourself unconsciously define your normal range of profit and loss. If you do, when the big trade finally comes along, you will lack the self-esteem to take all it promises. By doing so, you abandon both method and discipline.

* * *

So who was the all-time real-money profit record holder who turned in a 444.4% return in a four-month period in 1984? Answer: Robert Prechter ... and throughout the contest he stuck to his preferred method of analysis, the Wave Principle. To learn more about what a successful trader really needs, refer to the November 1986 *Elliott WaveTheorist* Special Report written by Robert Prechter in Appendix C.

3. Pick Your Poison … and Your Protective Stops

Four Kinds of Protective Stops
July 2006

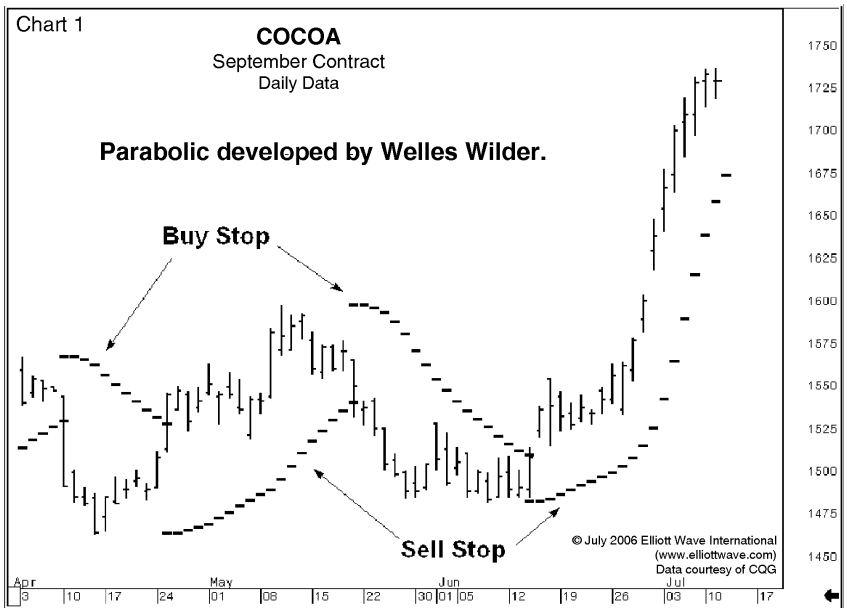
I have wanted to talk about protective stops for a long time in Trader's Classroom, because they are one of the most difficult aspects of successful trade management. Why? Because if a protective stop is too tight, chances are you'll get stopped out of a trade right before the big money move you were looking for. Conversely, if a protective stop is set too far away from where prices are currently trading, it opens you up to unnecessary market risk.

Now before I offer my 2 cents on the subject, what exactly are protective stops? Protective stops are part of a strategy that aims to limit potential losses by setting a sell stop if you are long or a buy stop if you are short. Some traders strongly advocate using them, primarily because protective stops saved their trading accounts on more than one occasion. Other traders don't use them at all, because they believe that having a protective stop in place simply gives floor traders (locals) in the pits something to gun for, a practice referred to as "stop running."

What exactly is stop running? It happens when floor traders who think they know where most of the resting buy or sell stops are located in a given market try to take profits by attempting to push prices into those stops, setting them off, and then letting the corresponding price move run its original course. Some say stop running is a myth, but on more than one occasion, I had my own positions stopped out by two or three ticks only to see prices return to moving in the direction I expected them to. Now, over the years of analyzing and trading, I've examined a number of different protective-stop techniques. Of the four I describe here, you will probably recognize two. The other two are personal favorites that I have developed.

1. Parabolic

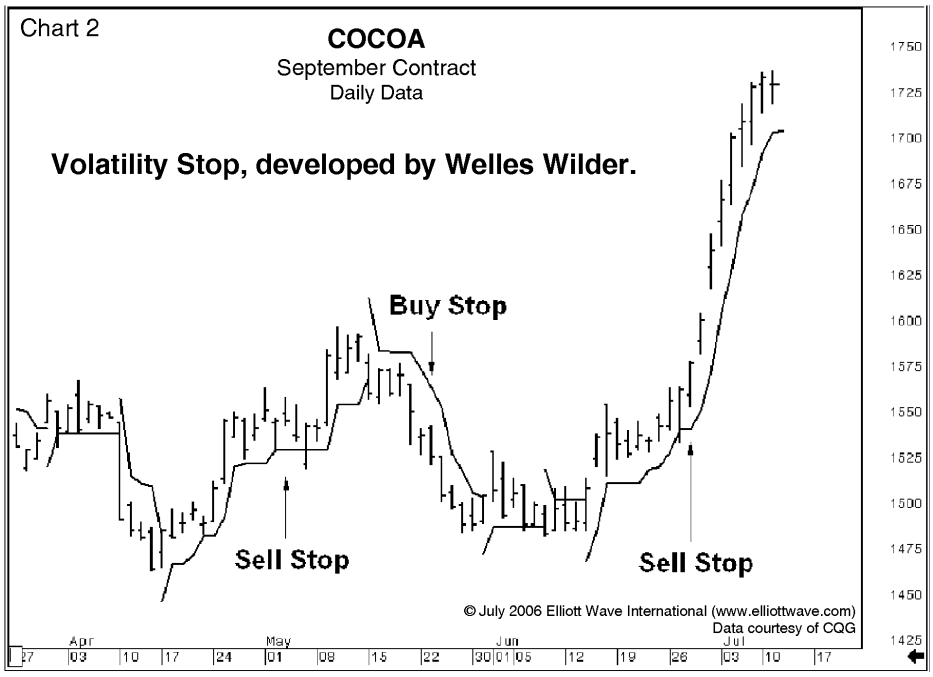
The Parabolic System, also called the Stop and Reverse (SAR) System, was created by Welles Wilder (Chart 1). The essence of the Parabolic System is that it incorporates not just price but also time. So once a trade is initiated, it allows time for the market to react to the change in trend and then adapts as the trend gets underway. Simply put, when a change in trend occurs, the protective stop is far away from the actual market price, but as the trend develops over time, the stop progressively tightens, thereby protecting accrued profits.



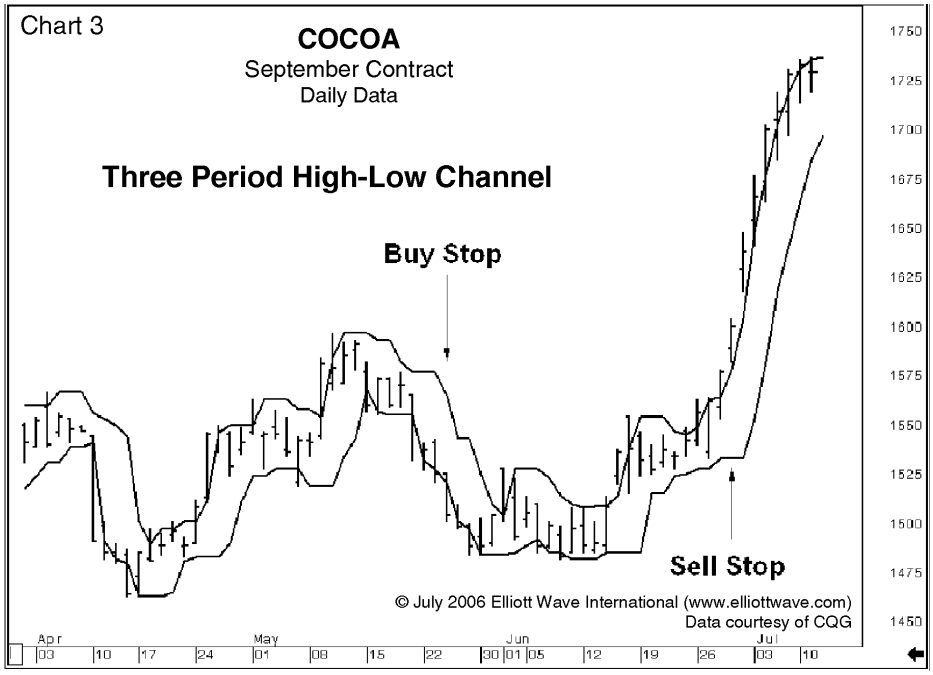
My 2 cents: Overall, I like Parabolic as a protective-stop technique, and I applaud Mr. Wilder for his genius. However, personally, I like my protective stops just a little bit tighter than what Parabolic sometimes offers.

2. Volatility Stop

The Volatility Stop is a component of the Volatility System, also developed by Welles Wilder. It is based on a volatility index made up of the ongoing calculated average of True Range. (The True Range is always positive and is defined as the highest difference in value among these three values: today's daily high minus today's daily low, today's daily high minus yesterday's closing price, and today's low minus yesterday's closing price.)

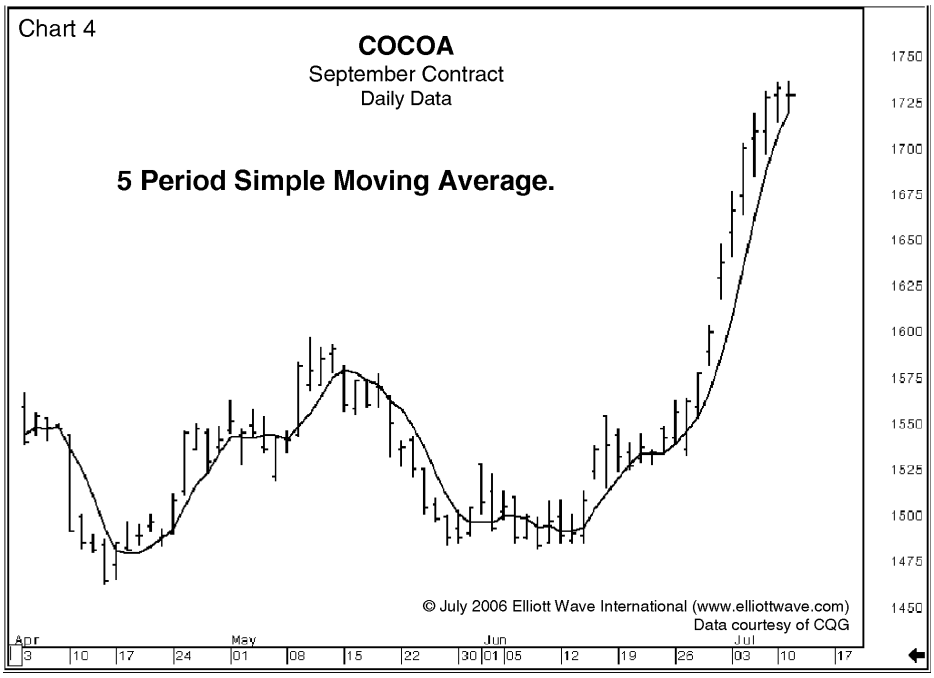


My 2 cents: The Volatility Stop is a bit more to my liking, especially when penetrated on a closing basis. As you can see in Chart 2, the protective stop identified by this technique is much tighter than the levels offered by Parabolic. And while this approach to identifying protective stops is excellent in trending markets, when a market is not trending smoothly, the result is whipsaws – something we saw in the first few weeks of trading in Cocoa in early June.



3. Three Period High-Low Channel

The Three Period High-Low Channel isn't the brainchild of any one analyst but stems from my own observation of what I consider to be tradable moves. A tradable move is a move where prices travel very far very fast (i.e. impulse waves). And as you can see in Chart 3, since the June advance began in Cocoa, prices have consistently remained above the three-period low channel. What exactly is a high-low channel? It's a channel that marks the highest high and lowest low within a specified period of time, in this case three periods.



4. Five-Period Simple Moving Average

Here's another observation in my ongoing analysis of tradable moves: I notice that when a market trends, its closes tend to stay above a five-period simple moving average of the close. And as you can see, the levels identified in Chart 4 are significantly tighter than the levels in any of the preceding price charts. So as not to miss out on a developing trend, I often set a protective stop a few ticks above or below the high of the first bar that successfully penetrates the five-period moving average on a closing basis.

My 2 cents overall: As a result of many years in search of the perfect protective-stop technique, I have discovered that there isn't one. So when deciding which stopping technique to employ, I suggest you choose one that matches your own trading style best.

My best advice: If there is a single gem I can offer in regard to using protective stops, it is this: If you're confident about a trade, give it plenty of breathing room. If you're not, then keep your protective stops tight.

1. Why Do Wave Labels Change?

How A New Context Can Change Wave Labels
March 2006

One question that every Elliottician hears sooner or later is: Why did you change your wave count? Let me begin to answer this question by asking one of my own: Have you ever changed your opinion about something once you had more information? It's called "putting things in context."

Why is context so important? Well, let me share a story with you: Recently, I read an article in my small town local newspaper that was intended to reveal wasteful spending by our county government. The article reported on recent pay increases for members of the board of education. It seems that they decided to vote themselves a whopping 200% pay increase. Naturally, the residents of our small town were infuriated, stopping just short of taking up arms and marching on town hall.

I must admit that I got a little caught up in the herd mentality and vented my opinion at the local coffee shop along with the other citizenry. At least I did until the context of the story was revealed.

It was true that the board of education members did vote and accept a 200% pay increase. But a few facts that provided context were left out of the story. The board of education members voted to raise their compensation from $200 to $600 per year. Moreover, it was their first pay increase in more than 20 years, and it won't take effect until the next board of education members are elected.

As you can see, the proper context of any situation is vitally important for an accurate understanding of current events. The same holds true for wave counts. What seems like a reasonable labeling in January may not seem as reasonable in March when more price information is available.

For an example of how my wave labels change, let's examine Charts 1 - 6 (Live Cattle) and Charts 7 - 12 (Feeder Cattle), which come directly from the Wave Watch section of the previous six months' worth of Monthly Futures Junctures.

You can see that, during the past six months, I made some changes in my wave counts in Cattle. Some of the changes I made were minor, simply changing the degree of a label here and there. Other changes – for example the differences between charts 7 and 8 (Feeder Cattle) and 9 and 10 (Feeder Cattle) – were more dramatic, because I changed wave patterns altogether. Regardless of these changes, though, my overall bearish view in Cattle remains the same.

So why did I make adjustments to my wave counts in Cattle? Because I had more price information that helped me to put my wave counts in a new context. As each new price bar forms – be it 60-minute, daily, weekly or monthly – it sheds light on previous price action, thereby revealing the market's true context. And this is why wave labels change.

Chart 1

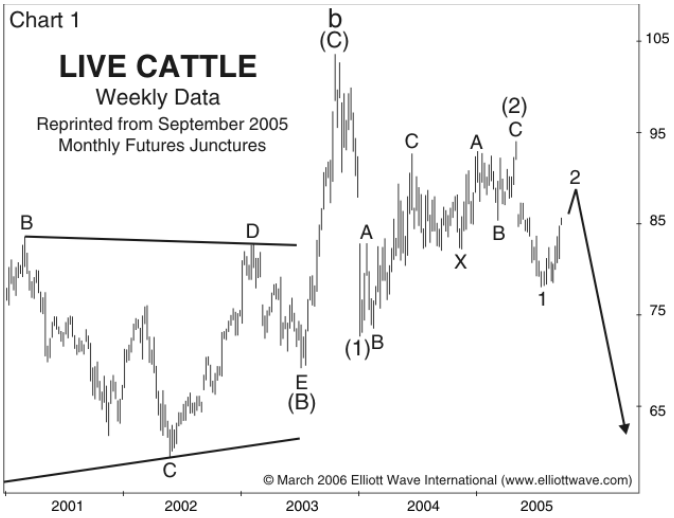


Chart 2

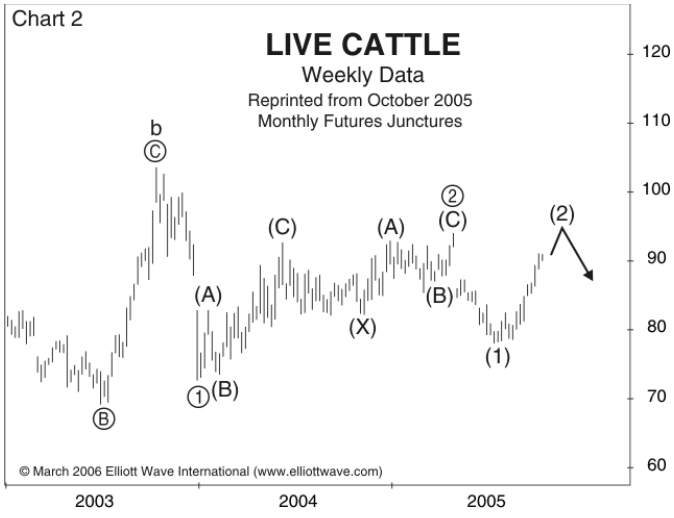


Chart 3

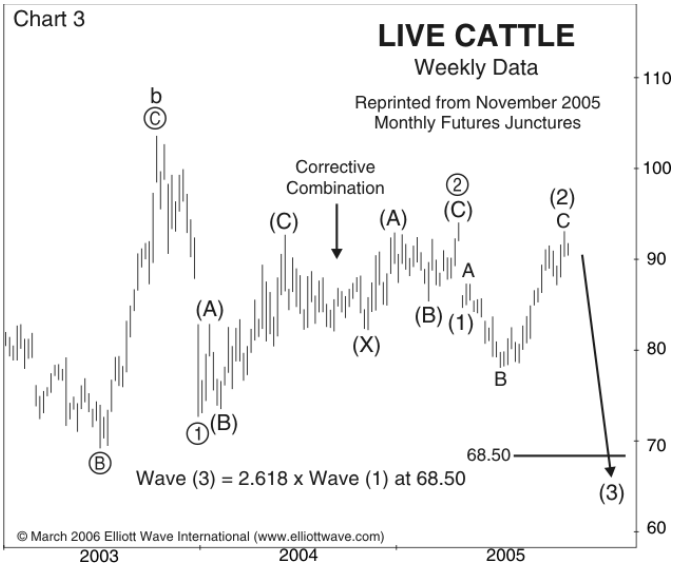


Chart 4

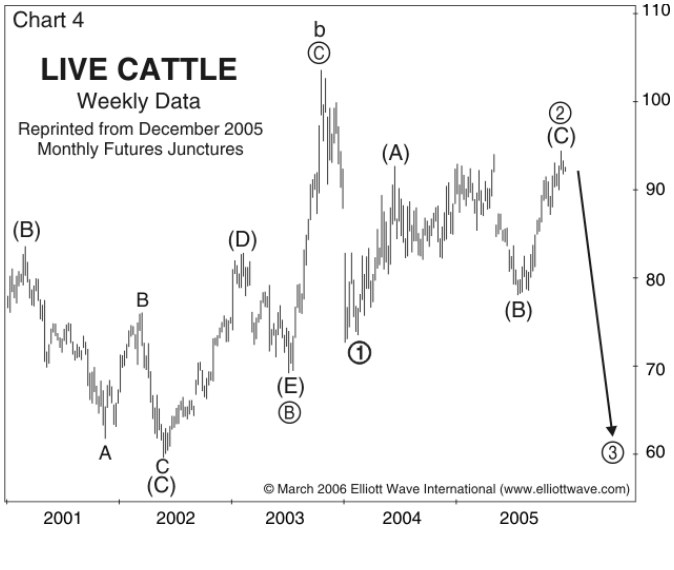


Chart 5

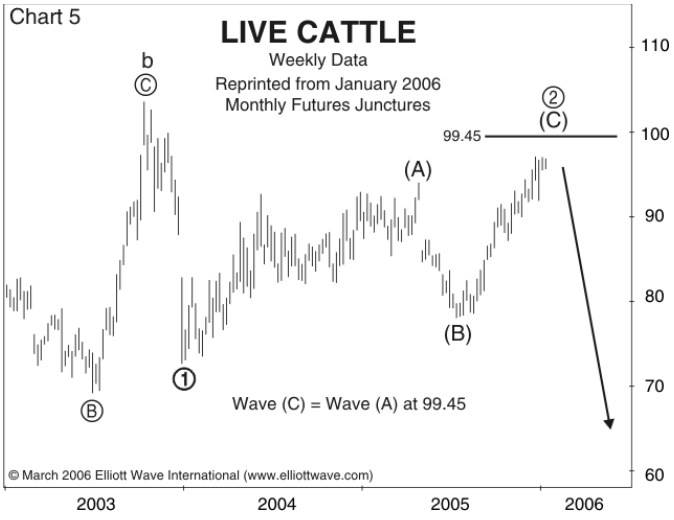


Chart 6

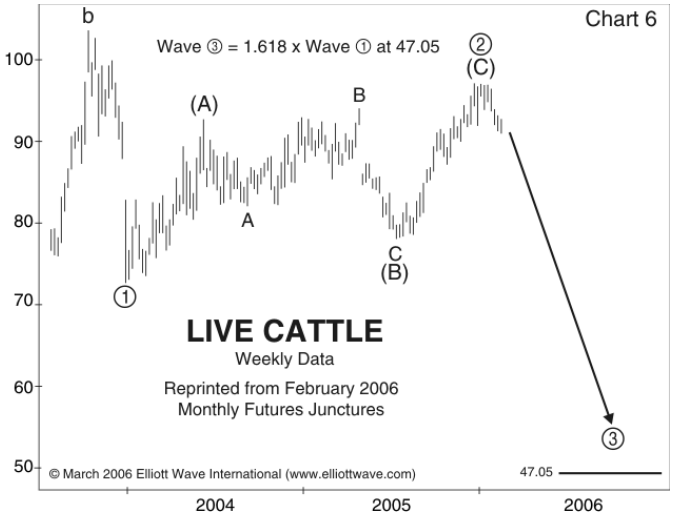


Chart 7

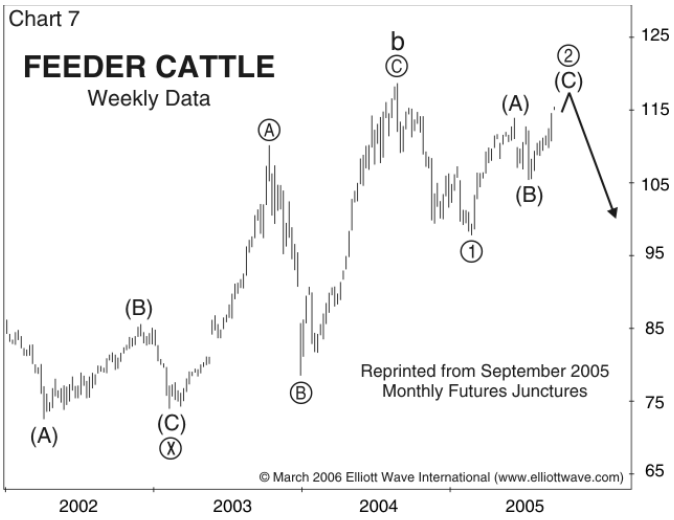


Chart 8

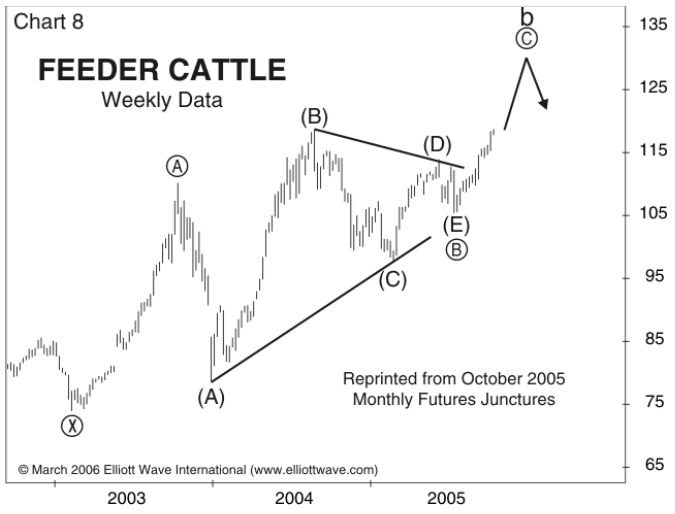


Chart 9

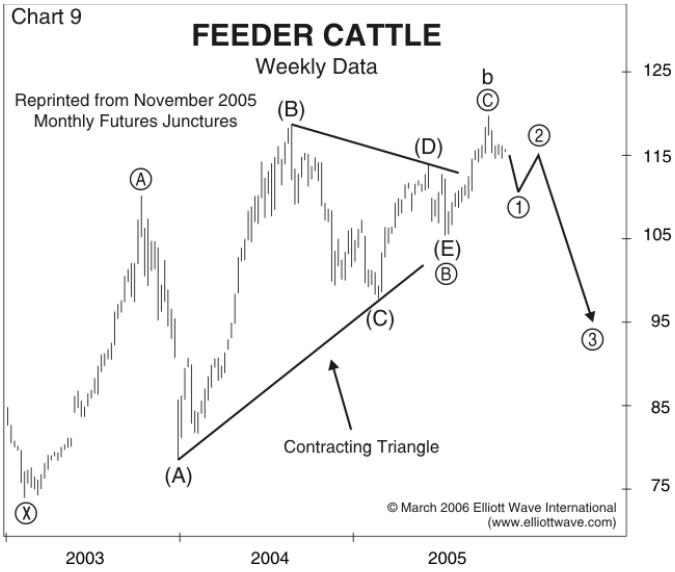


Chart 10

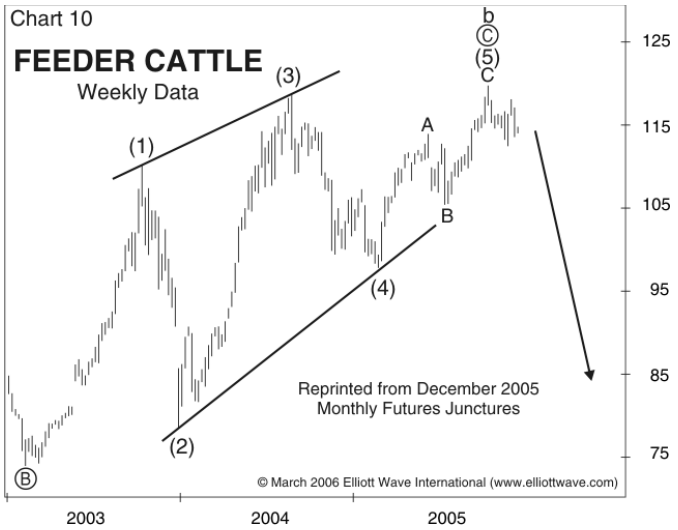


Chart 11

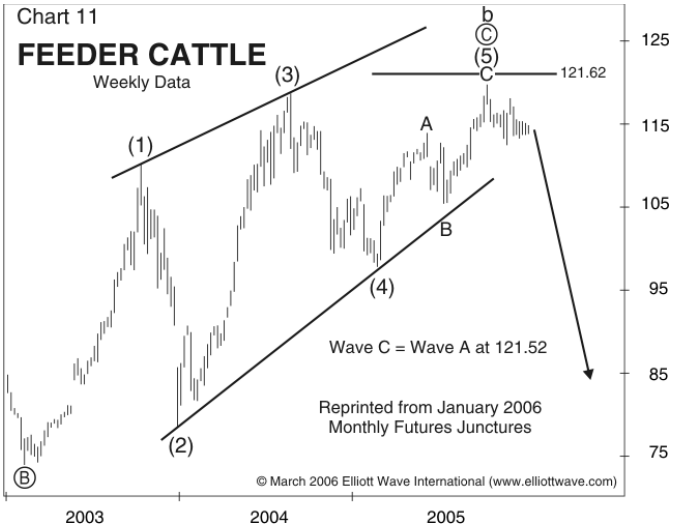
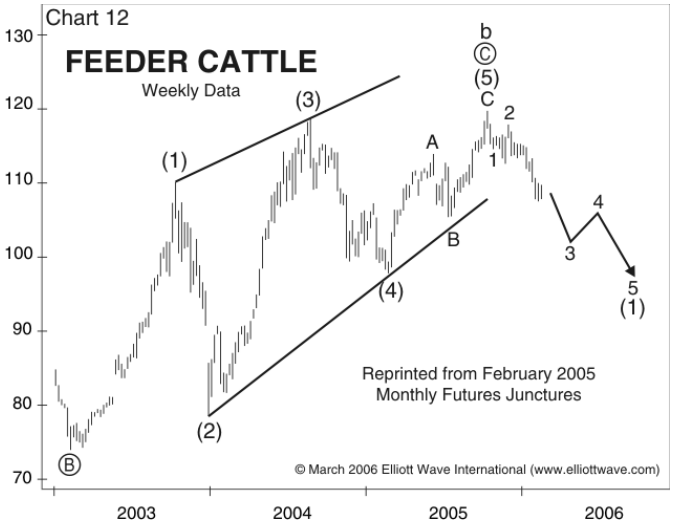


Chart 12



2. Take Two Steps and Then Leap

How to Recognize and Then Confirm a Wave Pattern
September 2006

Let's assume that you have mastered the Wave Principle, have sufficient trading capital and have determined your risk tolerance. In other words, you're ready to trade. What should be the first step you take in making that giant leap from analyzing a price chart to taking a chance on an opportunity that your analysis reveals?

Steps One and Two

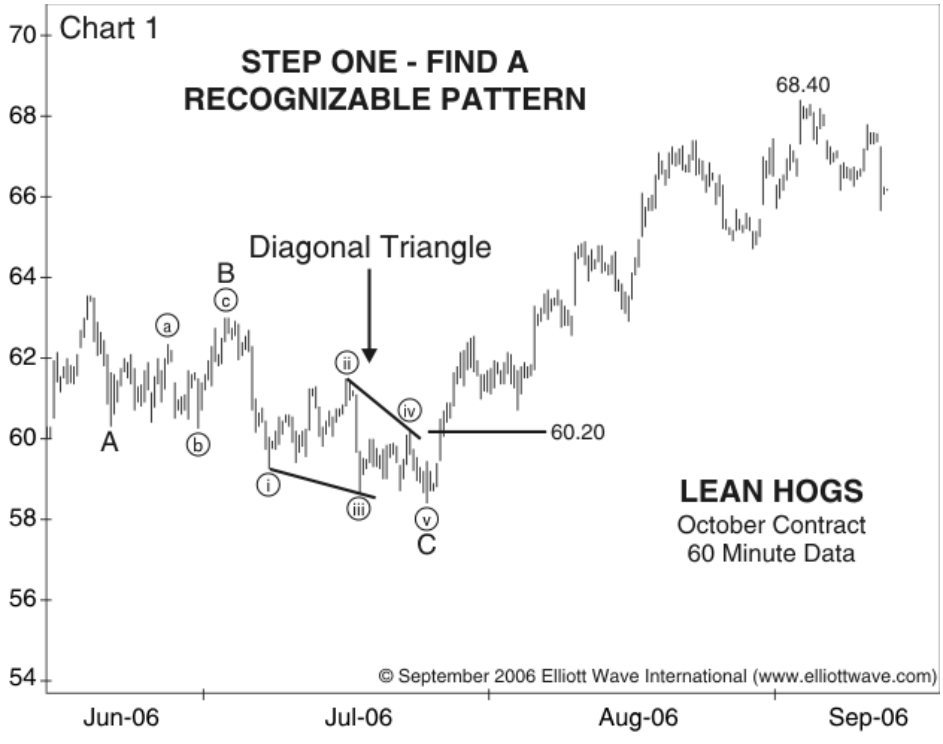
Your very first step is simple – you should begin with a wave pattern that you recognize. I know this step may sound elementary, but it's the best basis for finding a reason to trade. In fact, it is the basis of my own trading style. When searching for a trading opportunity, I spend time quickly scanning through many price charts on multiple time frames. Then, I sort through them until I "see" a wave pattern I recognize. In other words, Step One is to look at different charts until a wave pattern leaps out at you.

It probably goes without saying that only a few charts exhibit an obvious, eye-catching wave pattern. When searching for a stock trade, I might scan 100 or more price charts before a wave pattern leaps out at me – and I've been doing this kind of analysis for a long time. Now, that doesn't mean that all these price charts can't be labeled or that they don't have their own distinct wave counts. It simply means that I have more confidence in a clear wave pattern.

Why the quick-scan approach? Because in my experience, I find that if you try to force-fit a labeling or a wave count on a market, you greatly diminish the odds of a successful trade. The notion to keep in mind is, "All waves can be counted, but all waves don't offer a trade."

Now for Step Two. Once you find a wave pattern you recognize, then you examine its validity. What I mean by this is that you examine the Fibonacci relationships within the formation, and, most importantly, you assess the wave pattern's true personality, either impulsive or corrective.

The result of Step Two is confirmation – confirmation that your identification is indeed correct or recognition that you are not confident enough in your identification to warrant initiating a trade.



Real World Example in Lean Hogs

To drive my points home, let's review the Sample Trade Strategy that I offered to Daily Futures Junctures subscribers on July 26, 2006. Lean Hogs had a pattern in the daily price

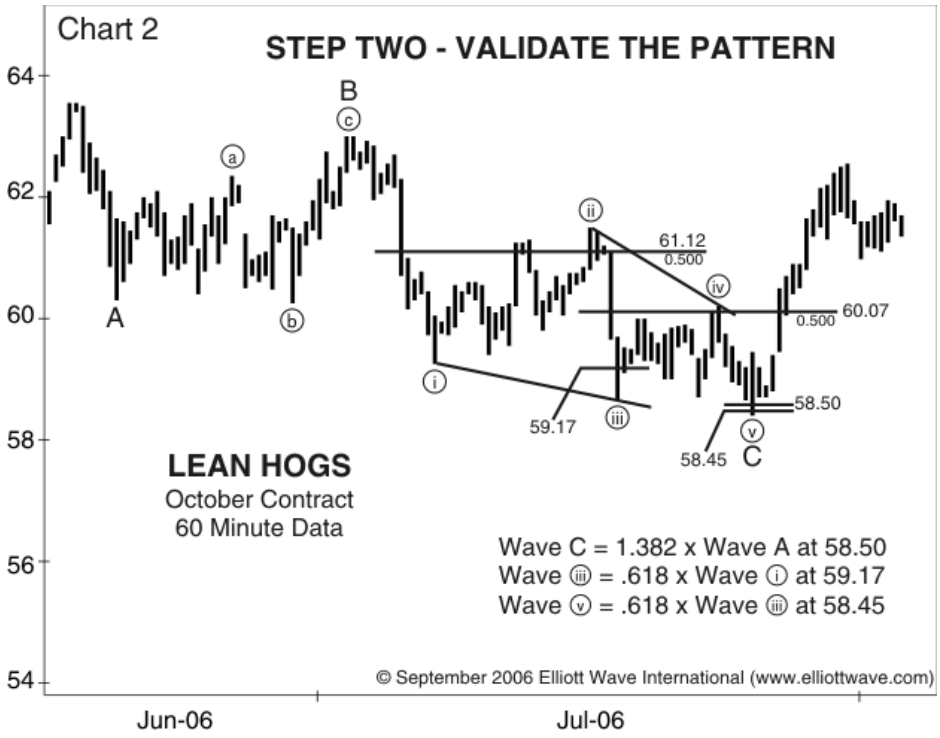


chart that leaped out at me, so I suggested buying a break above 60.20. My hope was that subscribers could catch a rally to initially 63.00, and ultimately well beyond that June high. Obviously, you can see from Chart 1 that this trade strategy was fruitful (although not all are). The question is, what led me to make this recommendation in the first place?

Well, as you can see from my labeling, I recognized a wave pattern (Step One) – a Diagonal Triangle. As many of you know, the Diagonal Triangle is my favorite Elliott wave pattern above all others because of its high probability of success. (If you would like to learn more about Diagonal Triangles, be sure to check out my two webinars: How To Trade Diagonal Triangles, Parts 1 and 2. Please go to www.elliottwave.com/wave/JKdiagonals.)

Chart 2 illustrates how I validated that the wave pattern was indeed a Diagonal Triangle (Step Two). What caught my eye initially about the structure in Lean Hogs was the five-wave, overlapping move within converging trendlines – the trademark of a Diagonal Triangle. I further noticed that it also demonstrated the personality of a corrective wave pattern – a slow-moving price move that contains numerous overlapping waves. Finally, a number of relevant relationships stood out after some extensive Fibonacci analysis, which you can see in Chart 2. Bottom line, closer examination supported the initial assessment. So, confident that Lean Hogs had a Flat correction in place and that wave C of this pattern was indeed a Diagonal Triangle that ended at 58.40, I offered a sample trade strategy.

These are exactly the same two steps that every prospective trader should take before putting hard cash on a trade. When you trade, you always end up having to take a leap of faith. But rather than taking a leap into the unknown, you might want to take a look at these two steps first before you leap.

3. How to Use the Thrust Measurement

Predicting Price Action Following a Contracting Triangle
November 2006

In this month's feature story about Coffee, I explain the rules, Fibonacci relationships and guidelines that apply when a Contracting Triangle is forming. In this Trader's Classroom, I'd like to describe what happens when a Contracting Triangle ends. Are there any rules or guidelines that apply to price action following a Contracting Triangle? The answer to this question is a resounding "Yes."

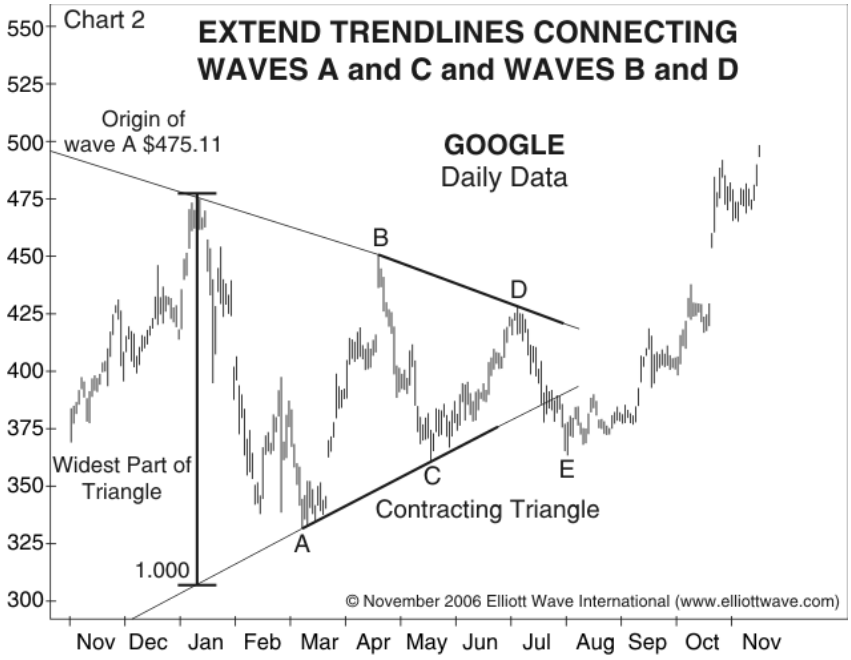
When a Contracting Triangle ends, the resultant move is often swift. Elliotticians call it a Thrust, and they use an old trick to plot its possible length, called – are you ready? – a Thrust Measurement. This technique simply measures the widest part of the Triangle and translates it into the length of the thrust upward or downward from the extreme of wave E of the pattern.

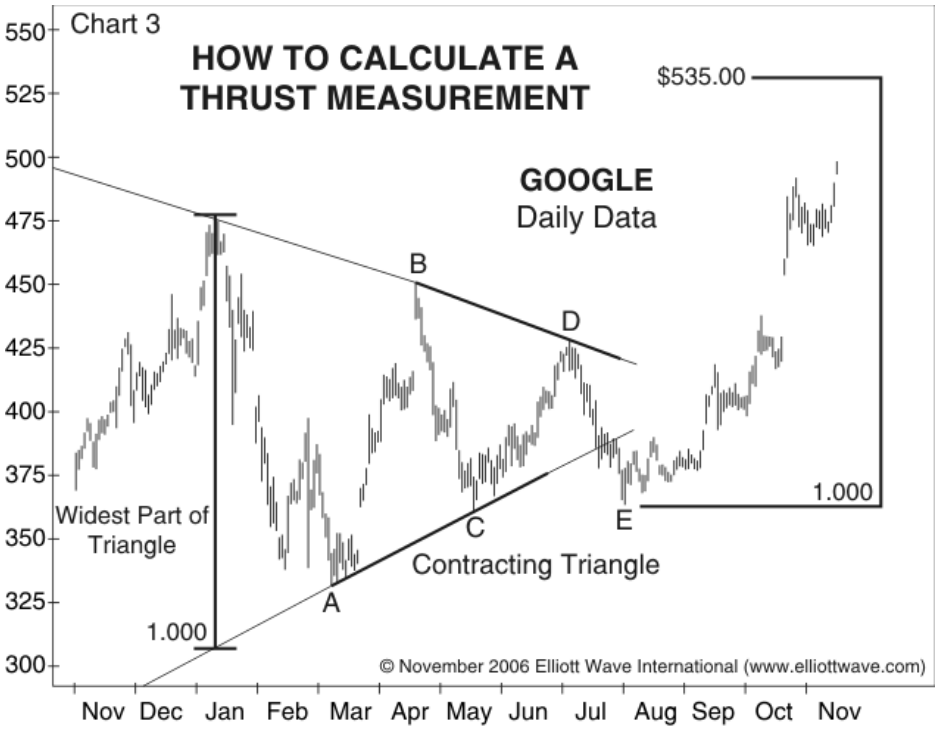
Let's take a look at Google's chart, and I'll show you what I mean. In Chart 1, it's easy to see that prices recently traced out a Contracting Triangle that ended at $363.36 in August.



1. Now the first step in calculating the Thrust Measurement of this triangle is to extend the trendlines that connect the bottoms of waves A and C and the tops of waves B and D as illustrated in Chart 2.

2. Next, go back to the origin of wave A in January at $475.11 and measure the distance between the trendlines we just extended. Then take this length of the widest part of the Triangle and extend it upward from the extreme of wave E at $363.36.





As you can see in Chart 3, the Thrust Measurement for this Contracting Triangle in Google projected a target price of approximately $535.00. That's it – it is indeed that simple to perform a Thrust Measurement on your own.

The only thing I can add is that the Thrust Measurement is just a ballpark figure. It is not an absolute by any means. Prices can easily fall short of the Thrust Measurement objective or surpass it greatly. Even so, I determined over many years that this tool is indeed worthwhile, because, more often than not, prices attain the price target it maps out.

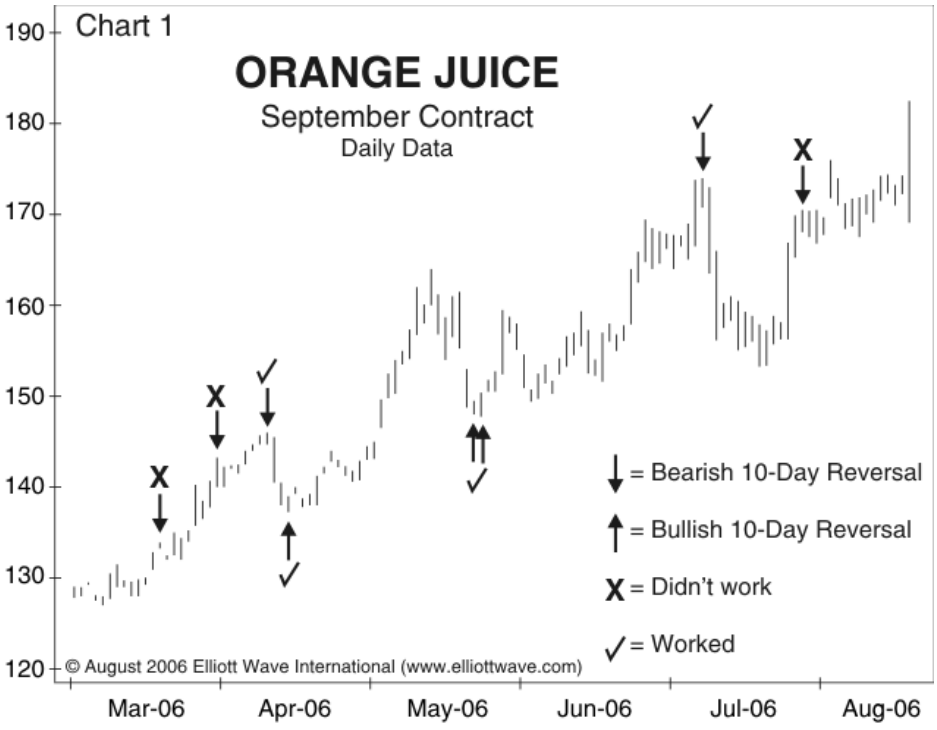
1. The 10-Day Reversal

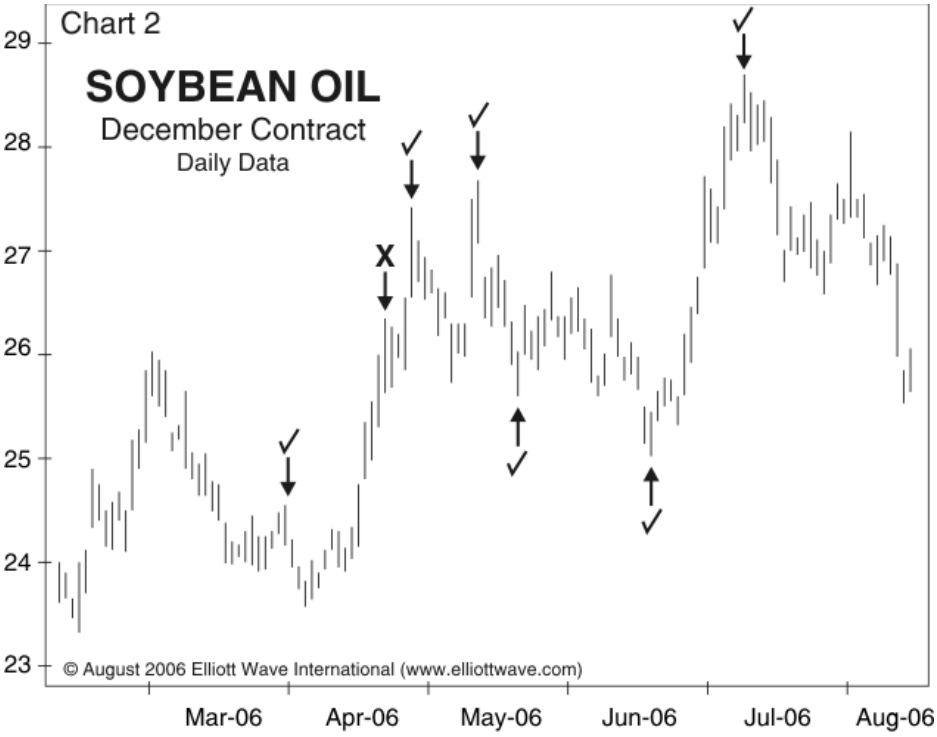
Your Own Alert to a Potential Trading Opportunity
August 2006

As many of you know, I spend much of my spare time analyzing markets. Yes, analysis is my day job, but it is also my passion. So, whenever the weekend rolls around, I spend much of my time in front of the computer studying price charts.

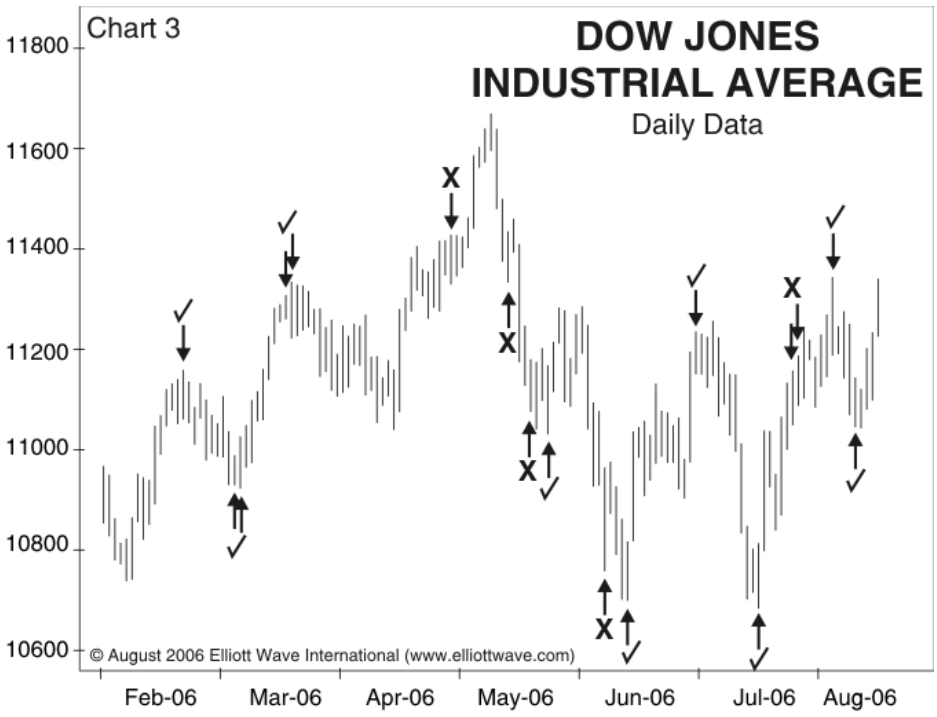
What am I looking for when I examine a price chart? I look for "opportunity." For an Elliottician, opportunity on a price chart looks like a three-wave move following a five-wave move – in other words, a completed wave pattern waiting to begin its next impulsive wave. Even so, opportunity has many faces, some of which I outlined in previous Trader's Classrooms.

In this month's issue of Trader's Classroom, I would like to share with you another picture of what opportunity looks like on a price chart. It's called the 10-Day Reversal, and it occurs when prices make a new 10-day price extreme but close in the opposite direction of the 10-day trend. For example, prices advance for 9 days, and on day 10 they make a new high above day nine but close below that day's open, preferably below the midpoint of that day's trading range.



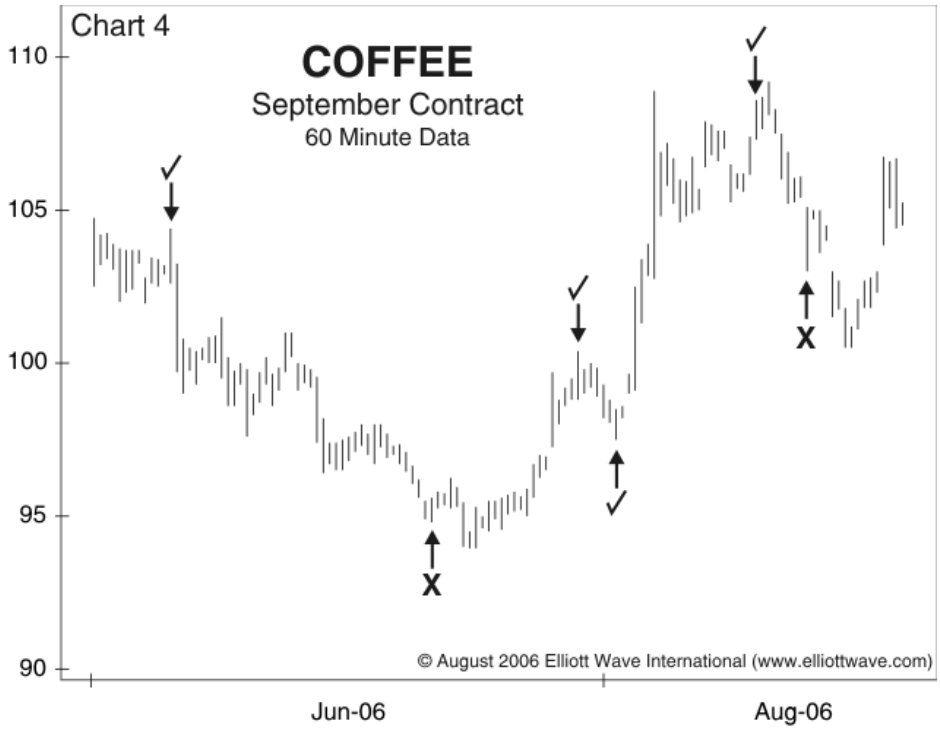


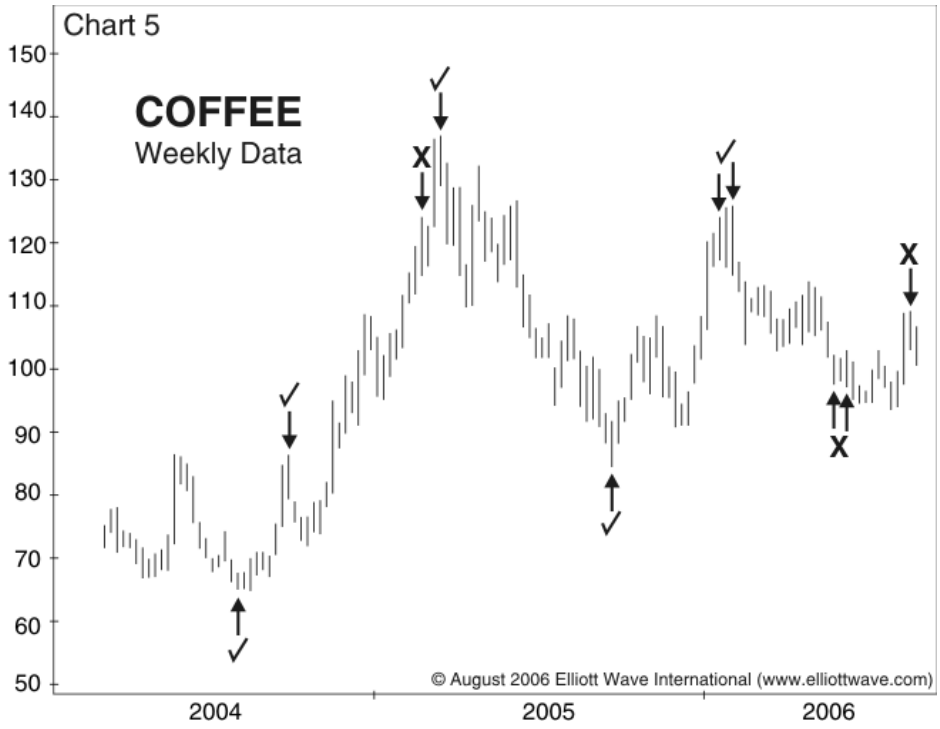
Now the first thing I notice after studying this bar pattern is that it's not as reliable as I normally like. I tend to favor trade set-ups that are at least 80% reliable. And as you can see in Charts 1 - 5, I would guesstimate the reliability of this trade set-up at about 60%. Even so, when the pattern does work, which is identified by a checkmark in the following price charts, the subsequent move can be quite astounding, which is why I believe this pattern is worth being aware of.



So rather than treat the 10-Day Reversal as an actual trade set-up, I recommend using it more as an alert to a potential trade set-up. Possibly by using the 10-Day Reversal pattern in conjunction with the Wave Principle or your favorite technical study, the reliability of the pattern can be increased.

And as always, whenever I define a tradable bar pattern or system, it must work across all time frames and markets, which is why I am including price charts highlighting the 10-Day (or bar as the case may be) Reversal pattern on various markets and on the daily, weekly and 60-minute time frames.

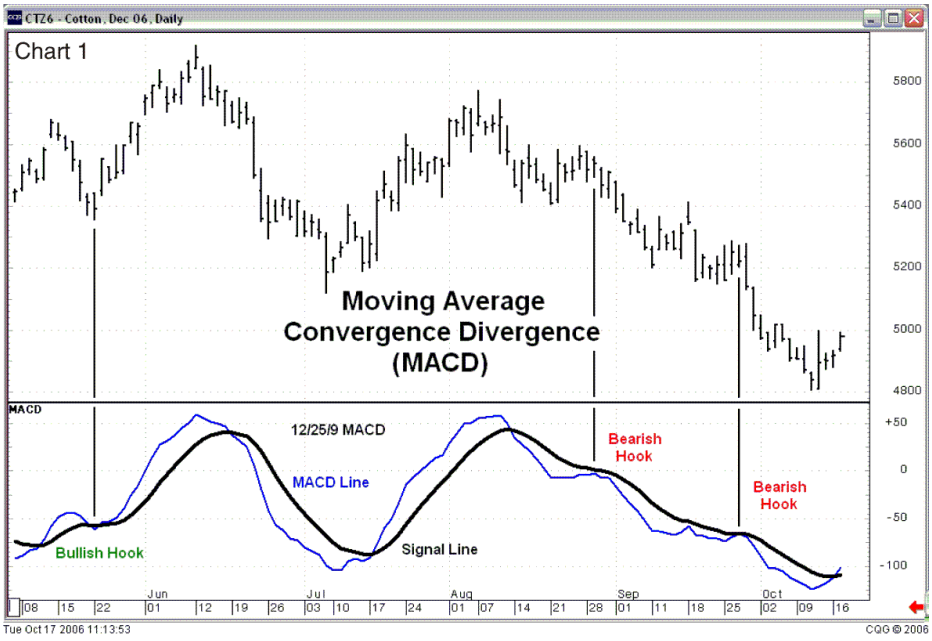



Chart 5
COFFEE
Weekly Data
150
140
130
120
110
100
90
80
70
60
50
2004
2005
2006
© August 2006 Elliott Wave International (www.elliottwave.com)

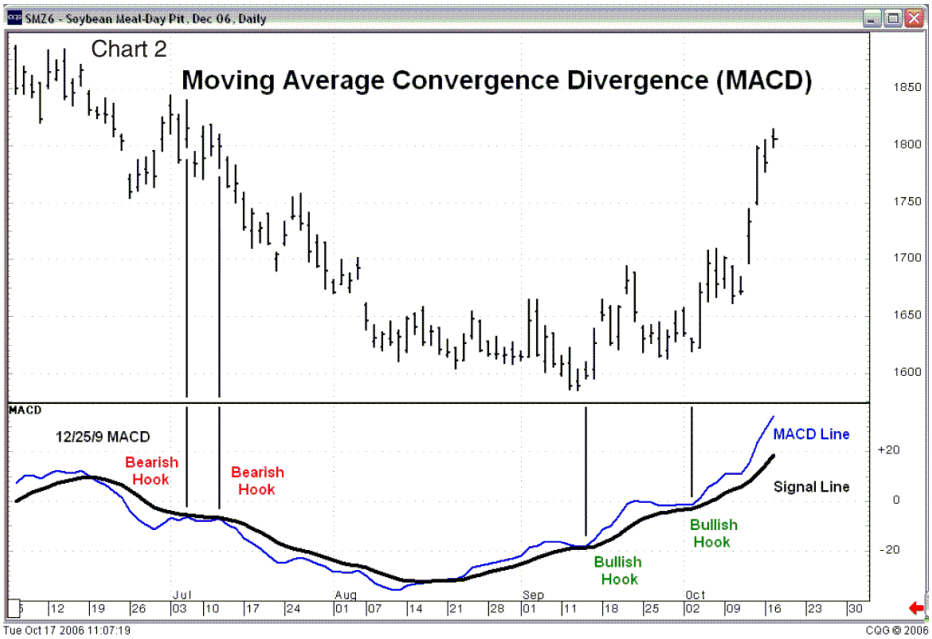
2. The Only Technical Trade Setup You'll Ever Need

All About The MACD Hook
October 2006

When you come home to a dark house, what's the first thing you do? You turn on the lights – you do this, I do this, everybody does this. Why? Because light forces back the darkness and the imagined (and sometimes real) monsters that lurk in the dark. And who do we have to thank for this seeming miracle? Thomas A. Edison, the inventor of the incandescent light bulb.



In addition to inventing the light bulb, Edison should also get some credit for the only technical trade setup you'll ever need: the Hook. Maybe not credit for the whole idea, but certainly for providing the basis of the idea. Let me explain.



Many of you are already familiar with the Hook or the MACD Hook that I wrote about in countless Daily Futures Junctures, Monthly Futures Junctures and in Trader's Classroom Collection Volume II. (Just so you'll know, MACD stands for Moving Average Convergence Divergence, a popular and effective technical study developed by Gerald Appel.)

A MACD Hook occurs when the MACD line attempts to penetrate the MACD Signal line but reverses at the very last moment. Sometimes, the MACD line will penetrate the Signal line for a single period (e.g., for a day or an hour) and reverse. In other words, the MACD line "fails" to successfully break through the MACD Signal line. And as I mentioned with regard to the Hook, it is a very reliable, technically based trade set-up. See some illustrations of how it looks in Charts 1 and 2 (Cotton and Soybean Meal).

So how is Edison involved with the Hook? On a conceptual basis, stemming from one of his many famous quotes:

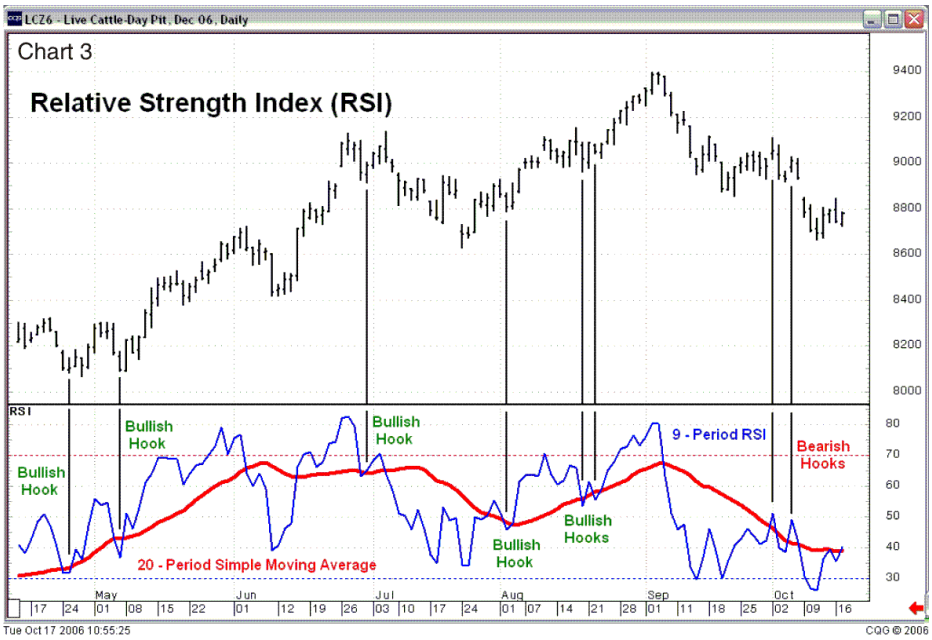
> "*If I find 10,000 ways something won't work, I haven't failed. I am not discouraged, because every wrong attempt discarded is another step forward. Just because something doesn't do what you planned it to do doesn't mean it's useless.*" - Thomas A. Edison

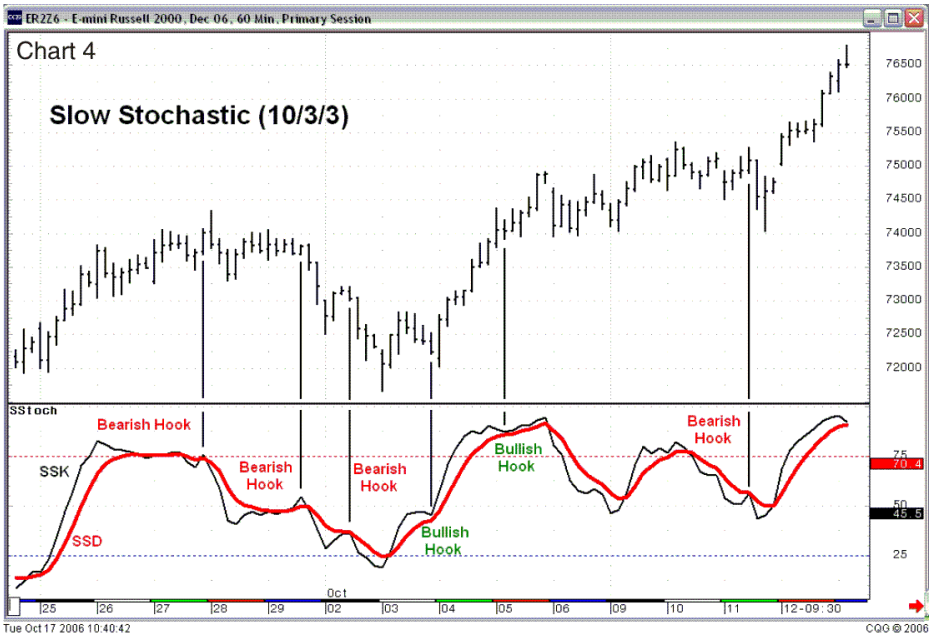
I interpret Edison's words to mean that there is no such thing as a right or wrong answer. All information, in its own way, is useful. It doesn't achieve the status of right or wrong until it passes through our own individual filters or judgments.

So while one could initially see the inability of the MACD line to penetrate the Signal line as a failure, in actuality, it is a success – because it signals a potentially successful trade setup.

Moreover, what no one realizes is that, as a concept, the Hook is not limited to MACD alone. As I illustrate in Chart 3 (Live Cattle), Hooks can occur within just about any technical study or indicator. In this case, we use a 9-period Relative Strength Index (RSI) combined with a 20-period simple moving average, and the Hook shows up – and is useful – just the same. A second example in Chart 4 (E-mini Russell 2000) shows a 10/3/3 Slow Stochastic that again uses the Hook.

The ability of the Hook to identify high probability trade setups is actually limited only by your imagination, because the settings of most technical studies can be changed according to your own individual preferences.





So instead of viewing financial markets, forecasts, wave counts, technical studies and oscillators as right or wrong, think of them simply as information and don't apply the labels of right or wrong. If you can learn to do this, you'll be amazed at out how in-sync you become with the markets. And, in doing so, you'll find that the Hook is indeed the only technical trade setup you'll ever need to discover high-probability trade setups.

3. Panning for Gold

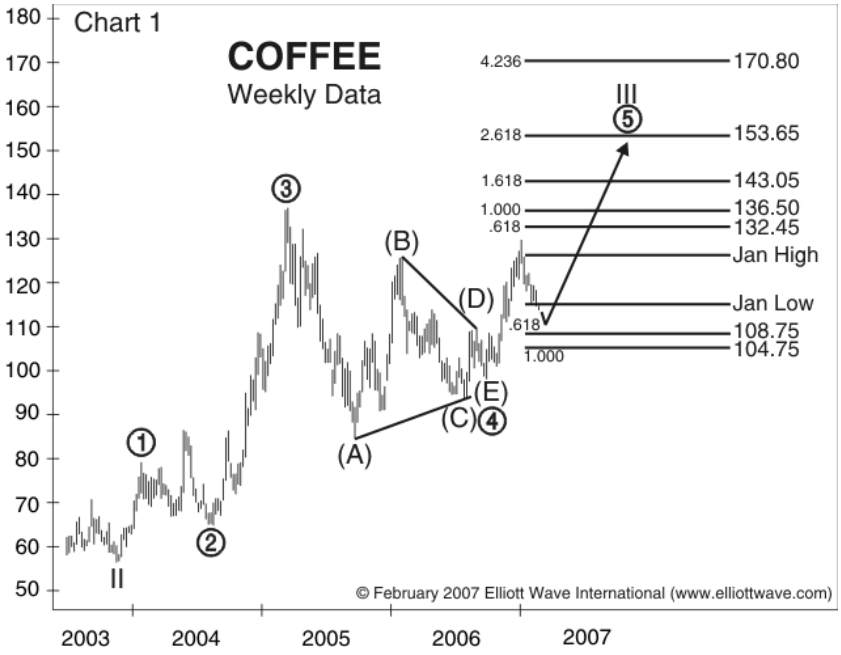
Looking For Trade Setups in Forward Month Contracts
January 2007

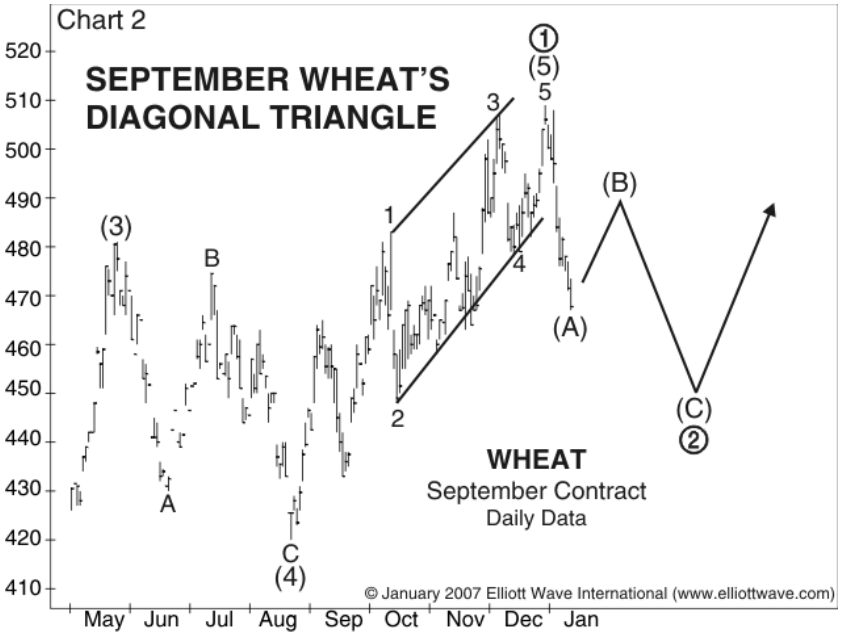
As a trader, you wear more hats than you think you do – try analyst, accountant, statistician, student, gambler and on occasion, member of the clergy. Another hat you'll wear is that of a prospector, just like those old 49ers on their way to California or the Klondike.

The prospecting hat comes into play when you're in search of that next big trade, regardless of whether it is in currencies, stocks, bonds, metals or commodities. Moreover, the opportunity you're in search of may even be time-dependent (i.e., a short-term trade versus a long-term trade). In other words, just like those old 49ers moving from stream to stream in search of a big nugget of gold, you spend countless hours combing through price charts looking for that next big trade setup.

As you know, one way I look for such opportunities is by looking at price data in different formats (for example, standard continuation and active continuation). Another technique is to scan markets in different scales (for example, linear and log scale). Still another way to pan for opportunities in financial markets is to look at forward month contracts.

The front-month contract is the futures contract that is being most actively traded. However, futures have multiple contract months; some have a contract for each month. For example, right now, March Sugar is the front-month contract in Sugar futures. However, it is not the only contract being traded. You can also trade the May 2007, July 2007 or even the October 2007 contract. Note that the farther out you go, volume, open interest and liquidity greatly diminish. Even so, it is possible to trade futures contracts many months if not years into the future.

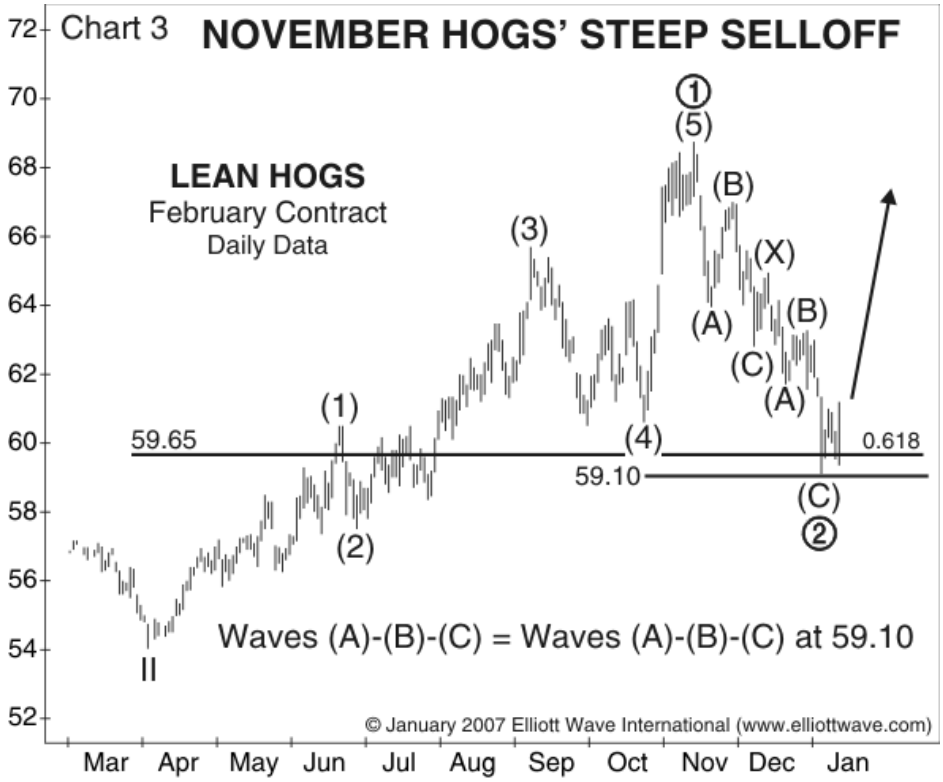


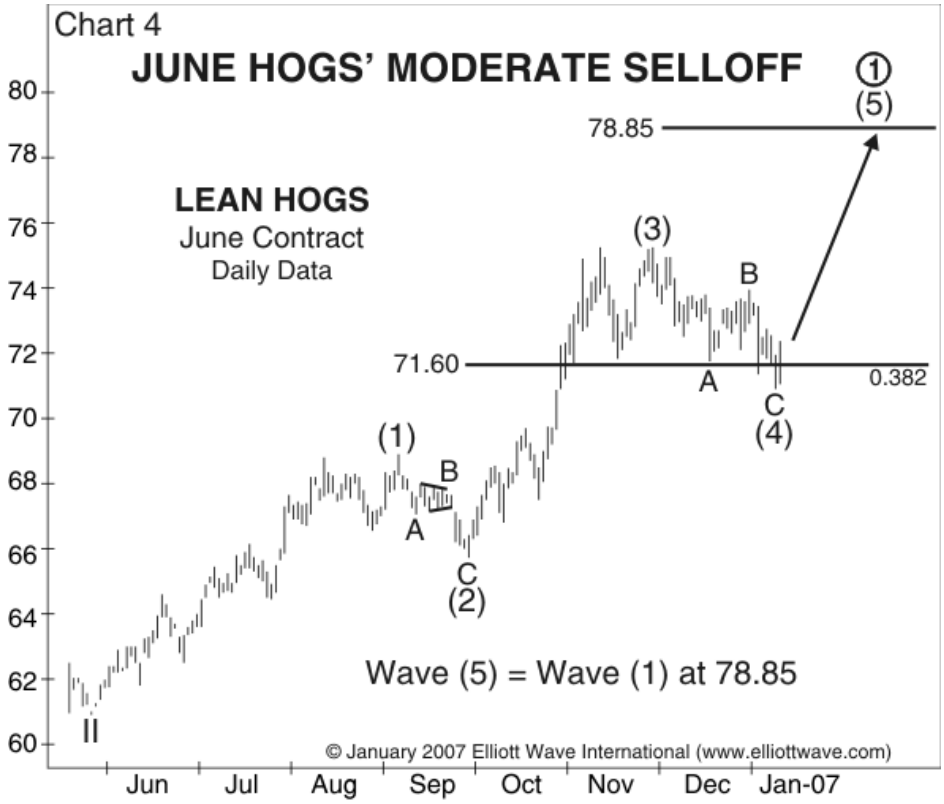


Why are forward months worth considering as trading opportunities? Even though wave patterns tend to be similar in progressive contract months, it's not always the case. Notice in Chart 1 how March Wheat has declined steadily since the October peak. However, if you look at the September 2007 Wheat contract in Chart 2, Wheat prices have done the opposite: steadily advancing since the October low. Moreover, the wave patterns of March Wheat and September Wheat are starkly different — in recent months, September Wheat traced out a Diagonal Triangle.

Lean Hogs offers another example of why it is prudent to examine forward month contracts. Notice in Chart 3 the extent of the November selloff — it more than fully retraced the October advance. However, if you look instead at June 2007 Lean Hogs (Chart 4), Hog prices declined only moderately. More importantly, wave (4) ended just below the .382 retracement of wave (3). This condition is significant because a .382 multiple of wave three is the most common Fibonacci retracement for fourth waves.

If you want to be a successful trader, you must be willing to not only think but also search outside the box. I believe that examining your basic price chart of the front-month contract is a thing of the past. Opportunity exists all around us, and we must adopt the pioneering spirit of those 49er prospectors to go in search of high probability trade setups – right in front of us as well as in the future.





1. Why Is February the Best Month of the Year?

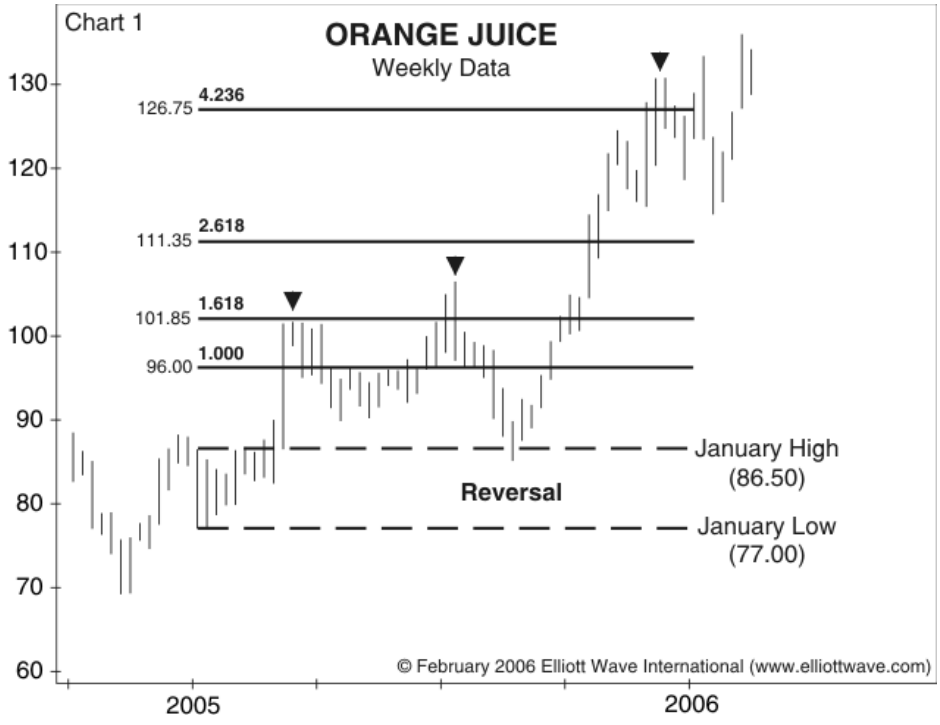
Time To Set Up Key Support and Resistance Levels
February 2006

Winter may be great for skiers and summer may be the best time for surfers, but for an analyst like me, February is the best month. Once February comes around, it means that January's price action is behind us, and I can use it to map out the next 11 months.

Last February in Trader's Classroom, I explained that by taking Fibonacci multiples of January's trading range, you could identify key support and resistance levels for the entire year. I followed up in November 2005 with examples of price charts, showing how useful this technique proved to be.

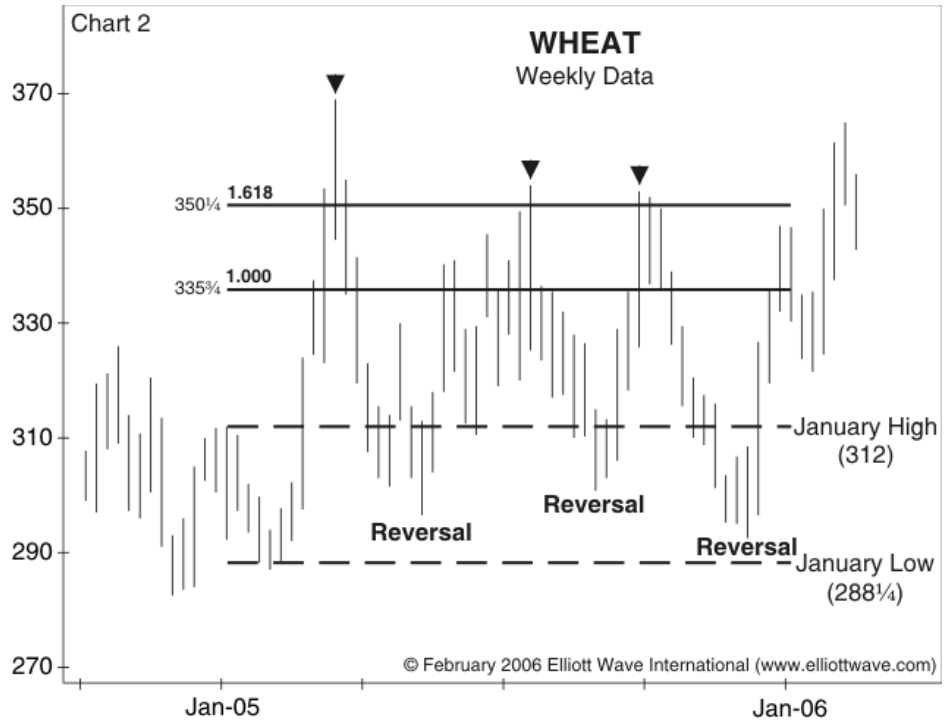
To refresh your memory, I am including charts of Orange Juice and Wheat (Charts 1 and 2). Notice in Chart 1 how the 1.618 multiple of January's trading range provided resistance on two separate occasions in 2005, sparking reversals in price in March and July. Also notice that when prices revisited January's trading range in August, prices reversed sharply and rallied right to the 4.236 multiple of January's trading range at 126.75.

Chart 2 provides another example of how valuable this technique is. Notice that Wheat sold off three times from resistance found at the 1.618 multiple of January's trading range. And each time prices re-entered January's trading range, they reversed.



How to Apply the Technique

So how do you apply this technique yourself? It's simple: take January's trading range (that is, subtract the low point from the high point) and multiply that number by 1.000, 1.618, 2.618 and 4.236. Then, take these values and both add



them to January's high and subtract them from January's low. It's that easy to create the year-long charts for each commodity you follow.

Now comes the time to heighten your awareness. As prices approach these support and resistance levels, be on the lookout for them to reverse. Also be on the lookout when prices revisit January's trading range. Here's another tip: I notice that once prices exceed the 1.000 multiple of January's range (either up or down), prices will continue on to higher or lower Fibonacci levels. If they don't break the 1.000 multiple, odds favor a range-bound market.

I'm providing a list of key Fibonacci support and resistance levels for 2006 for many of the commodities I follow. As you know, I strive to make all my tools applicable in all markets and all time frames. No surprise then – this technique works equally well in markets that aren't in the table. So your homework assignment for the month is to calculate the key levels for your favorite market, such as the Dow, Gold, Crude Oil or a currency. And one more thing before I sign off: believe it or not, this approach works equally well on individual stocks. If you take the time to prepare your charts now, you will have a leg up on finding opportunities in your favorite markets all year long.

Annual Fibonnaci Resistance Levels - 2006							
	January High	January Low	Fibonacci Resistance 1.000	1.618	2.618	4.236	6.854
Coffee	125.90	106.20	145.60	157.77	177.47	209.35	260.92
Cocoa	1600.00	1443.00	1757.00	1854.03	2011.03	2265.05	2676.08
Sugar	18.82	14.00	23.64	26.62	31.44	39.24	51.86
Cotton	56.85	54.35	59.35	60.90	63.40	67.44	73.99
Orange Juice	133.40	114.50	152.30	163.98	182.88	213.46	262.94
Soybeans	622.00	561.00	683.00	720.70	781.70	880.40	1040.09
Corn	222.00	203.50	240.50	251.93	270.43	300.37	348.80
Wheat	350.00	321.50	378.50	396.11	424.61	470.73	545.34
Soybean Meal	202.50	175.60	229.40	246.02	272.92	316.45	386.87
Soybean Oil	23.22	21.00	25.44	26.81	29.03	32.62	38.44
Oats	202.00	182.75	221.25	233.15	252.40	283.54	333.94
Pork Bellies	88.50	74.25	102.75	111.56	125.81	148.86	186.17
Lean Hogs	65.32	55.62	75.02	81.01	90.71	106.41	131.80
Live Cattle	97.05	92.92	101.18	103.73	107.86	114.54	125.36
Feeder Cattle	115.10	109.10	121.10	124.81	130.81	140.52	156.22
Lumber	376.40	353.20	399.60	413.94	437.14	474.68	535.41
Copper	223.75	201.20	246.30	260.24	282.79	319.27	378.31
CRB Index	363.70	348.57	378.83	388.18	403.31	427.79	467.40

Annual Fibonnaci Support Levels - 2006							
	January High	January Low	Fibonacci Support 1.000	1.618	2.618	4.236	6.854
Coffee	125.90	106.20	86.50	74.33	54.63	22.75	-28.82
Cocoa	1600.00	1443.00	1286.00	1188.97	1031.97	777.95	366.92
Sugar	18.82	14.00	9.18	6.20	1.38	-6.42	-19.04
Cotton	56.85	54.35	*51.85*	*50.31*	*47.81*	*43.76*	*37.22*
Orange Juice	133.40	114.50	95.60	83.92	65.02	34.44	-15.04
Soybeans	622.00	561.00	500.00	462.30	401.30	302.60	142.91
Corn	222.00	203.50	185.00	173.57	155.07	125.13	76.70
Wheat	350.00	321.50	293.00	275.39	246.89	200.77	126.16
Soybean Meal	202.50	175.60	148.70	132.08	105.18	61.65	-8.77
Soybean Oil	23.22	21.00	18.78	17.41	15.19	11.60	5.78
Oats	202.00	182.75	163.50	151.60	132.35	101.21	50.81
Pork Bellies	88.50	74.25	60.00	51.19	36.94	13.89	-23.42
Lean Hogs	65.32	55.62	45.92	39.93	30.23	14.53	-10.86
Live Cattle	97.05	92.92	88.79	86.24	82.11	75.43	64.61
Feeder Cattle	115.10	109.10	103.10	99.39	93.39	83.68	67.98
Lumber	376.40	353.20	330.00	315.66	292.46	254.92	194.19
Copper	223.75	201.20	178.65	164.71	142.16	105.68	46.64
CRB Index	363.70	348.57	333.44	324.09	308.96	284.48	244.87

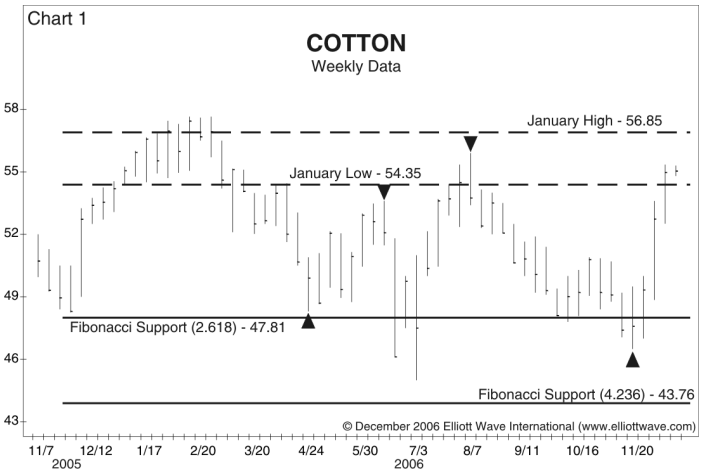
2. 2006's Annual Fibonacci Support And Resistance Levels ...

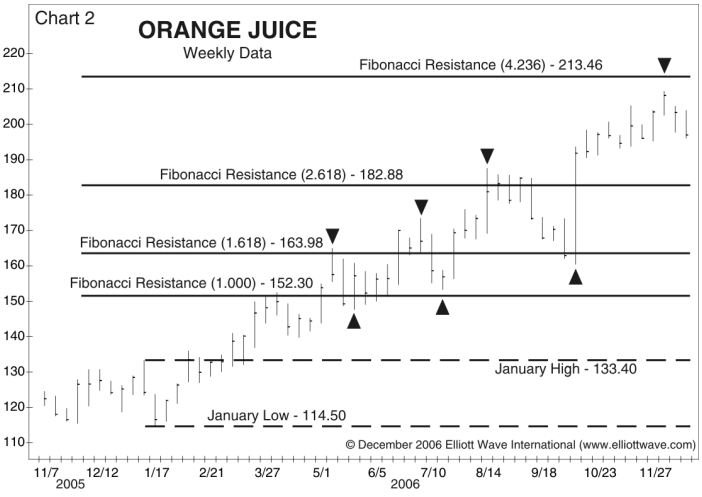
How Well Did They Work? (Part One)
December 2006

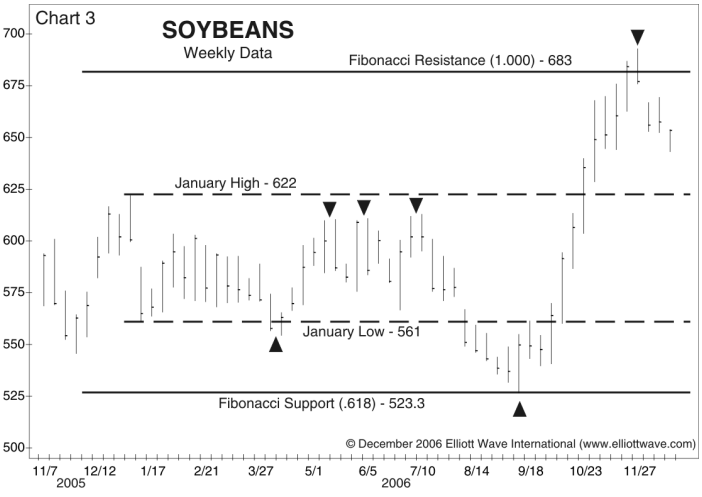
In the February 2006 Trader's Classroom, I explained how you can identify key support and resistance levels for the entire year in any financial market by taking Fibonacci multiples of January's trading range. That table (shown on the previous page) identified key Fibonacci support and resistance levels for many of the markets I follow for 2006.

Well, as 2006 comes to an end, how did these levels perform? Did they in fact provide support and resistance? And as support and resistance, once tested, did they ignite reversals in price or objectives for developing trends?

As you can see in Charts 1 through 5 (Cotton, Orange Juice, Soybeans, Wheat and the Continuous Commodity Index), these levels did indeed prove useful. Notice in Chart 1 (Wheat) that the January low provided resistance on two separate occasions in 2006 and a 2.618 multiple of January's trading range subtracted from January's low offered support on two separate occasions. In Chart 2 (Orange Juice), prices seemed to use the 1.000, 1.618, 2.618 and 4.236 Fibonacci multiples of January's trading range as stair steps toward a 200.00-plus objective. Chart 3 (Soybeans) is interesting, because this year's low in Soybeans occurred at 526-1/2, just three points away from January's trading range multiplied by .618 and subtracted from January's low at 523-1/2. Also, the subsequent move that resulted, the September advance, rallied directly to Fibonacci resistance (1.000) at 683. Charts 4 and 5 (Wheat and the Continuous Commodity Index) provide even more evidence that these numbers derived from January's trading range can help predict reversals in price.







How to Apply the Technique

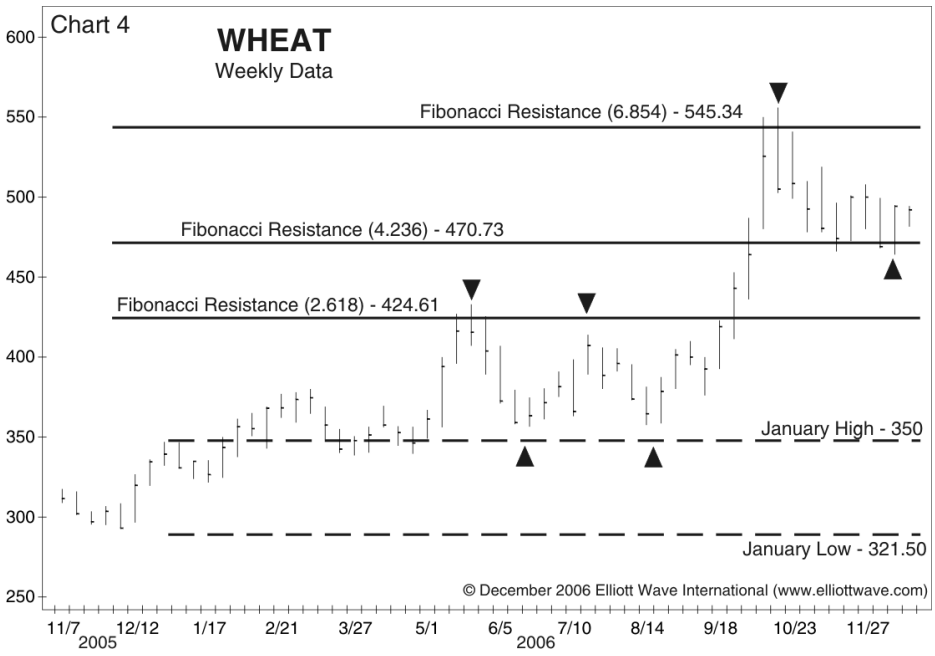
So how do you apply this technique yourself? It's simple: take January's trading range (that is, subtract the low point from the high point) and multiply that number by 1.000, 1.618, 2.618 and 4.236. If you would like, you can even use smaller Fibonacci ratios such as .382, .500 and .618 to provide additional levels of support and resistance. Then, take these values and

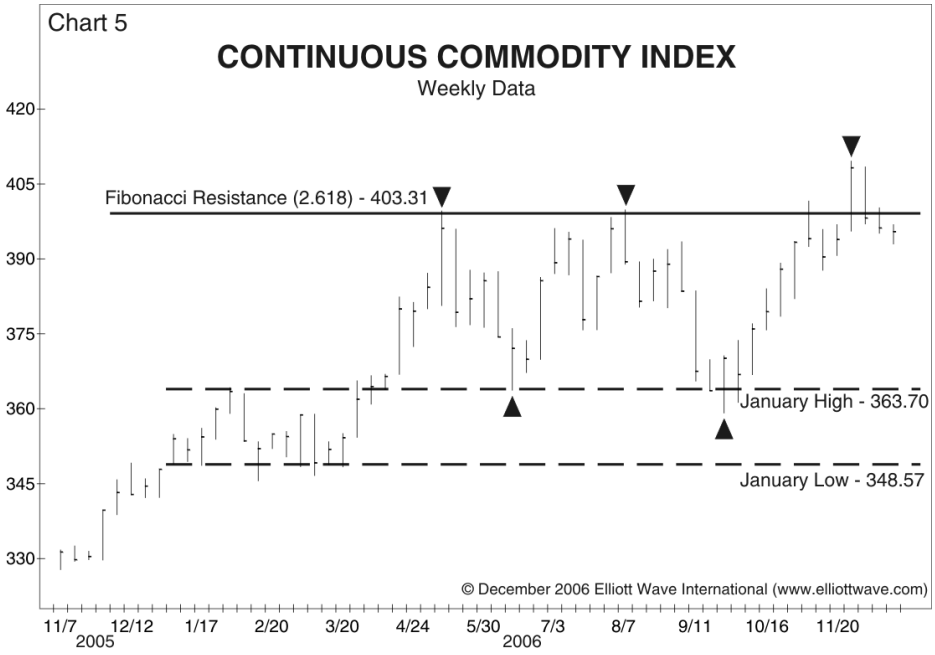
both add them to January's high and subtract them from January's low to identify key levels of support and resistance in any financial market for the entire year.

How do you use these key levels to your advantage? As prices approach these support and resistance levels, be on the lookout for a possible reversal in price (i.e., a change in trend). If prices begin to stall as they approach these levels, a reversal in trend is likely. If prices slice through these levels as if they weren't even there, then look for the current trend to continue on toward the next higher or lower number.

Also, be on the lookout when prices revisit January's trading range. I find that this range also sparks reversals in price. And here's another tip: I notice that once prices exceed the 1.000 multiple of January's range (either up or down), prices will most likely continue on higher or lower to the next Fibonacci level. If prices can't manage to exceed the 1.000 multiple of January's trading range, odds favor a range-bound market for that year.

In January or February, I will publish Part Two of this Trader's Classroom and provide a list of key Fibonacci support and resistance levels for 2007 for many of the commodities I follow. I strive to make all my tools applicable in all markets and all time frames, so don't be surprised when you discover that this technique works equally well in all markets, even those not found in the table on page 28. It even works for individual stocks. If you take the time to prepare your charts after the first of the year, you will have a leg up on finding opportunities in your favorite markets for all of 2007.





3. 2007's Annual Fibonacci Support and Resistance Levels

How To Use Them to Your Advantage (Part Two)
February 2007

In the December 2006 Trader's Classroom, I explained how you can identify key support and resistance levels for the entire year in any financial market by taking Fibonacci multiples of January's trading range. I also illustrated how effective this technique was for 2006, based on the support and resistance levels generated at the start of the year. With this Part Two, as promised, I bring you the key Fibonacci support and resistance levels for 2007 in each of the commodities I follow. As the year unfolds, I hope you will keep track of them as closely as I will.

Annual Fibonacci Resistance Levels - 2007

	January High	January Low	Fibonacci Resistance 0.618	1.000	1.618	2.618	4.236	6.854
Coffee	125.90	115.30	132.45	136.50	143.05	153.65	170.80	198.55
Cocoa	1696.00	1566.00	1776.34	1826.00	1906.34	2036.34	2246.68	2587.02
Sugar	11.66	10.35	12.47	12.97	13.78	15.09	17.21	20.64
Cotton	55.90	52.85	57.78	58.95	60.83	63.88	68.82	76.80
Orange Juice	208.80	184.20	224.00	233.40	248.60	273.20	313.01	377.41
Soybeans	729.25	647.00	780.08	811.50	862.33	944.58	1077.66	1292.99
Corn	420.50	352.50	462.52	488.50	530.52	598.52	708.55	886.57
Wheat	488.00	447.50	513.03	528.50	553.53	594.03	659.56	765.59
Soybean Meal	202.20	187.00	211.59	217.40	226.79	241.99	266.59	306.38
Soybean Oil	29.97	27.58	31.45	32.36	33.84	36.23	40.09	46.35
Oats	276.50	246.00	295.35	307.00	325.85	356.35	405.70	485.55
Pork Bellies	102.60	87.90	111.68	117.30	126.38	141.08	164.87	203.35
Lean Hogs	64.60	59.10	68.00	70.10	73.50	79.00	87.90	102.30
Live Cattle	94.20	89.35	97.20	99.05	102.05	106.90	114.74	127.44
Feeder Cattle	100.75	92.10	106.10	109.40	114.75	123.40	137.39	160.04
Lumber	279.50	251.50	296.80	307.50	324.80	352.80	398.11	471.41
Copper	271.00	248.25	285.06	293.75	307.81	330.56	367.37	426.93
CRB Index	395.47	377.59	406.52	413.35	424.40	442.28	471.21	518.02

Annual Fibonacci Support Levels - 2007

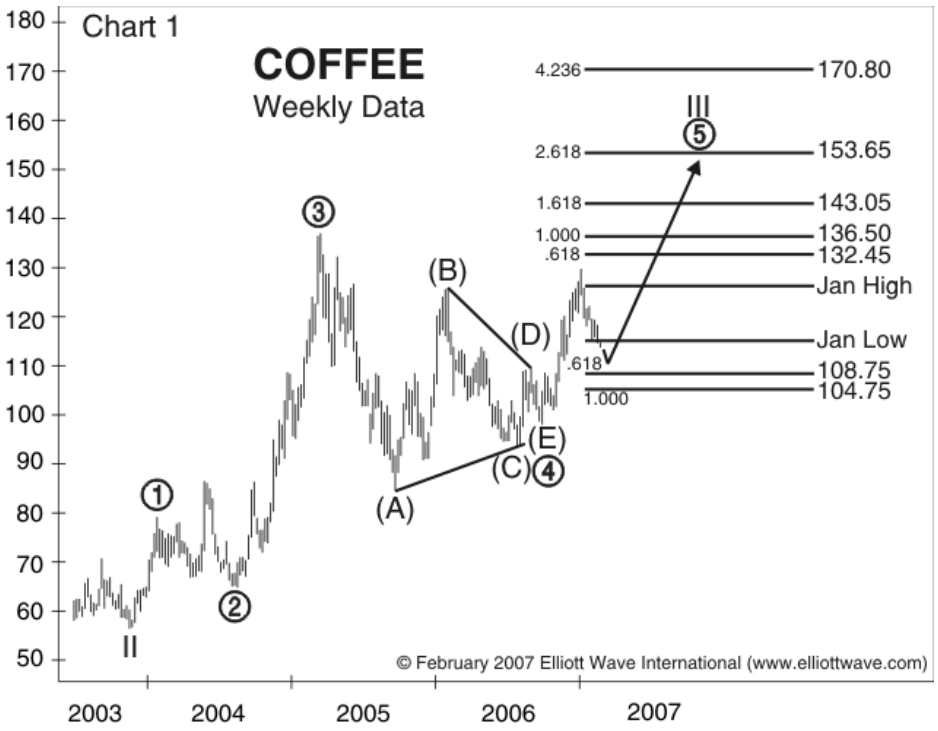
	January High	January Low	Fibonacci Support 0.618	1.000	1.618	2.618	4.236	6.854
Coffee	125.90	115.30	108.75	104.70	98.15	87.55	70.40	42.65
Cocoa	1696.00	1566.00	1485.66	1436.00	1355.66	1225.66	1015.32	674.98
Sugar	11.66	10.35	9.54	9.04	8.23	6.92	4.80	1.37
Cotton	55.90	52.85	50.97	49.80	47.92	44.87	39.93	31.95
Orange Juice	208.80	184.20	169.00	159.60	144.40	119.80	79.99	15.59
Soybeans	729.25	647.00	596.17	564.75	513.92	431.67	298.59	83.26
Corn	420.50	352.50	310.48	284.50	242.48	174.48	64.45	113.57
Wheat	488.00	447.50	422.47	407.00	381.97	341.47	275.94	169.91
Soybean Meal	202.20	187.00	177.61	171.80	162.41	147.21	122.61	82.82
Soybean Oil	29.97	27.58	26.10	25.19	23.71	21.32	17.46	11.20
Oats	276.50	246.00	227.15	215.50	196.65	166.15	116.80	36.95
Pork Bellies	102.60	87.90	78.82	73.20	64.12	49.42	25.63	-12.85
Lean Hogs	64.60	59.10	55.70	53.60	50.20	44.70	35.80	21.40
Live Cattle	94.20	89.35	86.35	84.50	81.50	76.65	68.81	56.11
Feeder Cattle	100.75	92.10	86.75	83.45	78.10	69.45	55.46	32.81
Lumber	279.50	251.50	234.20	223.50	206.20	178.20	132.89	59.59
Copper	271.00	248.25	234.19	225.50	211.44	188.69	151.88	92.32
CRB Index	395.47	377.59	366.54	359.71	348.66	330.78	301.85	255.04

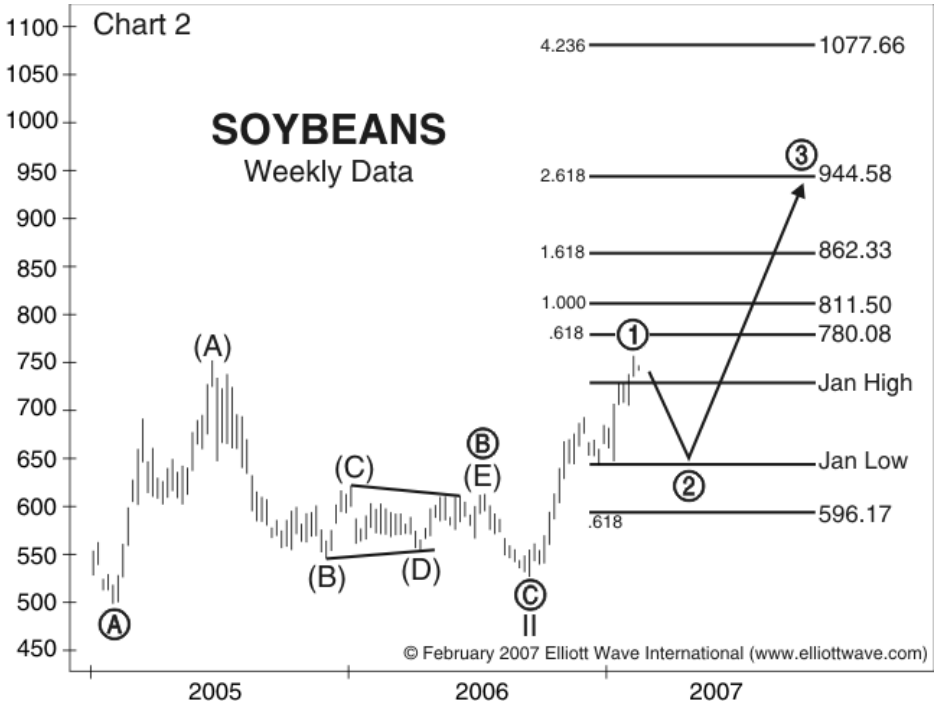
How to Apply the Technique

So, as a quick refresher, how do you apply this technique? Simple: Take January's trading range (that is, subtract the low from the high) and multiply that number by .618, 1.000, 1.618, 2.618 and 4.236. If you like, you can use even smaller Fibonacci ratios such as .236, .382 and .500 to provide additional levels of support and resistance. Then, take these values and both add them to January's high and subtract them from January's low to identify key levels of support and resistance in any financial market for the entire year. As I mentioned before, this technique works equally well on stock indexes, currencies, bonds, gold, silver ... even individual stocks.

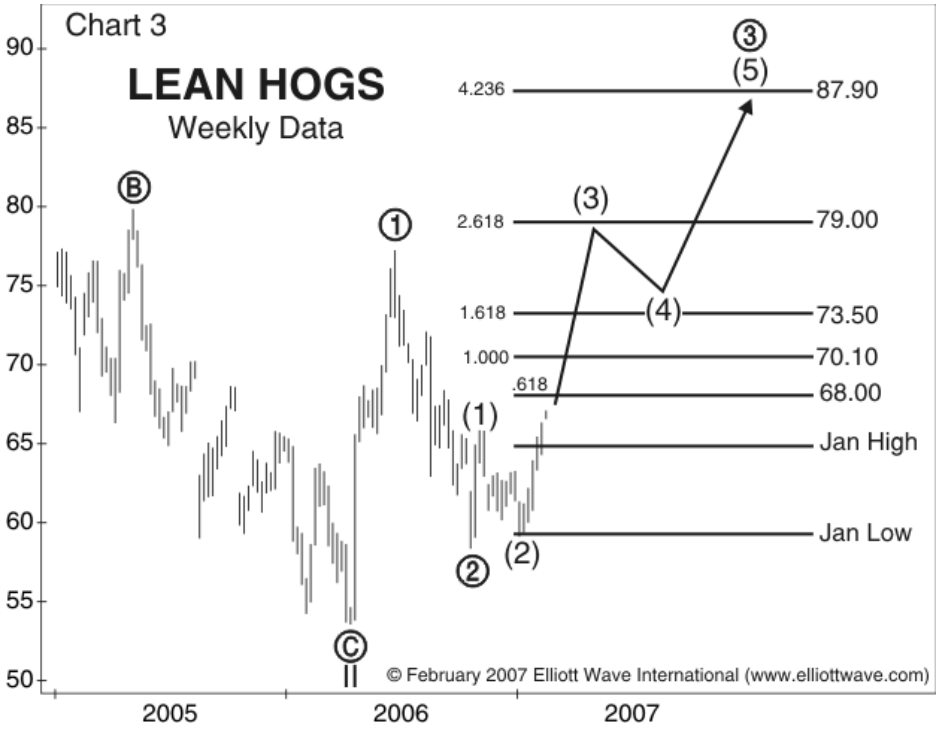
How do you use these key levels to your advantage? As prices approach these support and resistance levels, be on the lookout for a possible reversal in price (i.e., a change in trend). If prices begin to stall as they approach these levels, the trend will likely reverse. If prices slice through these levels as if they weren't even there, then look for the current trend to continue on toward the next higher or lower number.

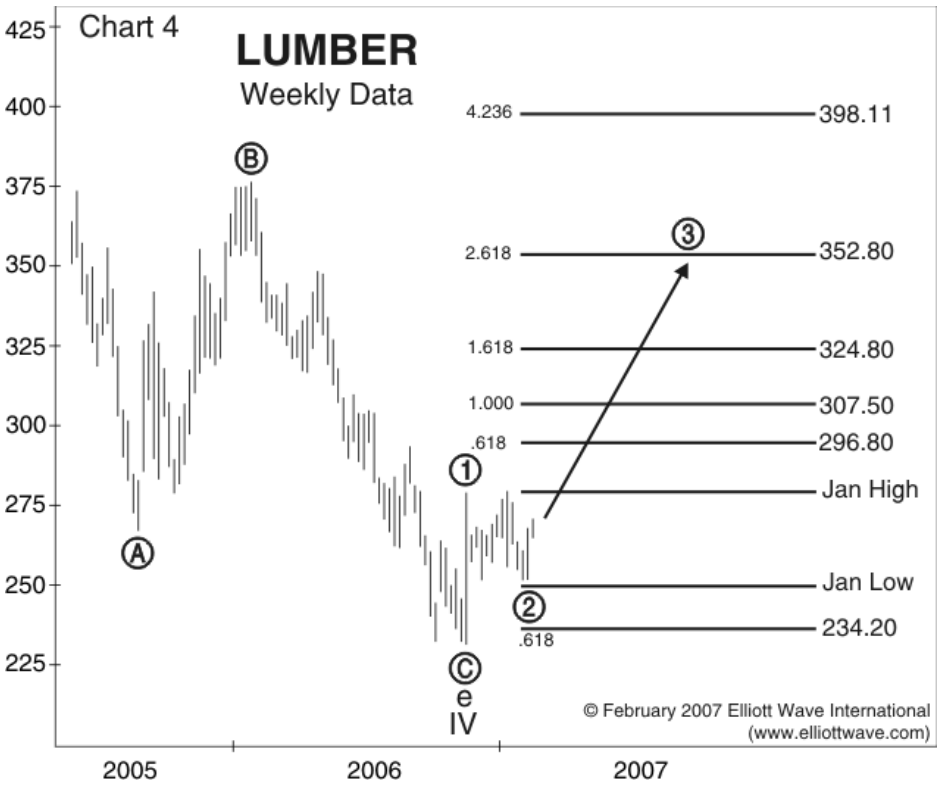
Also, be aware when prices revisit January's trading range. I find that this range also sparks reversals in price. And here's another tip: once prices exceed the 1.000 multiple of January's range (either up or down), prices will most likely continue on higher or lower to the next Fibonacci level, thereby indicating that the current trend is "entrenched." If prices can't manage to exceed the 1.000 multiple of January's trading range, odds favor a range-bound market for that year.





In the Wave Watch section of each issue of *Monthly Futures Junctures*, I update the weekly and daily Elliott wave labelings for each of the commodity markets I follow. Now if we combine those Elliott wave labelings with the Annual Fibonacci Support and Resistance levels, we can get a better idea of how and where prices will travel. See Charts 1, 2, 3 and 4 for examples. Furthermore, these Annual Fibonacci Support and Resistance levels can be combined with internal wave projections of any time frame to more accurately identify "clusters" of Fibonacci support and resistance. For those of you who aren't aware, a "cluster" of Fibonacci support or resistance occurs when multiple Fibonacci retracement or extension levels fall in a general area. From my experience, the more tightly bound these areas are, the more significant they are, often resulting in reversals in price.





4. The Fibonacci Time and Price Paradigm

More About Resistance and Support Applied to the Canadian Dollar, Euro, Dow And Microsoft April 2007

"Does it really work on all markets, including individual stocks?" That's the question asked the most by subscribers who e-mailed me about the technique I detailed in the February 2007 Trader's Classroom. In that issue, I explained how you could identify key support and resistance levels for the entire year in any financial market by taking Fibonacci multiples of January's trading range. I also provided a list of these levels for each of the commodity markets I follow.

My answer to the question is a resounding, "Yes!" To show how effective this technique truly is, I am including long-term charts of the Canadian Dollar, Euro, Dow Jones Industrial Average and Microsoft in this month's Trader's Classroom.

But before I explain again how to use this approach yourself, let me draw your attention to the title of this month's article: "The Fibonacci Time and Price Paradigm." Why such a formal title? Well, as my work and research on this technique continues, I feel it necessary to give it a name. But why the word "paradigm"? Once you boil down the official Merriam-Webster's dictionary definition, you get that a paradigm is simply a philosophical or theoretical framework for theories, laws and generalizations, as well as experiments to support them. And since I believe that, as analysts, we have only scratched the surface of what technical analysis has to offer, I think paradigm is the right word to show that I expect there to be further discoveries about this technique and its uses.

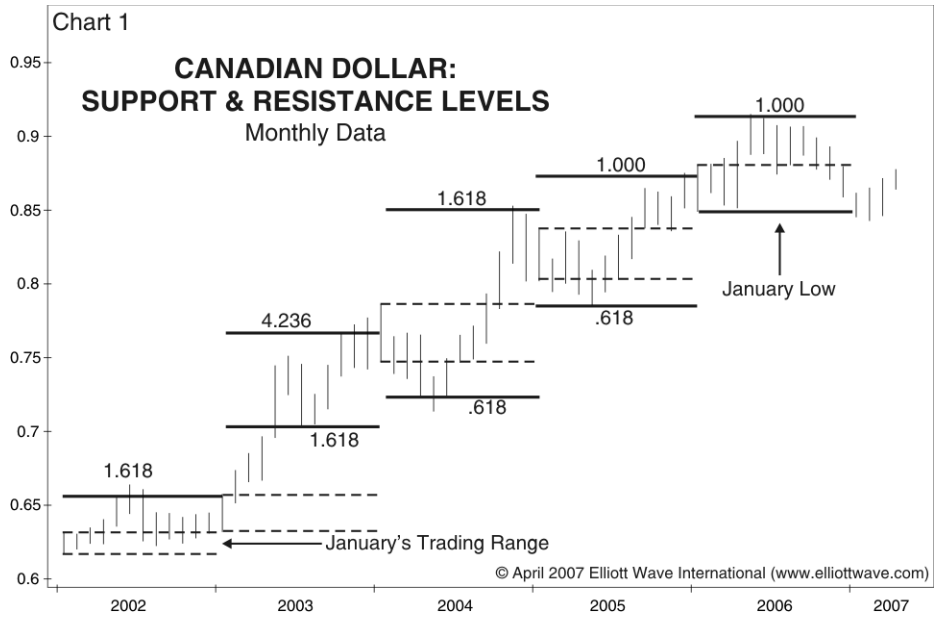
How To Apply the Paradigm

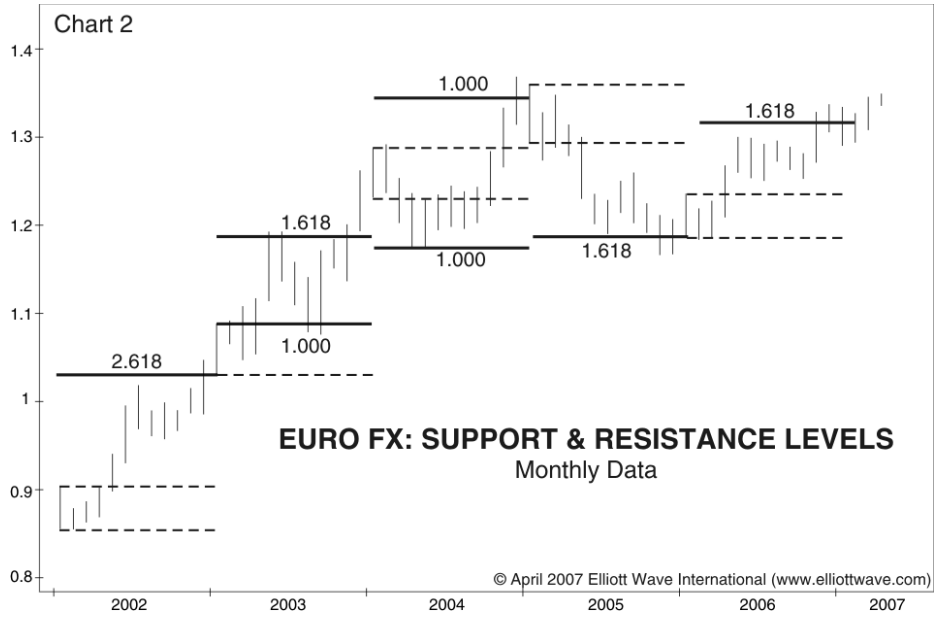
How do you apply the Fibonacci Time and Price Paradigm? Simple: Take January's trading range (that is, subtract the low from the high) and multiply that number by these Fibonacci ratios: .618, 1.000, 1.618, 2.618 and 4.236. If you like, you can use even smaller Fibonacci ratios, such as .236, .382 and .500 to provide additional levels of support and resistance. Then, take these values and both add them to January's high and subtract them from January's low to identify key levels of support and resistance in any financial market for the entire year.

As an added exercise: I also find that Fibonacci retracements of January's trading range itself (without adding it to January's high or subtracting it from the low) often identify significant levels of support and resistance (i.e., .382, .500 and .618).

How do you use these key levels to your advantage?

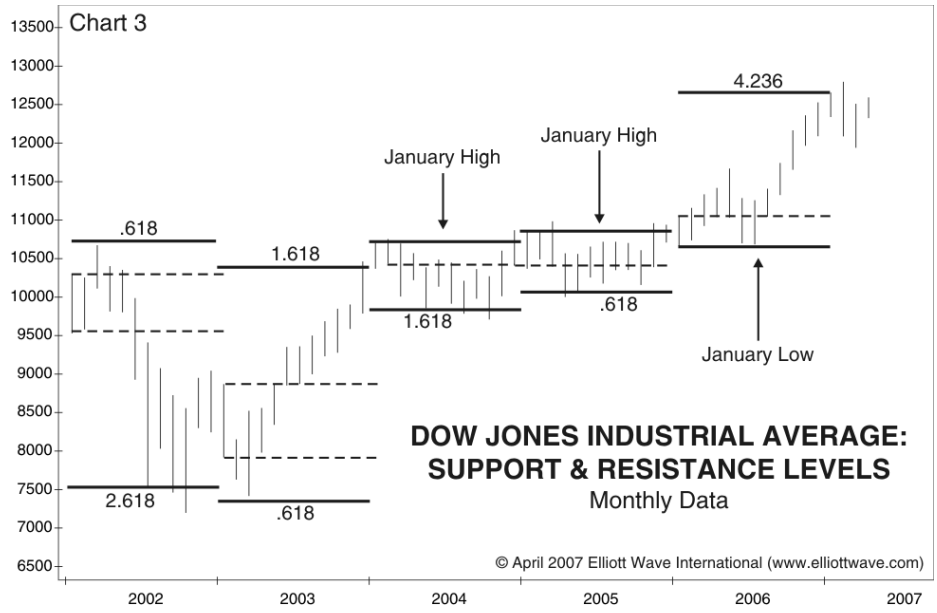
- As prices approach these support and resistance levels, be on the lookout for a possible reversal in price (i.e., a change in trend).
- If prices begin to stall as they approach these levels, the trend will likely reverse.
- If prices slice through these levels as if they weren't even there, then look for the current trend to continue on toward the next higher or lower number.

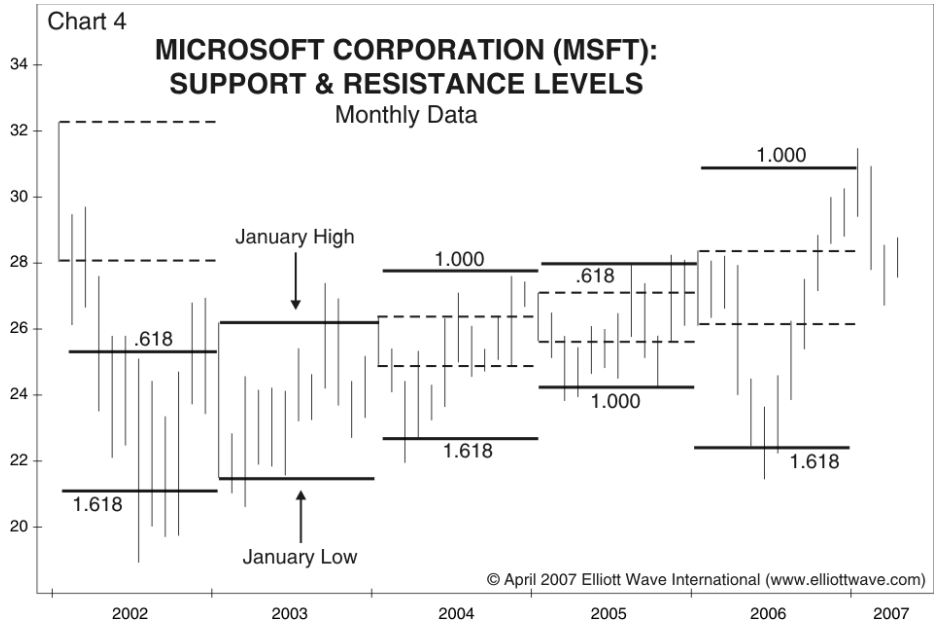




The Importance of January's Trading Range

Also, be aware when prices revisit January's trading range. I find that this range also sparks reversals in price, as it did in 2002 in the Canadian Dollar (Chart 1). And here's another tip: Once prices exceed the 1.000 multiple of January's range (either up or down), prices will most likely continue on higher or lower to the next Fibonacci level, thereby indicating that the current trend is "entrenched," which occurred in 2002, 2003, 2005 and 2006 in the Euro (Chart 2). If prices can't manage to exceed the 1.000 multiple of January's trading range, as it did in 2004, odds favor a range-bound market for that year.





In addition to realizing how important the 1.000 multiple of January's trading range is, I also uncovered numerous instances in which the January high or low provides significant resistance and support, much as it did in 2004, 2005 and 2006 in the Dow Jones Industrial Average (Chart 3). This tendency can also be seen again in 2003 in Microsoft (MSFT, Chart 4).

Remember, just like you, day after day, year after year, I sit and watch price action unfold on the screen in front of me. Why? Because my work is my passion and because I sense something about the markets that is exciting, mysterious and alluring. If this chord rings true for you, please spend some time exploring this approach to discover how it can best work for you. You may be the one who unravels a mystery or discovers a nuance about the markets that no other technical analyst ever has.

Appendix A

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 A-1 shows, these basic patterns link to form five- and three-wave structures of increasingly larger size (larger "degree" in Elliott terminology).

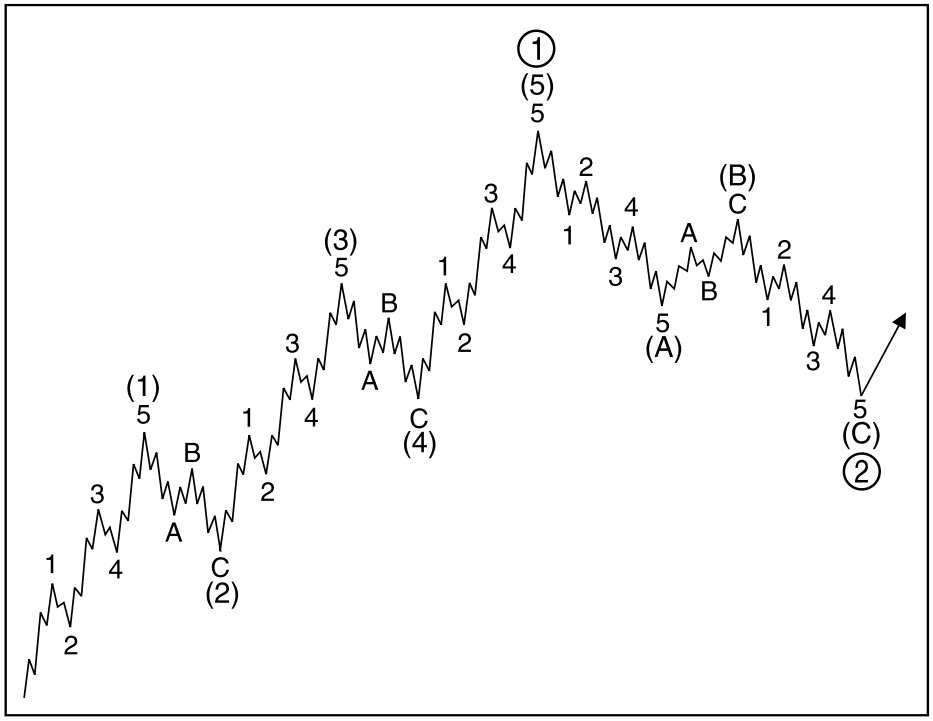


Figure A-1

In Figure A-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 A-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	ⓘ	ⓘⓘ	ⓘⓘⓘ	ⓘⓥ	ⓥ	ⓐ	ⓑ	ⓒ
Minuette	(i)	(ii)	(iii)	(iv)	(v)	(a)	(b)	(c)
Subminuette	i	ii	iii	iv	v	a	b	c

Figure A-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.

Appendix B

Glossary Of Terms

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.

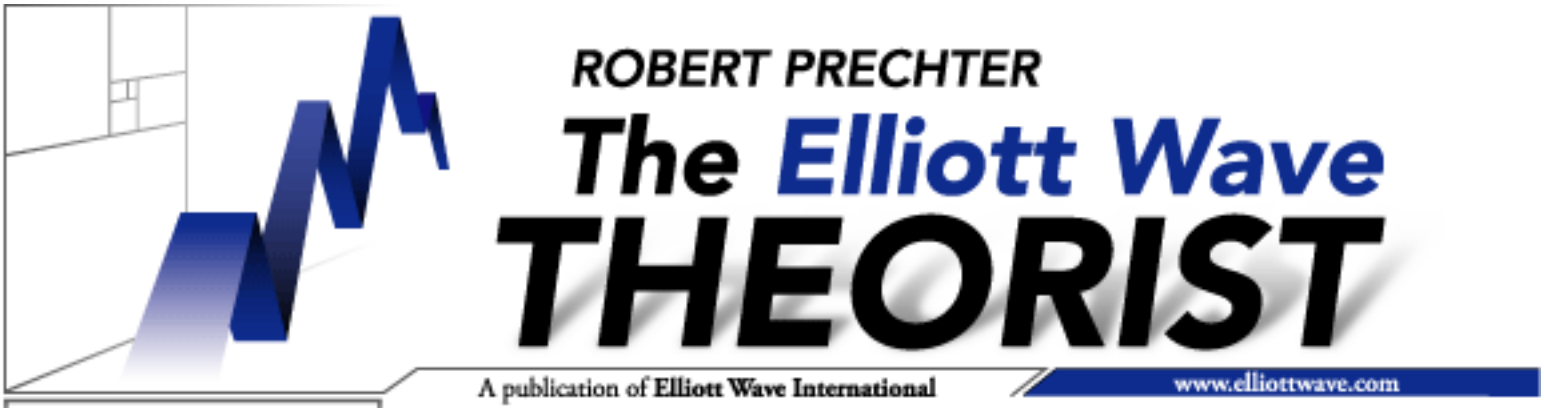
Triple Three - Combination of three simple sideways corrective patterns labeled W, Y and Z, each separated by a corrective wave labeled X.

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.

Appendix C



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SPECIAL REPORT

WHAT A TRADER REALLY NEEDS TO BE SUCCESSFUL

Ever since winning the United States Trading Championship in 1984 (see footnotes, p.4), subscribers have asked for a list of "tips" on trading, or even a play-by-play of the approximately 200 short term trades I made while following hourly market data over a four month period. Neither of these would do anyone any good. What successful trading requires is both more and less than most people think. In watching the reports of each new Championship over the past three years, it has been a joy to see what a large percentage of the top winners have been *Elliott Wave Theorist* subscribers and telephone consultation customers. (In fact, in the latest "standings" report from the USTC, of the *top three producers* in each of four categories, *half* are EWT subscribers!) However, while good traders may want the input from EWT, not all EWT subscribers are good traders. Obviously the winners know something the losers don't. What is it? What are the guidelines you *really* need to meet in order to trade the markets successfully?

When I first began trading, I did what many others who start out in the markets do: I developed a list of trading rules. The list was created piecemeal, with each new rule added, usually, following the conclusion of an unsuccessful trade. I continually asked myself, what would I do differently next time to make sure that this mistake would not recur? The resulting list of "do's" and "don'ts" ultimately comprised about 16 statements. Approximately six months following the completion of my carved-in-stone list of trading rules, I balled up the paper and threw it in the trash.

What was the problem with my list, a list typical of so many novices who think they are learning something? After several months of attempting to apply the "rules," it became clear that I made not merely a mistake here and there in the list, but a fundamental error in compiling the list in the first place. The error was in taking aim at the *last* trade each time, as if the next trading situation would present a similar problem. By the time 16 rules are created, all situations are covered and the trader is back to square one.

Let me give you an example of the ironies that result from the typical method of generating a list of trading rules. One of the most popular trading maxims is, "You can't go broke taking a profit." (The brokers invented that one, of course, which is one reason that new traders always hear of it!) This trading maxim appears to make wonderful sense, but only when viewed in the context of a recent trade with a specific outcome. When you have entered a trade at a good price, watched it go your way for a while, then watched it go against you and turn into a loss, the maxim sounds like a pronouncement of divine wisdom. What you are really saying, however, is that in the context of the last trade, "*I should have sold when I had a small profit.*"

Now let's see what happens on the next trade. You enter a trade, and after just a few days of watching it go your way, you sell out, only to stare in amazement as it continues to go in the direction you had expected, racking up paper gains of several hundred percent. You ask a more experienced trader what your error was, and he advises you sagely while

peering over his glasses, "Remember this forever: Cut losses short; let profits run." So you reach for your list of trading rules and write this maxim, which means only, of course, "*I should NOT have sold when I had a small profit.*"

So trading rules #2 and #14 are in direct conflict. Is this an isolated incident? What about rule #3, which reads, "Stay cool; never let emotions rule your trading," and #8, which reads, "If a trade is obviously going against you, get out of the way before it turns into a disaster." Stripped of their fancy attire, #3 says, "*Don't panic during trading,*" and #8 says, "*Go ahead and panic!*" Such formulations are, in the final analysis, utterly useless.

What I finally desired to create was a description not of each of the trees, but of the forest. After several years of trading, I came up with —guess what— another list! But this is *not* a list of "trading rules"; it's a list of requirements for successful trading. Most worthwhile truths are simple, and this list contains only five items. (In fact, the last two are actually subsets of the first two.) Whether this list is true or complete is arguable, but in forcing myself to express my conclusions, it has helped me understand the true dimensions of the problem, and thus provided a better way of solving it. Like most rewards life offers, market profits are not as easy to come by as the novice believes. Making money in the market requires a good deal of education, like any craft or business. If you've got the time, the drive, and the right psychological makeup, you can enter that elite realm of the truly professional, or at least successful, trader or investor. Here's what you need:

1. A method.

I mean an *objectively definable* method. One that is thought out in its entirety to the extent that if someone asks you how you make your decisions, you can explain it to him, and if he asks you again in six months, he will receive the same answer. This is not to say that a method cannot be altered or improved; it must, however, be developed as a totality before it is implemented. A prerequisite for obtaining a method is acceptance of the fact that perfection is not achievable. People who demand it are wasting their time searching for the Holy Grail, and they will never get beyond this first step of obtaining a method. I chose to use, for my decision making, an approach which was explained in our book, *Elliott Wave Principle*. I think the Wave Principle is the best way to understand the framework of a market and where prices are within that framework. There are a hundred other methods which will work if successful trading is your only goal. As I have often said, a simple 10-day moving average of the daily advance-decline net, probably the first indicator a stock market technician learns, can be used as a trading tool, if objectively defined rules are created for its use. The bad news is that as difficult and time consuming as this first major requirement can be, it is the easiest one to fulfill.

2. The discipline to follow your method.

This requirement is so widely understood by the true professionals that among them, it almost sounds like a cliche´ . Neverthless, it is such an important cliche´ that it cannot be sidestepped, ignored, or excepted. Without discipline, you really have no method in the first place. It struck me one day that among a handful of *consistently successful* professional options and futures traders of my acquaintance, three of them are former Marines. In fact, the only advisor, as ranked by Commodity Traders Consumer Report, consistently to beat my Telephone Hotline record from 1983 to 1985 was a former Marine as well (he has retired from the advisory business). Now, this is a ratio way out of proportion to former Marines as a percentage of the general population! Why should this anomaly exist? Think about it. At some point in their lives, these people *volunteered* to serve in an organization which requires, above all, *discipline*. These are people who *asked* for the opportunity to go charging through a jungle pointing a bayonet and pitching grenades, surviving on roots and bugs when necessary. That's an overdramatization perhaps, but you get the point. These people knew they were "tough," and wanted the chance to prove it. Being "tough" in this context means having the ability to suppress a host of emotions in order to act in a manner which would strike fear in the hearts of most people. I was never a Marine, but years ago while attending summer school with Georgia's "Governor's Honors Program," I was given a psychological test and told that one of my skewed traits was "tough-mindedness" (as opposed to "tender-mindedness"). I didn't exactly know what that meant, but after trading and forecasting the markets for fourteen years, it is clear that without that trait, I would have been forced long ago to elect another profession. The pressures are enormous, and they get to everyone, including me. If you are not disciplined, forget the markets.

3. Experience.

Some people advocate "paper trading" as a learning tool. Paper trading is useful for the testing of methodology, but it is of no value in learning about trading. In fact, it can be detrimental, by imbuing the novice with a false sense of security in "knowing" that he has successfully paper traded the past six months, thus believing that the next six months with real money will be no different. In fact, nothing could be further from the truth. Why? Because the markets are not merely an intellectual exercise. They are an emotional (and in extreme cases, even physical) one as well. If you buy a computer baseball game and become a hitting expert with the joystick while sitting quietly alone on the floor of your living room, you may conclude that you are one talented baseball player. Now let the Mean Green Giant reach in, pick you up, and place you in the batter's box at the bottom of the ninth inning in the final game of the World Series with your team behind by one run, the third base coach flashing signals one after another, a fastball heading toward your face at 90 m.p.h., and sixty beer soaked fans in the front row screaming, "Yer a bum! Yer a bum!" Guess what? *You feel different!* To put it mildly, you will find it impossible to approach your task with the same cool detachment you displayed in your living room. This new situation is real, it matters, it is *physical*, it is *dangerous, other people are watching*, and you are being *bombarded with stimuli*. This is what your life is like when you are actually speculating. You know it is real, you know it matters, you must physically pick up the phone and speak to place orders, you perform under the scrutiny of your broker or clients, your spouse and business acquaintances, and you must operate while thousands of conflicting messages are thrown at you from the financial media, the brokerage industry, analysts, and the market itself. In short, you must conquer a *host* of problems, most of them related to your own inner strength in battling powerful human emotions, in order to trade real money successfully. The School of Hard Knocks is the *only* school that will teach it to you, and the tuition is expensive.

There is only one shortcut to obtaining experience, and that is to find a *mentor*. Locate someone who has proved himself over the years to be a successful trader or investor, and go visit him. You will undoubtedly find that he is very friendly since his runaway ego of yesteryear, which undoubtedly got him involved in the markets in the first place, has long since been humbled, matured by the experience of trading. Watch this person operate. Observe not only what he does, but far more important, *what he does not allow himself to do*. This person does exist, but it is hard to find him. He will usually welcome the opportunity to tell you what he knows.

4. The Mental Fortitude to Accept the Fact that Losses Are Part of the Game.

There are many denials of reality which automatically disqualify millions of people from joining the ranks of successful speculators. For instance, to moan that "pools," "manipulators," "insiders," "they," "the big boys" or "program trading" are to blame for one's losses is a common fault. Anyone who utters such a conviction is doomed before he starts. But my observation, after eleven years "in the business," is that the biggest obstacle to successful speculation is the failure merely even to recognize and accept the simple fact that *losses are part of the game*, and that they must be accommodated. The perfect trading system does not exist. Expecting, or even hoping for, perfection is a guarantee of failure. Speculation is akin to batting in baseball. A player hitting .300 is good. A player hitting .400 is great. But even the great player *fails to hit* 60% of the time! He even *strikes out* often. But he still earns six figures a year, because although not perfect, he has approached the best that can be achieved. You don't have to be perfect to win in the markets, either; you "merely" have to be better than almost everybody else, and that's hard enough. Practically speaking, you must include an objective money management system when formulating your trading method in the first place. There are many ways to do it. Some methods use stops. If stops are impractical (such as with options), you may decide to risk only small amounts of total capital at a time. After all is said and done, learning to handle losses will be your greatest triumph.

The last on my list is one I have never heard mentioned before.

5. The Mental Fortitude to Accept Huge Gains.

This comment usually gets a hearty laugh, which merely goes to show how little most people have determined it actually to be a problem. But consider. How many times has the following sequence of events occurred? For a full year, you trade futures contracts, making $1000 here, losing $1500 there, making $3000 here and losing $2000 there. Once again, you

enter a trade because your method told you to do so. Within a week, you're up $4000. Your friend/partner/acquaintance/broker/advisor calls you and, looking out only for your welfare, tells you to take your profit. You have guts, though, and you wait. The following week, your position is up $8000, the best gain you have ever experienced. "Get out!" says your friend. You sweat, still hoping for further gains. The next Monday, your contract opens limit against you. Your friend calls and says, "I *told* you so. You got greedy. But hey, you're still way up on the trade. Get out tomorrow." The next day, on the opening, you exit the trade, taking a $5000 profit. It's your biggest profit of the year, and you click your heels, smiling gratefully, proud of yourself. Then, day after day for the next six months, you watch the market continue to go in the direction of your original trade. You try to find another entry point and continue to miss. At the end of six months, your method finally, quietly, calmly says, "Get out." You check the figures and realize that your initial entry, if held, would have netted $450,000.

So what was your problem? Simply that you had allowed yourself unconsciously to define your "normal" range of profit and loss. When the big trade finally came along, you lacked the self esteem to take all it promised. You looked at a job requiring the services of a Paul Bunyan and decided that you were just a Pee Wee Herman. Who were *you* to shoot for such huge gains? Why should *you* deserve more than your best trade of the year? You then abandoned both *method* and *discipline*.

To win the game, make sure that you understand why you're in it. The big moves in markets only come once or twice a year. Those are the ones which will pay you for all the work, fear, sweat and aggravation of the previous eleven months or even eleven years. Don't miss them for reasons *other than* those required by your objectively defined method.

The I.R.S. categorizes capital gains as "unearned income." That's baloney. It's *hard* to make money in the market. Every dime you make, you *richly deserve*. Don't ever forget that. I wish you success.

In 1984, Bob Prechter won the United States Trading Championship, setting a new all-time profit record of 444.4% in a monitored real money options account in four months. That February through May period presented a difficult and choppy market to the effect that the second highest reported gain in the options division was just 84%, and 83% of the contestants lost money. According to contest sponsors, many market letter writers have entered the contest over the years, but almost all have lost money. In the average 4-month contest, over 75% of contestants, most of whom are professionals paying $200 to prove their abilities, fail to report profits.

I highly recommend the United States Trading Championship. It is the only trading contest which fairly allows each entrant to perform at his maximum ability, without arbitrary constraints. Most others are started by brokerage firms to create business; they impose minimum accounts, insist on trading one type of vehicle, etc. For information on the USTC, contact the Financial Traders Association, P.O. Box 7634, Beverly Hills, CA 90212-7634; phone 310-550-0062

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March 2007 – April 2008 Volume 4

Trader's Classroom Collection



More Lessons from Futures Junctures

Editor Jeffrey Kennedy

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THE TRADER'S CLASSROOM COLLECTION

Volume 4

Lessons from *Futures Junctures* Editor Jeffrey Kennedy

Published by

Elliott Wave International

www.elliottwave.com

THE TRADER'S CLASSROOM COLLECTION: Volume 4

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Elliott Wave International, Inc.

For information, address the publisher:

Elliott Wave International

Post Office Box 1618

Gainesville, Georgia 30503 USA

www.elliottwave.com

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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.*

A Note from Jeffrey Kennedy on Volume IV…
June 2008

Each month, I enjoy taking time out from my wave analysis and forecasting of commodities to write a Trader's Classroom column for the *Monthly Futures Junctures* publication. Why do I take the time to write these columns each month? To supply you with ***simple tools and methods that work on any timeframe and in any financial market, which you can apply yourselves.***

Since 2005, we have been gathering my columns and publishing them as *The Trader's Classroom Collection*: now we're bringing you Volume IV, which includes 13 more columns from early 2007 to mid-2008. Many readers have told us how useful the previous volumes are, so I hope that you, too, will find something to learn from and use in these columns, which are divided into four sections:

I. How To Get the Mindset of a Trader

II. Using Fibonacci To Improve Your Trading

III. Tricks of the Trader

IV. How To Make Bar Patterns Work for You

Recent years have seen some of the most historically volatile times for commodities and, in turn, have provided some of the clearest wave patterns. It has been the perfect environment to offer real-life, real-time trading lessons via the Trader's Classroom column in *Monthly Futures Junctures*. The advances in grains in 2007 offered a number of examples of how important the Wave Principle is. But I have also drawn on price charts from stocks (Google and Citigroup), metals (gold), currencies (Swiss Franc) and bonds (10-year Treasury Note) to explain how my techniques can identify high-probability trading opportunities in any financial market.

Welcome to the fourth edition of *The Trader's Classroom Collection*,



Jeffrey Kennedy

Chief Commodity Analyst and Editor of *Futures Junctures*

Elliott Wave International

P.S. I have added more information to our Futures Junctures Service to include webinars and video updates as well as Commitment of Traders data, Daily Sentiment Index data, the Futures Junctures Index of Crowd Psychology and a Trader's Toolbox. If you would like to receive these *and* the Trader's Classroom columns as I publish them, learn more about how to subscribe to our Futures Junctures service at http://www.elliottwave.com/wave/TCCFJ.

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1. Why Do Traders Lose?

Because They Haven't Overcome These Five Fatal Flaws
May 2007

If you've been trading for a long time, you've no doubt felt that a monstrous, invisible hand sometimes reaches into your trading account and takes out money. It doesn't seem to matter how many books you buy, how many seminars you attend or how many hours you spend analyzing price charts, you just can't seem to prevent that invisible hand from depleting your trading account funds.

Which brings us to the question: Why do traders lose? Or maybe we should ask, "How do you stop the Hand?" Whether you are a seasoned professional or just thinking about opening your first trading account, the ability to stop the Hand is proportional to how well you understand and overcome the Five Fatal Flaws of trading. For each fatal flaw represents a finger on the invisible hand that wreaks havoc on your trading account.

Fatal Flaw No. 1 – Lack of Methodology

The first fatal flaw is a Lack of Methodology. If you aim to be a consistently successful trader, then you must have a defined trading methodology, which is simply a clear and concise way of looking at markets. Guessing or going by gut instinct won't work over the long run. If you don't have a defined trading methodology, then you don't have a way to know what constitutes a buy or sell signal. Moreover, you can't even consistently identify the trend correctly.

How to overcome this fatal flaw? Answer: Write down your methodology. Define in writing what your analytical tools are and, more importantly, how you use them. It doesn't matter whether you use the Wave Principle, Point and Figure charts, Stochastics, RSI or a combination of all of the above. What does matter is that you actually take the effort to define it (i.e., what constitutes a buy, a sell, your trailing stop and instructions on exiting a position). And the best hint I can give you regarding developing a defined trading methodology is this: If you can't fit it on the back of a business card, it's probably too complicated.

Fatal Flaw No. 2 – Lack of Discipline

After clearly outlining and identifying your trading methodology, then you must have the discipline to follow your system. A Lack of Discipline in this regard is the second fatal flaw. If the way you view a price chart or evaluate a potential trade setup is different from how you did it a month ago, then you have either not identified your methodology or you lack the discipline to follow the methodology you have identified. The formula for success is to consistently apply a proven methodology. So the best advice I can give you to overcome a lack of discipline is to define a trading methodology that works best for you and follow it religiously.

Fatal Flaw No. 3 – Unrealistic Expectations

Between you and me, nothing makes me angrier than those commercials that say something like, "...$5,000 properly positioned in Natural Gas can give you returns of over $40,000..." Advertisements like this are a disservice to the financial industry as a whole and end up costing uneducated investors a lot more than $5,000. In addition, they help to create the third fatal flaw: Unrealistic Expectations.

Yes, it is possible to experience above-average returns trading your own account. However, it's difficult to do it without taking on above-average risk. So what is a realistic return to shoot for in your first year as a trader – 50%, 100%, 200%? Whoa, let's rein in those unrealistic expectations. In my opinion, the goal for new traders their first year out should be not to lose money. In other words, shoot for a 0% return your first year. If you can manage that, then in year two, try to beat the Dow or the S&P. These goals may not be flashy but they are realistic, and if you can learn to live with them – and achieve them – you will fend off the Hand.

Fatal Flaw No. 4 – Lack of Patience

The fourth finger of the invisible hand that robs your trading account is Lack of Patience. I forget where, but I once read that markets trend only 20% of the time, and, from my experience, I would say that this is an accurate statement. So think about it, the other 80% of the time the markets are not trending in one clear direction.

That may explain why I believe that for any given time frame, there are only two or three really good trading opportunities. For example, if you're a long-term trader, there are typically only two or three compelling tradable moves in a market during any given year. Similarly, if you are a short-term trader, there are only two or three high-quality trade setups in a given week.

All too often, because trading is inherently exciting – and anything involving money usually is exciting – it's easy to feel like you're missing the party if you don't trade a lot. As a result, you start taking trade setups of lesser and lesser quality and begin to over-trade.

How do you overcome this lack of patience? The advice I find to be most valuable is to remind yourself that every week, there is another trade-of-the-year. In other words, don't worry about missing an opportunity today, because there will be another one tomorrow, next week and next month ... I promise.

I remember a line from a movie (either Sergeant York with Gary Cooper or The Patriot with Mel Gibson) in which one character gives advice to another on how to shoot a rifle: "Aim small, miss small." I offer the same advice in this new context. To aim small requires patience. So be patient, and you'll miss small.

Fatal Flaw No. 5 – Lack of Money Management

The final fatal flaw to overcome as a trader is a Lack of Money Management. This topic deserves more than just a few paragraphs, because money management encompasses risk/reward analysis, probability of success and failure, protective stops and so much more. Even so, I would like to address the subject of money management with a focus on risk as a function of portfolio size.

Now the big boys (i.e., the professional traders) tend to limit their risk on any given position to 1% - 3% of their portfolio. If we apply this rule to ourselves, then for every $5,000 we have in our trading account, we can risk only $50-$150 on any given trade. Stocks might be a little different, but a $50 stop in Corn, which is one point, is simply too tight a stop, especially when the 10-day average trading range in Corn recently has been more than 10 points. A more plausible stop might be five points or 10, in which case, depending on what percentage of your total portfolio you want to risk, you would need an account size between $15,000 and $50,000.

Simply put, I believe that many traders begin to trade either under-funded or without sufficient capital in their trading account to trade the markets they choose to trade. And that doesn't even address the size that they trade (i.e., multiple contracts).

To overcome this fatal flaw, let me expand on the logic from the "aim small, miss small" movie line. If you have a small trading account, then trade small. You can accomplish this by trading fewer contracts, or trading e-mini contracts or even stocks. Bottom line, on your way to becoming a consistently successful trader, you must realize that one key is longevity. If your risk on any given position is relatively small, then you can weather the rough spots. Conversely, if you risk 25% of your portfolio on each trade, after four consecutive losers, you're out all together.

Break the Hand's Grip

Trading successfully is not easy. It's hard work ... damn hard. And if anyone leads you to believe otherwise, run the other way, and fast. But this hard work can be rewarding, above-average gains are possible and the sense of satisfaction you feel after a few nice trades is absolutely priceless. To get to that point, though, you must first break the fingers of the Hand that is holding you back and stealing money from your trading account. I can guarantee that if you attend to the five fatal flaws I've outlined, you won't be caught red-handed stealing from your own account.

2. Ready, Aim ... Fire

Knowing When To Place a Trade
July 2007

A very important question you need to answer if you are going to use the Wave Principle to identify high-probability trade setups is, *"When does a wave count become a trade?"*

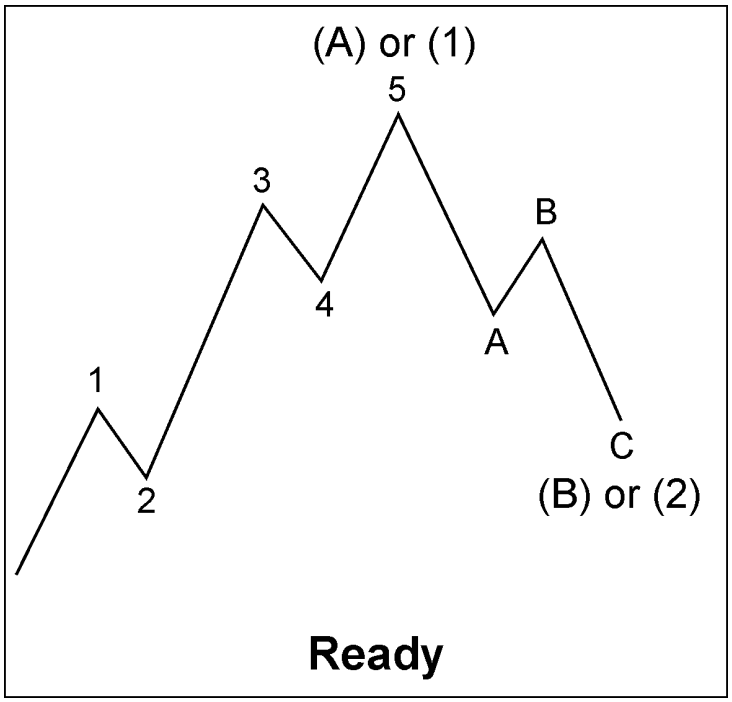
To answer this question, let me draw upon the steps required to fire a firearm:

Step 1 (Ready) – Hold the rifle or pistol still ... very still.

Step 2 (Aim) – Focus and align your sights.

Step 3 (Fire) – Pull the trigger without tensing your hand.

If you follow these steps, you should at least hit what you're aiming at, and, with a little practice, you should hit the target's bull's-eye more often than not.



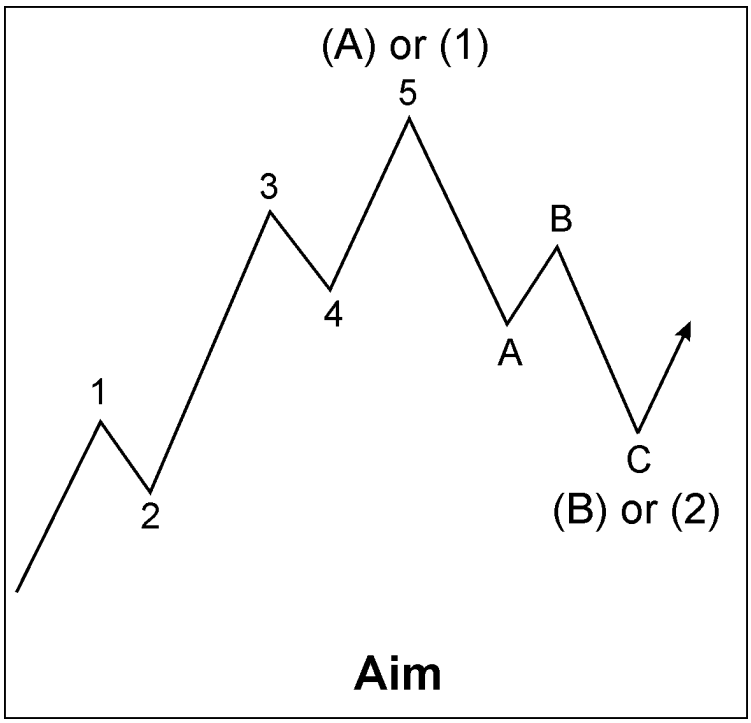
As an Elliottician and a trader, I employ a similar three-step approach to decide when to place a trade. Figure 1 shows a schematic diagram of a five-wave advance followed by a three-wave decline- let's call it a Zigzag. The picture these waves illustrate is what I call the *Ready* stage.

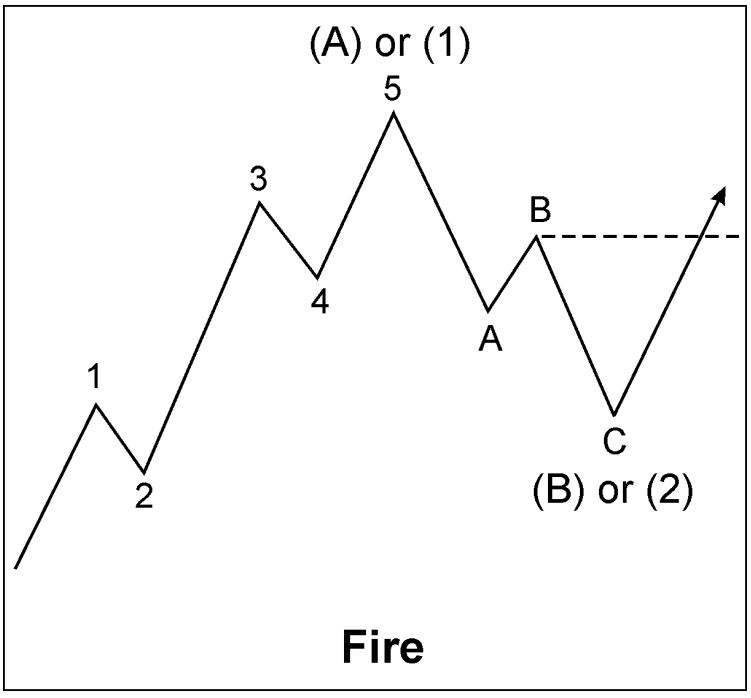
In Figure 2, prices are moving upward as indicated by the arrow. At this stage, I begin to *Aim* as I watch price action to see if it will confirm my wave count by moving in the direction determined by my labeling.

Once prices do indeed begin to confirm my wave count, I then determine the price level at which I will pull the trigger and *Fire* (that is, initiate a trade). And, as you can see in Figure 3, that level is the extreme of wave B.

Why do I wait for the extreme of wave B of a Zigzag to give way before initiating a position? Simple. By waiting, I allow the market time to either prove or disprove my wave count. Moreover, once the extreme of wave B is exceeded, it leaves behind a three-wave decline from the previous extreme. As you know, three-wave moves are corrections according to the Wave Principle, and as such, are destined to be more than fully retraced once complete. An additional bonus of this approach is that it allows me to easily and confidently determine an initial protective stop, the extreme of wave C.

Remember, all markets have a wave count; however, all wave counts don't offer a trading opportunity. So the next time you think you have a wave count, rather than just blindly jumping in, first steady yourself, wait while you aim, and then – if price action does indeed confirm your wave count – pull the trigger. Also, it is important to note that this is my way of applying the Wave Principle practically, but it's by no means the only way.





3. The Three Phases of a Trader's Education

Psychology, Money Management, Method
April 2008

Aspiring traders typically go through three phases in this order:

1. *Methodology* — The first phase is that all-too-familiar quest for the Holy Grail – a trading system that never fails. After spending thousands of dollars on books, seminars and trading systems, the aspiring trader eventually realizes that no such system exists.
2. *Money Management* — So, after getting frustrated with wasting time and money, the up-and-coming trader begins to understand the need for money management, risking only a small percentage of a portfolio on a given trade versus too large a bet.
3. *Psychology* — The third phase is realizing how important psychology is – not only personal psychology but also the psychology of crowds.

But it would be better to go through these phases in the opposite direction. I actually read of this idea in a magazine a few months ago but, for the life of me, can't find the article. Even so, with a measly 15 years of experience under my belt and an expensive Ph.D. from S.H.K. University (i.e., School of Hard Knocks), I wholeheartedly agree. Aspiring traders should begin their journey at phase three and work backward.

I believe the first step in becoming a consistently successful trader is to understand how psychology plays out in your own make-up and in the way the crowd reacts to changes in the markets. The reason for this is that a trader must realize that once he or she makes a trade, logic no longer applies. This is because the emotions of fear and greed take precedence – fear of losing money and greed for more money.

Once the aspiring trader understands this psychology, it's easier to understand why it's important to have a defined investment methodology and, more importantly, the discipline to follow it. New traders must realize that once they join a crowd, they lose their individuality. Worse yet, crowd psychology impairs their judgment, because crowds are wrong more often than not, typically selling at market bottoms and buying at market tops.

Moving onto phase two, after the aspiring trader understands a bit of psychology, he or she can focus on money management. Money management is an important subject and deserves much more than just a few sentences. Even so, there are two issues that I believe are critical to grasp: (1) risk in terms of individual trades and (2) risk as a percentage of account size.

When sizing up a trading opportunity, the rule-of-thumb I go by is 3:1. That is, if my risk on a given trading opportunity is $500, then the profit objective for that trade should equal $1,500, or more. With regard to risk as a percentage of account size, I'm more than comfortable utilizing the same guidelines that many professional money managers use – 1%-3% of the account per position. If your trading account is $100,000, then you should risk no more than $3,000 on a single position. Following this guideline not only helps to contain losses if one's trade decision is incorrect, but it also insures longevity. It's one thing to have a winning quarter; the real trick is to have a winning quarter next year and the year after.

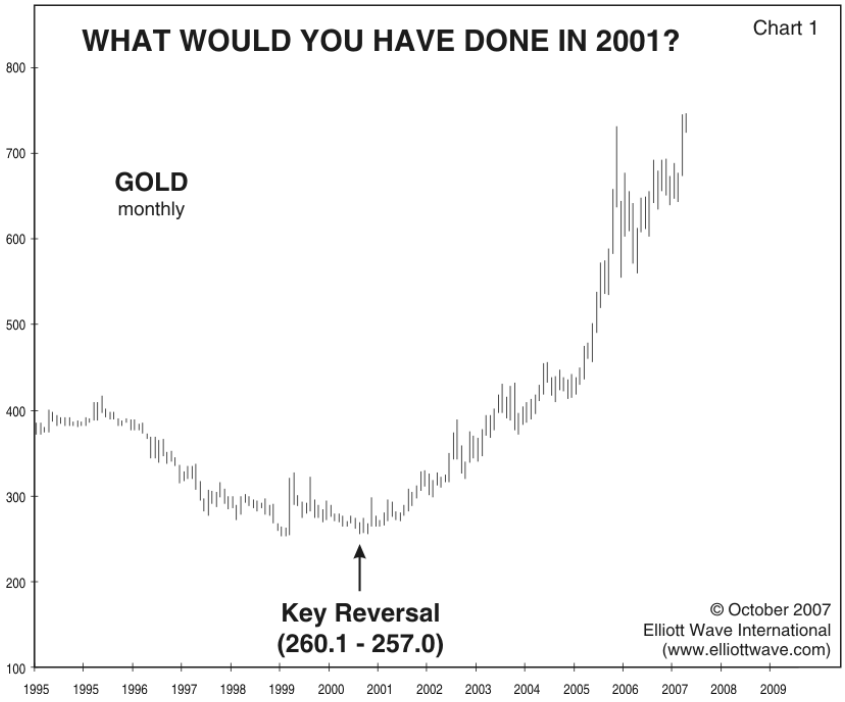
When aspiring traders grasp the importance of psychology and money management, they should then move to phase three – determining their methodology, a defined and unwavering way of examining price action. I principally use the Wave Principle as my methodology. However, wave analysis certainly isn't the only way to view price action. One can choose candlestick charts, Dow Theory, cycles, etc. My best advice in this realm is that whatever you choose to use, it should be simple. In fact, it should be simple enough to put on the back of a business card, because, like an appliance, the fewer parts it has, the less likely it is to break down.

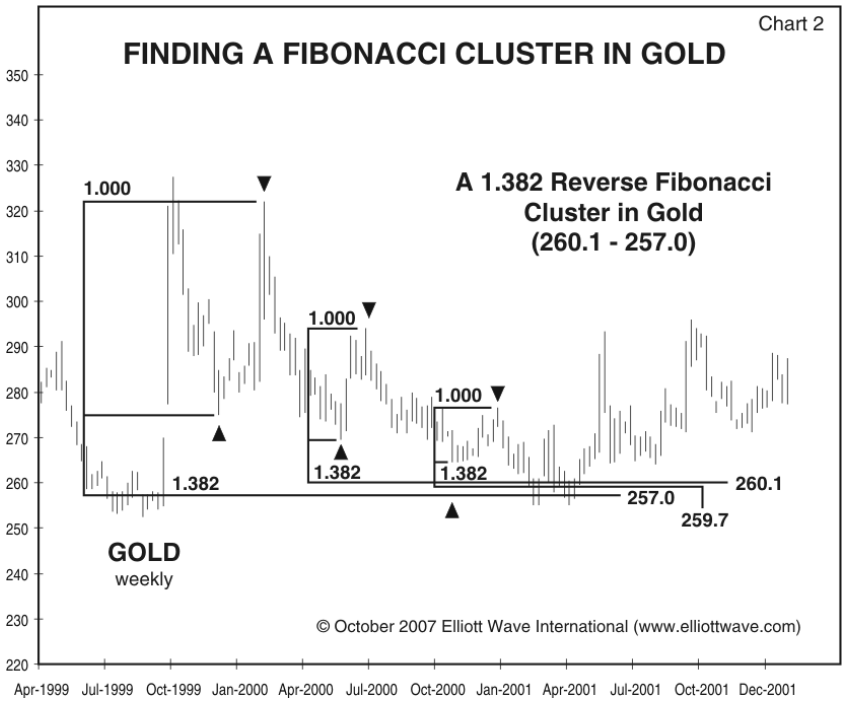
1. What If ...

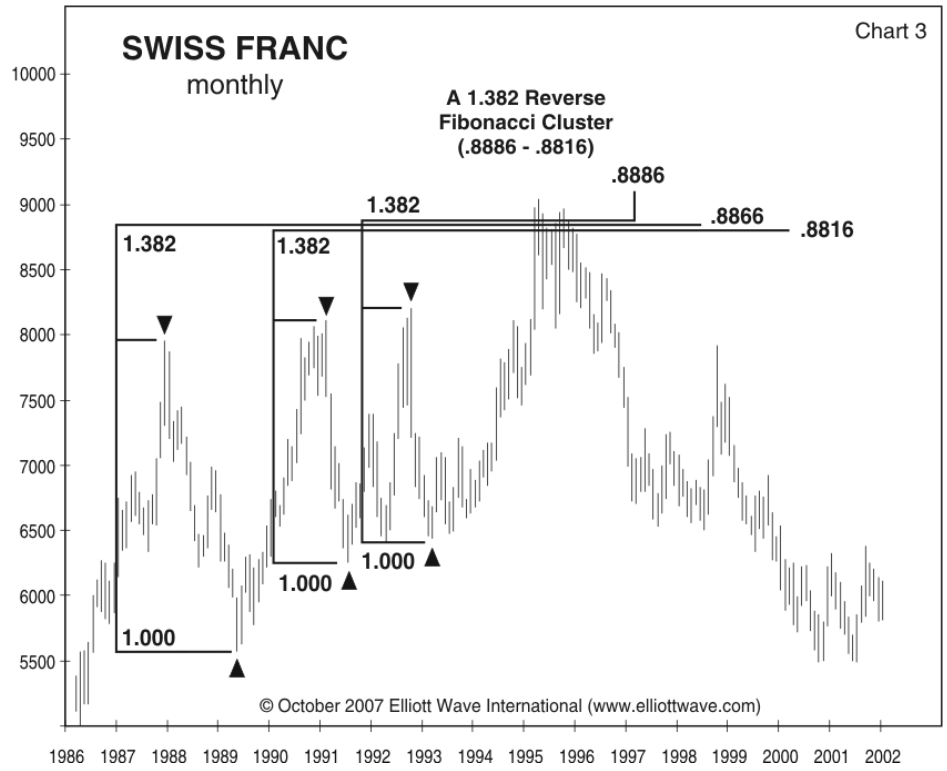
Using Reverse Fibonacci To Find Trade Setups
October 2007

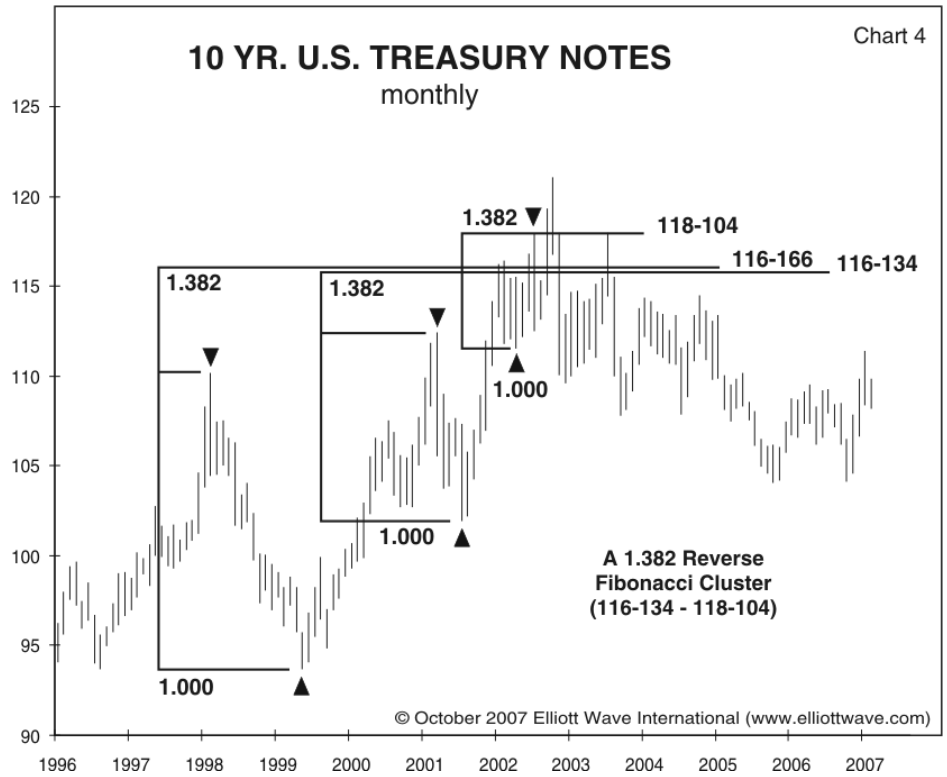
What would you have done in January 2001 if you had known that Gold (Chart 1) was soon likely to stage a significant reversal in price from the 260.1-257.0 level? Better yet, how would you have handled the likelihood in March 1995 that the Swiss Franc (Chart 3) would end a decade-long advance at the .8816-.8886 level and introduce a multi-year decline? No doubt, in each of these instances, you would have found this information to be extremely valuable, *if you could have known it in advance*.

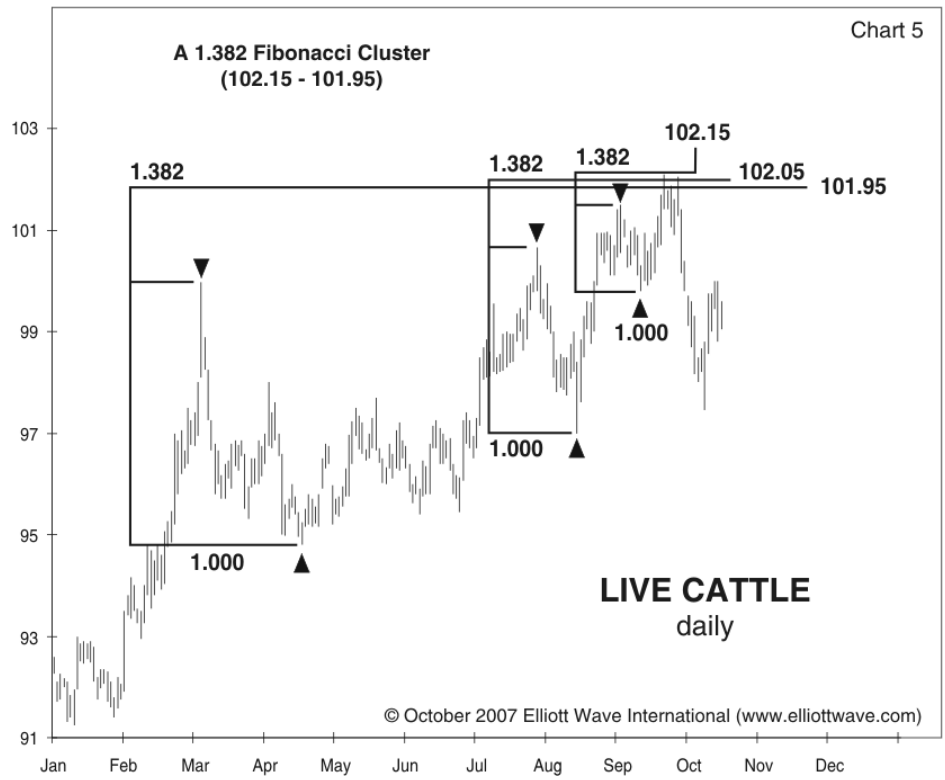
In this Trader's Classroom, I will explain a method to help you find key reversal points in the markets you follow. Since I use historical price charts to show you the technique I use to determine these high probability reversal zones, you may decide that it's simply a good example of Monday morning quarterbacking or 20/20 hindsight. But you would be wrong. In Section V of the Trader's Classroom Collection e-book Volume I, I described a non-traditional use of Fibonacci, using the ratios of 1.382 and 2.000 – a technique called reverse Fibonacci. Simply put, to derive future trade targets or levels of support and or resistance, you multiply previous price swings by 1.382 and 2.000 and then extend that distance upward or downward from their extremes. The result of this exercise will often yield either high probability trade targets or significant levels of support and resistance.






Chart 3
SWISS FRANC
monthly
A 1.382 Reverse
Fibonacci Cluster
(.8886 - .8816)
.8886
.8866
.8816
1.382
1.382
1.382
1.000
1.000
1.000
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10000
9500
9000
8500
8000
7500
7000
6500
6000
5500
1986 1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002


Chart 4
10 YR. U.S. TREASURY NOTES
monthly
1.382
118-104
116-166
116-134
1.382
1.382
1.000
1.000
1.000
A 1.382 Reverse
Fibonacci Cluster
(116-134 - 118-104)
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125
120
115
110
105
100
95
90
1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007



By itself, this technique is highly reliable, but it can be strengthened: by applying it to multiple price moves. You will sometimes find that clusters of Fibonacci support and resistance emerge. And the more tightly bound these clusters of Fibonacci levels are, the more likely the identified region will spark a significant reaction in price. You can see examples of this clustering technique in the price charts I am including for Gold, the Swiss Franc and Treasury Notes (Charts 2, 3 and 4).

Admittedly, it's rare for such tightly bound clusters of reverse Fibonacci retracement levels to occur. Even so, when they *do* occur, the result is often spectacular, just like the setup illustrated in Live Cattle's price chart from the beginning of 2007 (Chart 5). In this chart, a cluster of 1.382 reverse Fibonacci levels identified 102.05-102.15 as a significant area of resistance. And as you can see, a test of this region did indeed result in a dramatic reversal in price.

2. 2008's Annual Fibonacci Support and Resistance Levels – Part One

January 2008

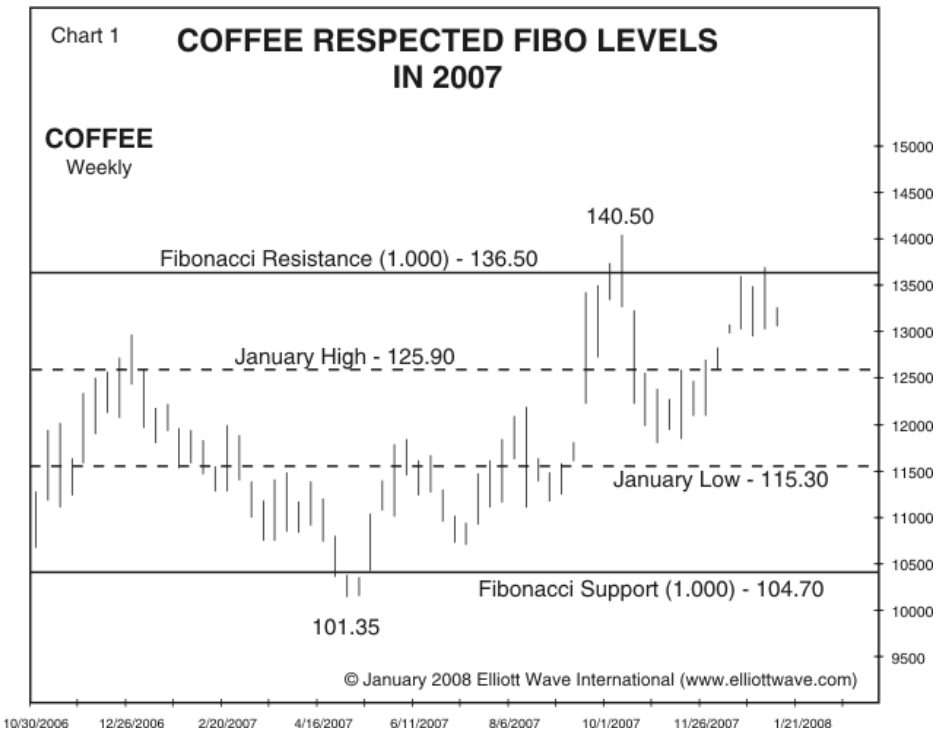
It's that time again when I review how our annual Fibonacci support and resistance level analysis did for the year just ended.

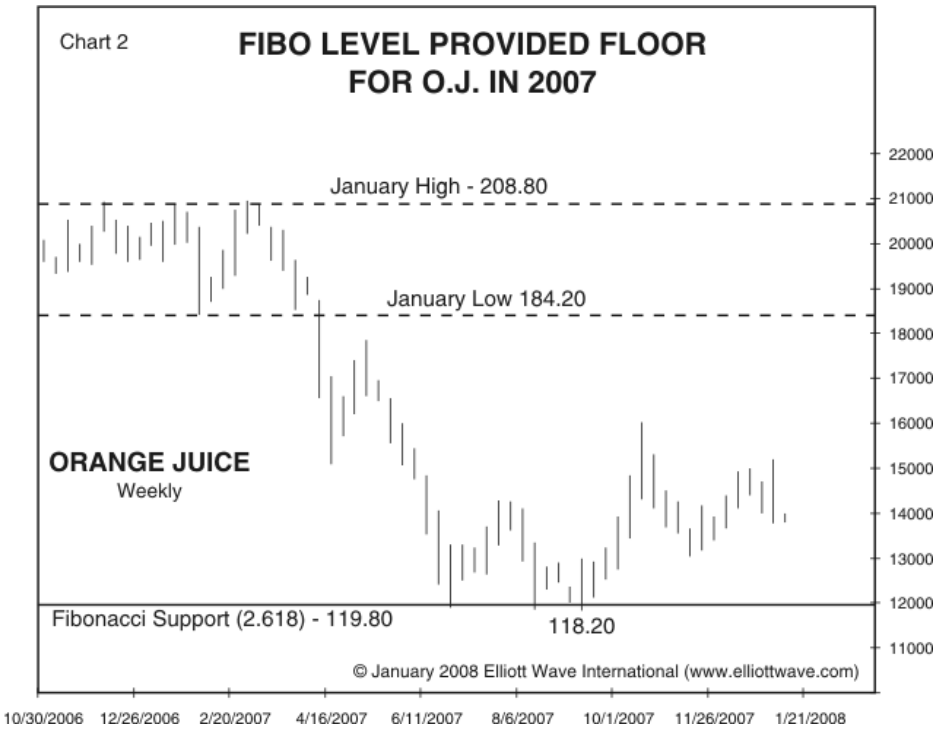
To explain a bit for those of you who are new to *Futures Junctures*: In January of each year, I remind readers that they can identify significant levels of support and resistance for the entire year in any financial market by taking Fibonacci multiples of January's trading range. The reason we perform such analysis is to identify high probability price levels that will either (1) act as objectives for advances and declines in the coming year or (2) ignite reversals in price.

A Few Examples

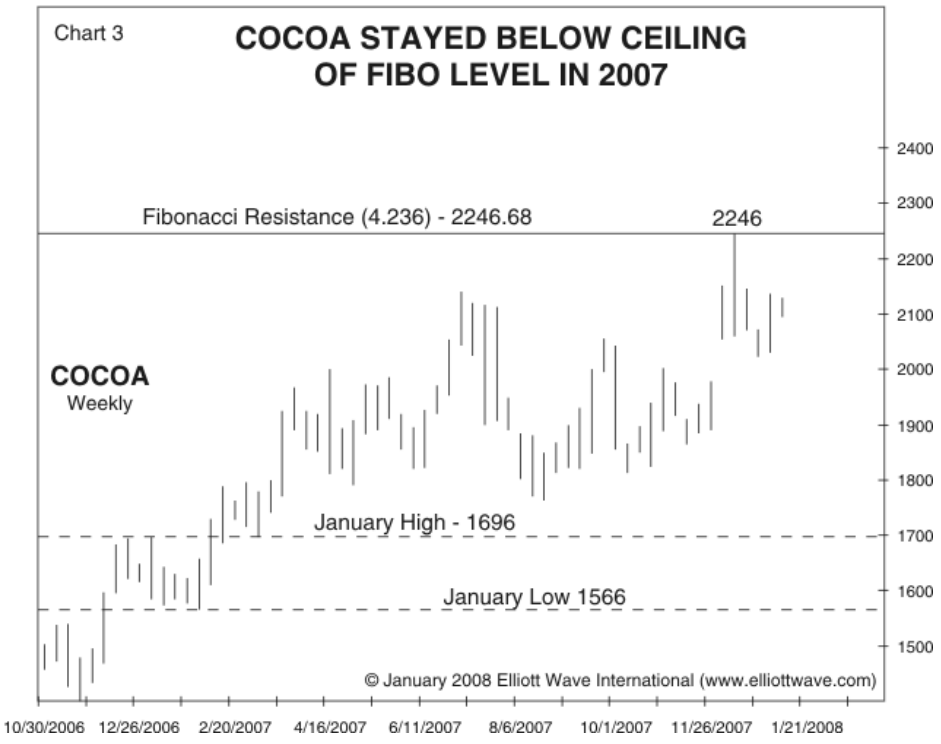
I'm highlighting the best of the crop. For instance, notice that Coffee (Chart 1), after falling to its 1.000 Fibonacci support level at 104.70, staged a rally to 140.50 – just four points above its 1.000 Fibonacci resistance level.

Even better examples of the effectiveness of annual Fibonacci support and resistance level analysis are illustrated in Orange Juice and Cocoa (Charts 2 and 3). In Chart 2, the 2.618 Fibonacci support level at 119.80 was essentially the floor for O.J. in 2007, and, as you can see, it proved to be formidable, surviving three separate attempts to penetrate it in June, August and again in September. In Cocoa, you can see that the high of the year was 2246, which coincides precisely with the 4.236 Fibonacci resistance level at 2246.68!

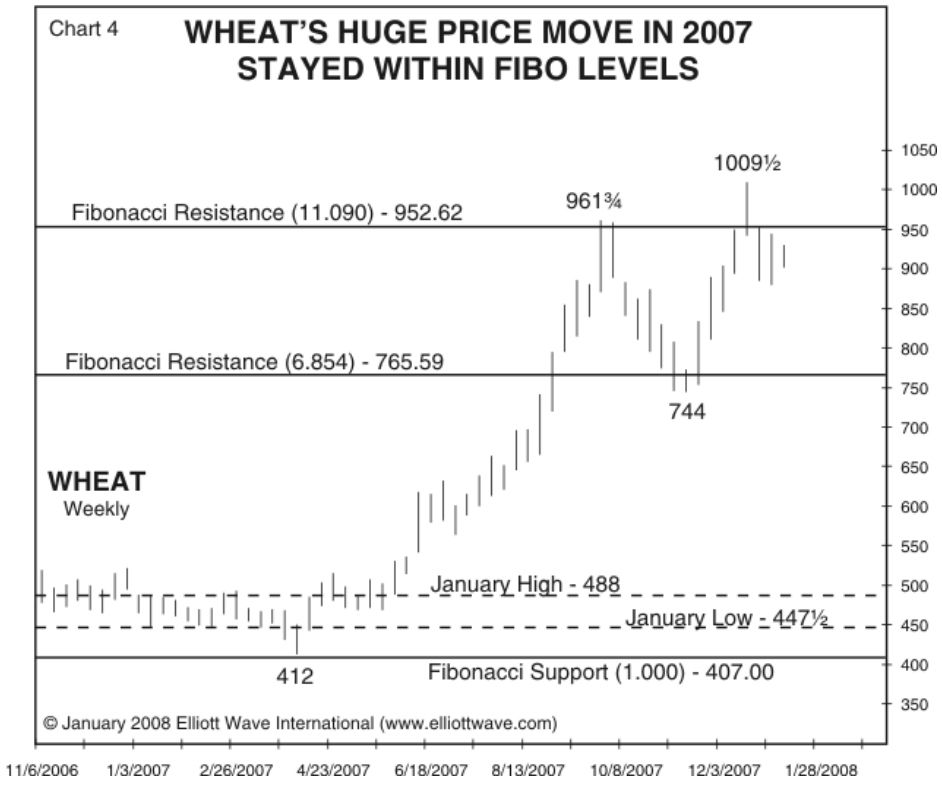




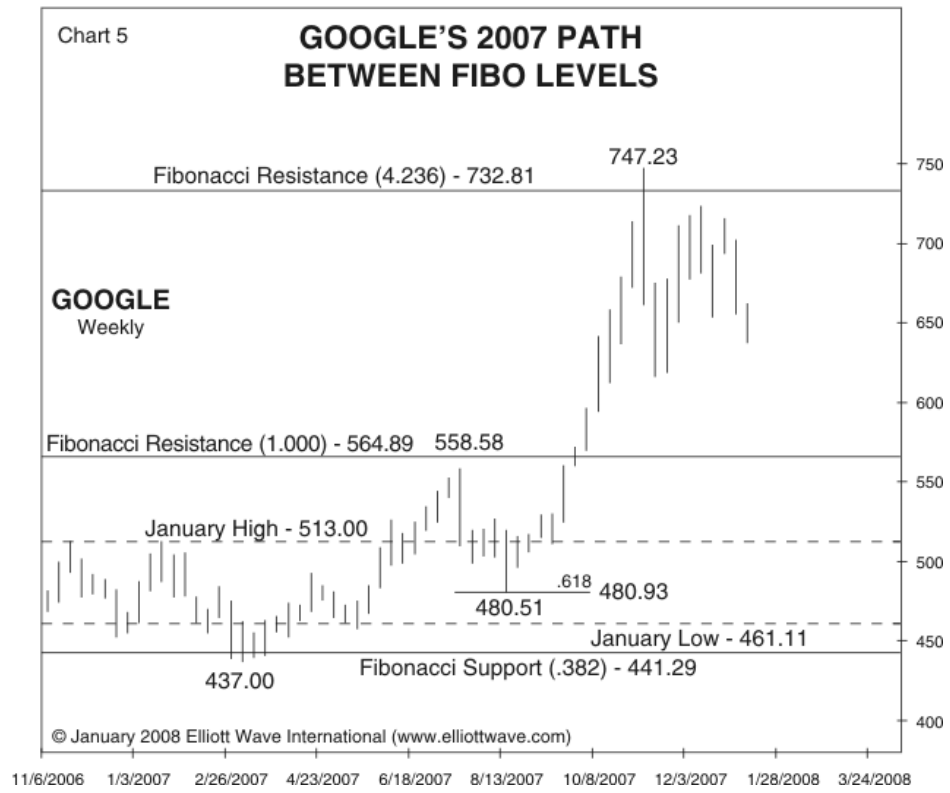
These examples are all well and good, but how does annual Fibonacci support and resistance level analysis hold up when applied to a really crazy market or even to individual stocks? Answer: It's just as effective. Let's see how.



I'm sure you would agree that Wheat was one market that definitely experienced an explosive price move in 2007. In fact, Wheat's price more than doubled from its intra-year low at 412 in 2007 to more than $10.00 a bushel. Even with such a huge price change, it still managed to stay within the Fibonacci levels suggested by our annual analysis, as you can see in Chart 4. Notice that the high that occurred in September 2007 was 961¾ – less than 10 cents above the 11.090 Fibonacci resistance level of 952.62. After testing this level, Wheat's price promptly fell to the 6.854 Fibonacci resistance level at 765.59, which ignited another advance in Wheat. Even though the high in Wheat during the third week of December was 1009½, it wasn't able to sustain this advance and closed on the week at 949 – less than 4 cents below the 11.090 Fibonacci resistance level at 952.62. That's remarkable corroboration for this method of analysis.



What about individual stocks? As I mentioned previously, annual Fibonacci support and resistance level analysis works effectively in any financial market, and I include individual stocks when I make this statement. To prove my point, I've put together a chart of Google (Ticker Symbol: GOOG) in 2007 (Chart 5). The high and low in January for Google was $513.00 and $461.11, respectively, and after trading below January's low of $461.11, price quickly fell to $437.00 in March 2007. The nearest annual Fibonacci support level to the March low was .382, which came in at $441.29 – a difference of less than 2.0%! After forming a low in March, Google prices staged a rally that ended in July



at $558.58, just under the 1.000 Fibonacci resistance level at $564.89, after which, Google fell to $480.51 – less than 50 cents below the .618 retracement of January's trading range. Considering that Google's price is close to $500 per share at this time, its movement within the Fibo support and resistance levels established in January 2007 shows the efficacy of this kind of analysis. Following the August low, the price of Google then rose to an intra-year high of $747.23 – again, less than 2% above the annual Fibonacci resistance level of 732.81.

Applying the Technique Yourself and Special Tips

So how do you apply this technique yourself? It's simple: Take January's trading range (that is, subtract the low point from the high point) and multiply that number by 1.000, 1.618, 2.618 and 4.236, etc. Then, take these values and both add them to January's high and subtract them from January's low to identify key levels of support and resistance in any financial market for the entire year. Moreover, I find that identifying smaller Fibonacci Retracements (i.e., .382, .500 and .618) of January's trading range is important to provide more information, as illustrated in the Google example.

How do you use these key levels to your advantage? As prices approach these support and resistance levels, be on the lookout for a possible reversal in price (i.e., a change in trend). If prices begin to stall as they approach these levels, the trend is likely to reverse. If prices slice through these levels as if they weren't even there, then look for the current trend to continue on toward the next higher or lower number. And just as in traditional technical analysis, what was once resistance often becomes support and vice versa. If an annual Fibonacci resistance level is penetrated in a sound and sustained manner, it will often act as support for an ensuing correction, as in the Wheat example.

Also, be on the lookout when prices revisit January's trading range. I find that this range also sparks reversals in price. And here's another tip: I notice that once prices exceed the 1.000 multiple of January's range (either up or down), prices will most likely continue on higher or lower to the next Fibonacci level. If prices can't manage to exceed the 1.000 multiple of January's trading range, odds favor a range-bound market for that year.

In February, I will publish a list of annual Fibonacci support and resistance levels for 2008 for the commodities I follow as Part Two of this Trader's Classroom.

3. 2008's Annual Fibonacci Support And Resistance Levels — Part Two

Plus Six Tips for Using Annual Fibonacci Levels
February 2008

Now that January is done, it's time to use its trading ranges to provide you with my 2008 annual list of Fibonacci support and resistance levels. (See the tables at the end of this column.) In last month's Trader's Classroom, I described and reviewed this simple technique, based on Fibonacci multiples of January's trading range, which is applicable to any market. As we have seen year after year, this approach continues to prove worthwhile.

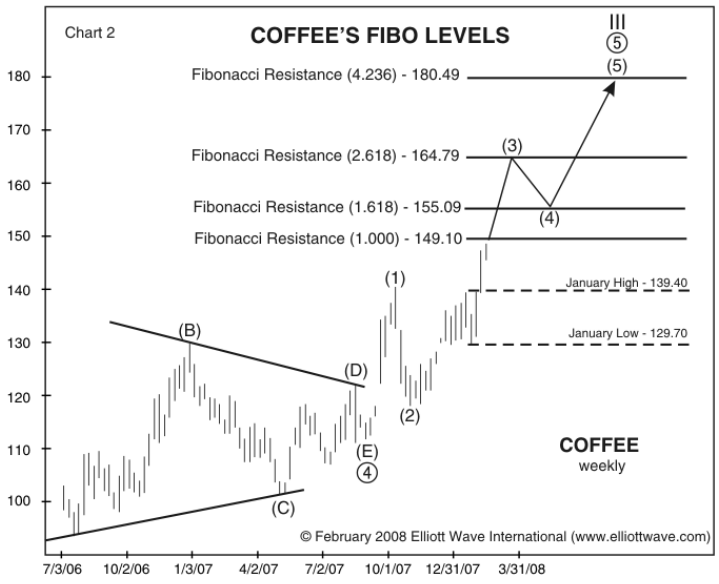
In addition to providing this year's levels for each of the commodity markets I follow, I also want to show you how to use them in conjunction with the Wave Principle to identify high probability objectives for developing waves. Let's look specifically at Coffee and Wheat.

Coffee's chart (Chart 1) comes from this month's Wave Watch section. As you can see, projections for wave ⑤, which are based on the internal wave relationships within wave III, target 156.95 and 193.40-193.55.

Now, if we examine the annual Fibonacci support and resistance levels for Coffee at right, we see similar levels of 155.09 and 180.49. The 155.09 level is the 1.618 multiple of January's trading range, and 180.49 is the 4.236 multiple of January's trading range. I find it interesting that two distinctly different methods of Fibonacci analysis yield such similar results for Coffee's price action.

How does this information aid Elliotticians? It allows us to create "clusters" of Fibonacci support and resistance. A cluster is an area of confluence of mathematically derived Fibonacci extensions or retracements. And the more tightly bound these levels are, the more significant the cluster tends to be.





Moreover, annual Fibonacci support and resistance level analysis allows analysts to plot a more accurate path for prices to travel. Note that in Coffee's Chart 2, I plotted a path for waves (3), (4) and (5). Taking into consideration that Coffee is thrusting out of a multi-year Contracting Triangle, odds strongly favor wave (3) pushing very near to the 2.618 annual Fibonacci resistance level of 164.79. Although I suspect the 1.618 level at 155.09 will provide little resistance, I do think that this level will prove its worth as support for wave (4). As I mention in the sidebar on the next page (6 Tips for Using Annual Fibonacci Levels) whenever an annual Fibonacci resistance level is decisively penetrated, it often acts as support for subsequent corrections. To complete the picture of this future wave pattern for Coffee, wave (5) of ⑤ should then rally into 180.49 -193.55.

6 Tips for Using Annual Fibonacci Levels

1 To identify significant annual Fibonacci support and resistance levels for any market you follow, take January's trading range (that is, subtract the low point from the high point) and multiply that number by 1.000, 1.618, 2.618 and 4.236, etc. Then, take these values and both add them to January's high and subtract them from January's low.

2 It's also worthwhile to identify smaller Fibonacci retracements (i.e., .382, .500 and .618) of January's trading range.

3 As prices approach these support and resistance levels, be on the lookout for a possible reversal in price (i.e., a change in trend). If prices begin to stall as they approach these levels, the trend is likely to reverse. If prices slice through these levels as if they weren't even there, then look for the current trend to continue on toward the next higher or lower number.

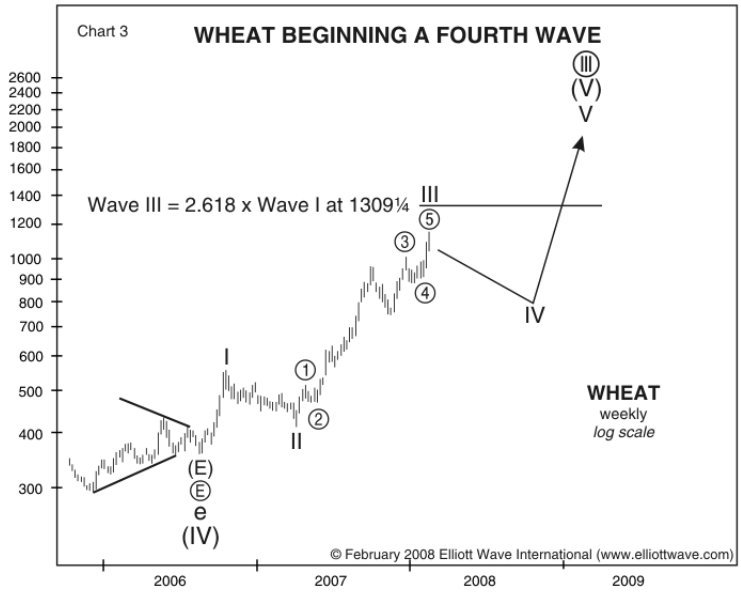
4 Just as in traditional technical analysis, what was once resistance often becomes support and vice versa. Thus, if an annual Fibonacci resistance level is penetrated in a sound and sustained manner, it will often act as support for an ensuing correction.

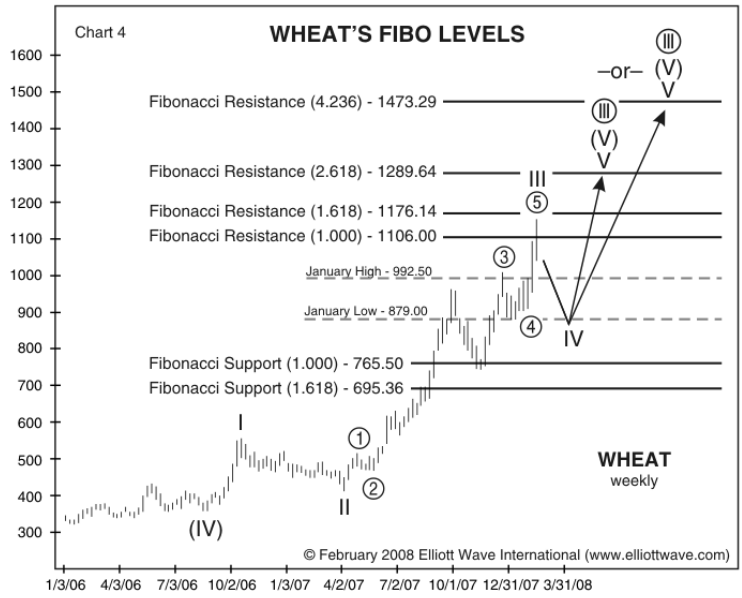
5 Also, be aware when prices revisit January's trading range. I find that this range also sparks reversals in price.

6 Here's a last tip: I notice that once prices exceed the 1.000 multiple of January's range (either up or down), prices will most likely continue on higher or lower to the next Fibonacci level. If prices can't manage to exceed the 1.000 multiple of January's trading range, odds favor a range-bound market for that year.

Now, let's examine Wheat (Chart 3), which also comes from this month's Wave Watch section. Whenever a third wave moves beyond its 1.618 multiple of wave one, it's logical to look next to a 2.618 multiple of wave one. In this case, wave III equals a 2.618 multiple of wave I at 1309.25.

Now, if we again incorporate annual Fibonacci support and resistance analysis, we find a level nearby at 1176.14, which is Wheat's 1.618 annual Fibonacci resistance level. However, considering short-term wave patterns and how prices have reversed so sharply from near 1176.14, I suspect 1309.25 is unattainable at this time and that the next most likely move in Wheat will be a fourth-wave decline targeting the January low at 879, or possibly even the annual 1.000 Fibonacci support level of 765.50. (Chart 4)





Annual Fibonacci Resistance Levels - 2008

	January High	January Low	Fibonacci Resistance 0.382	0.618	1.000	1.618	2.618	4.236	6.854
Coffee	**139.40**	**129.70**	143.11	145.39	149.10	155.09	164.79	180.49	205.88
Cocoa	**2330.00**	**2070.00**	2429.32	2490.68	2590.00	2750.68	3010.68	3431.36	4112.04
Sugar	**12.95**	**10.62**	13.84	14.39	15.28	16.72	19.05	22.82	28.92
Cotton	**72.96**	**66.80**	75.31	76.77	79.12	82.93	89.09	99.05	115.18
Orange Juice	**152.00**	**131.50**	159.83	164.67	172.50	185.17	205.67	238.84	292.51
Soybeans	**1320.00**	**1189.50**	1369.85	1400.65	1450.50	1531.15	1661.65	1872.80	2214.45
Corn	**519.00**	**459.00**	541.92	556.08	579.00	616.08	676.08	773.16	930.24
Wheat	**992.50**	**879.00**	1035.86	1062.64	1106.00	1176.14	1289.64	1473.29	1770.43
Soybean Meal	**361.50**	**322.50**	376.40	385.60	400.50	424.60	463.60	526.70	628.81
Soybean Oil	**53.97**	**49.30**	55.75	56.86	58.64	61.53	66.20	73.75	85.98
Oats	**343.00**	**305.20**	357.44	366.36	380.80	404.16	441.96	503.12	602.08
Pork Bellies	**94.35**	**82.60**	98.84	101.61	106.10	113.36	125.11	144.12	174.88
Lean Hogs	**58.65**	**53.90**	60.46	61.59	63.40	66.34	71.09	78.77	91.21
Live Cattle	**96.92**	**89.12**	99.90	101.74	104.72	109.54	117.34	129.96	150.38
Feeder Cattle	**104.65**	**96.15**	107.90	109.90	113.15	118.40	126.90	140.66	162.91
Lumber	**235.20**	**195.00**	250.56	260.04	275.40	300.24	340.44	405.49	510.73
Copper	**335.50**	**304.00**	347.53	354.97	367.00	386.47	417.97	468.93	551.40
CRB Index	**503.45**	**475.91**	513.97	520.47	530.99	548.01	575.55	620.11	692.21

Annual Fibonacci Support Levels - 2008

	January High	January Low	Fibonacci Support 0.382	0.618	1.000	1.618	2.618	4.236	6.854
Coffee	**139.40**	**129.70**	125.99	123.71	120.00	114.01	104.31	88.61	63.22
Cocoa	**2330.00**	**2070.00**	1970.68	1909.32	1810.00	1649.32	1389.32	968.64	287.96
Sugar	**12.95**	**10.62**	9.73	9.18	8.29	6.85	4.52	0.75	-5.35
Cotton	**72.96**	**66.80**	64.45	62.99	60.64	56.83	50.67	40.71	24.58
Orange Juice	**152.00**	**131.50**	123.67	118.83	111.00	98.33	77.83	44.66	-9.01
Soybeans	**1320.00**	**1189.50**	1139.65	1108.85	1059.00	978.35	847.85	636.70	295.05
Corn	**519.00**	**459.00**	436.08	421.92	399.00	361.92	301.92	204.84	47.76
Wheat	**992.50**	**879.00**	835.64	808.86	765.50	695.36	581.86	398.21	101.07
Soybean Meal	**361.50**	**322.50**	307.60	298.40	283.50	259.40	220.40	157.30	55.19
Soybean Oil	**53.97**	**49.30**	47.52	46.41	44.63	41.74	37.07	29.52	17.29
Oats	**343.00**	**305.20**	290.76	281.84	267.40	244.04	206.24	145.08	46.12
Pork Bellies	**94.35**	**82.60**	78.11	75.34	70.85	63.59	51.84	32.83	2.07
Lean Hogs	**58.65**	**53.90**	52.09	50.96	49.15	46.21	41.46	33.78	21.34
Live Cattle	**96.92**	**89.12**	86.14	84.30	81.32	76.50	68.70	56.08	35.66
Feeder Cattle	**104.65**	**96.15**	92.90	90.90	87.65	82.40	73.90	60.14	37.89
Lumber	**235.20**	**195.00**	179.64	170.16	154.80	129.96	89.76	24.71	-80.53
Copper	**335.50**	**304.00**	291.97	284.53	272.50	253.03	221.53	170.57	88.10
CRB Index	**503.45**	**475.91**	465.39	458.89	448.37	431.35	403.81	359.25	287.15

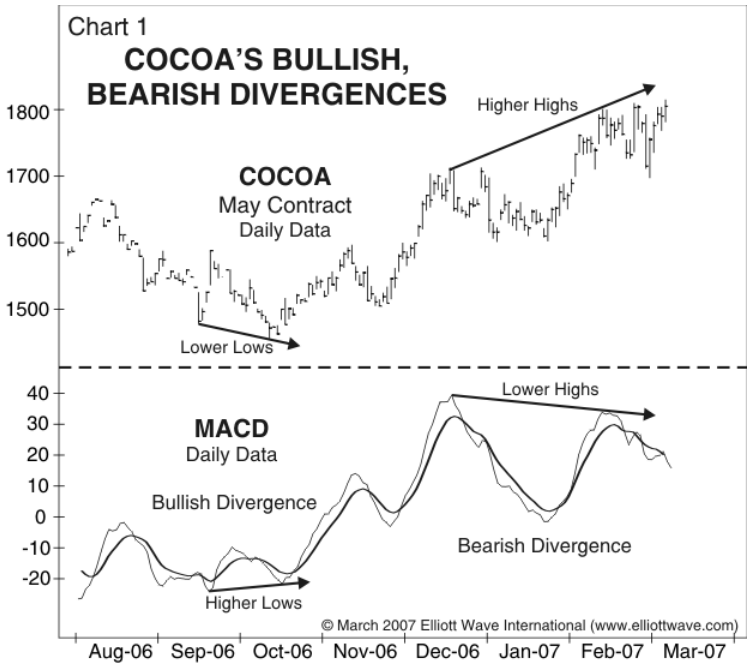
Normally, to identify high-probability targets for wave four, an Elliottician must wait for wave three to finish. However, you don't have to wait if you use annual Fibonacci support and resistance level analysis, as illustrated in Coffee.

I've written before that there is no wrong way to draw a trendline on a price chart. Even so, some trendline techniques are more useful than others. I believe the same thing about Fibonacci analysis: there's no wrong way to analyze price action using Fibonacci mathematics. However, I do believe annual Fibonacci support and resistance level analysis is more useful than other techniques.

1. Time Divergence: An Old Method Revisited

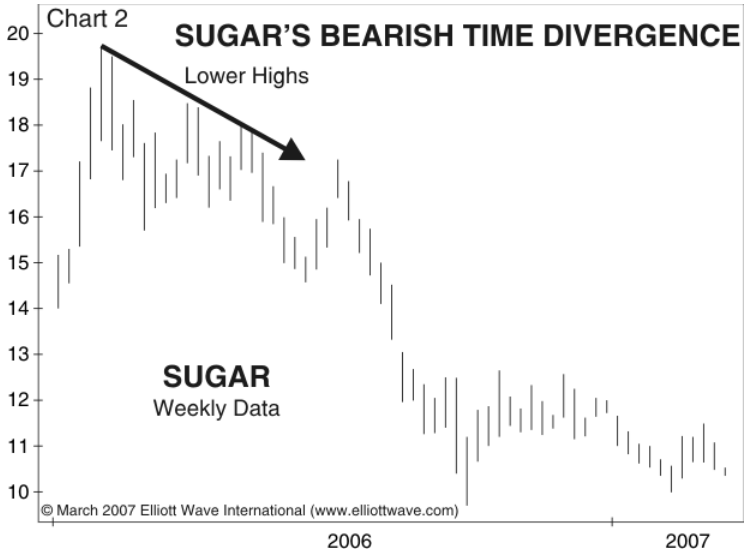
Old Timers' Method for Finding Trade Setups
March 2007

Most of you are familiar with what Divergence is. If not, it is simple and intuitive – divergence occurs when an underlying indicator doesn't reflect price movement. For example, a bearish divergence occurs when prices make new highs yet the underlying indicator does not. To clarify this point, I am including a price chart of Cocoa above its MACD (Moving Average Convergence/Divergence) chart to illustrate typical bullish and bearish divergences between the two (Chart 1).



Notice in the lower left hand corner of Chart 1 that in October 2006, Cocoa prices pushed below the September 2006 low. However, the underlying indicator (MACD) registered higher lows during this same period. This condition is referred to as bullish divergence. Indeed, Cocoa prices soon started trending up. Conversely, in February and March, we saw higher prices beyond the December 2006 peak. Yet MACD failed to mirror the price chart and instead registered lower highs during this same period. This bearish divergence suggests an upcoming decline in Cocoa prices.

Now that the explanation of Divergence is out of the way, let me share with you a unique twist on the subject. It's something I call Time Divergence, and it occurs when price extremes in front-month or forward-month futures contracts diverge from price extremes evident in higher time-frame continuation charts.

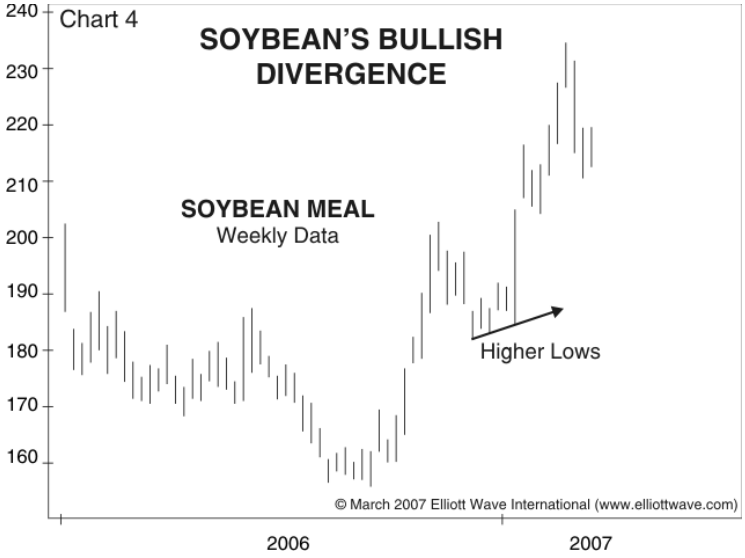


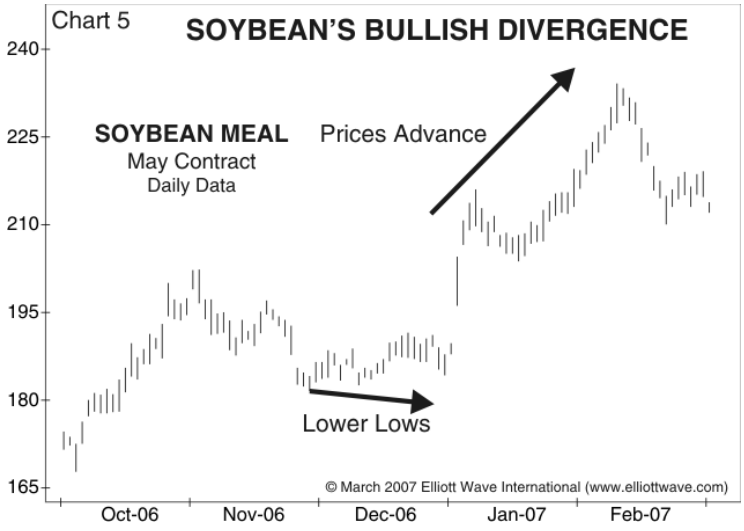
Let me explain. In Chart 2, you can see that in Sugar's weekly continuation chart, lower highs occurred during the first quarter of 2006. However, the daily data for the May 2007 Sugar contract shows that the opposite occurred, as Sugar posted higher highs (Chart 3). I consider this situation to be a Bearish Time Divergence, and as you can see, it indeed resulted in a steady selloff throughout the rest of 2006.

We can also look at a Bullish Time Divergence condition that occurred recently in Soybean Meal. Notice in Chart 4 that prices registered higher lows in December of 2006, basis the weekly continuation chart. Yet, basis the May 2007 contract, the daily data registered lower lows instead. This Bullish Time Divergence warned of a rally, and that significant rally in Soybean Meal prices actually continued into February of this year.

Now, I would love to say that I dreamed up this technique on my own. But that's not so – all I did was to give it a name. Time Divergence is actually an old-school technique used by many seasoned and knowledgeable traders to identify high probability trade setups. It simply doesn't get written or spoken about that much … but, if you think about, neither did the Elliott Wave Principle until A.J. Frost and Robert Prechter pulled it from obscurity.





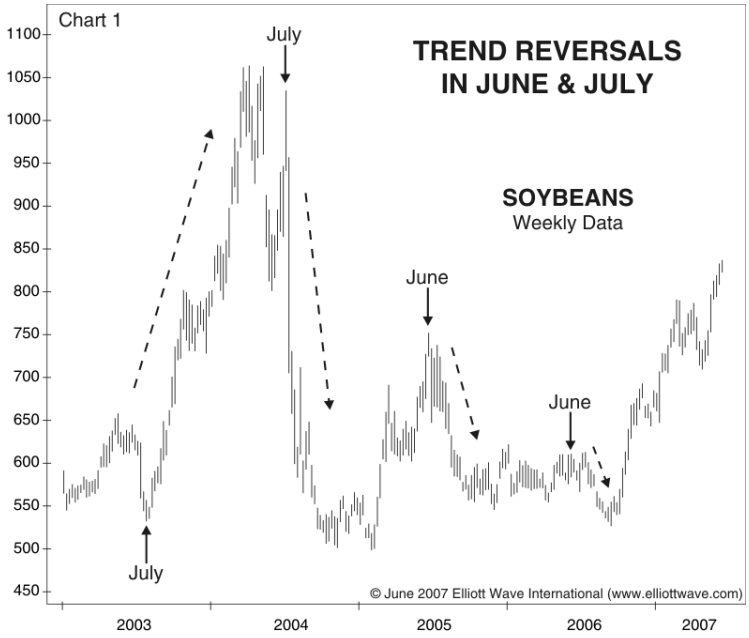


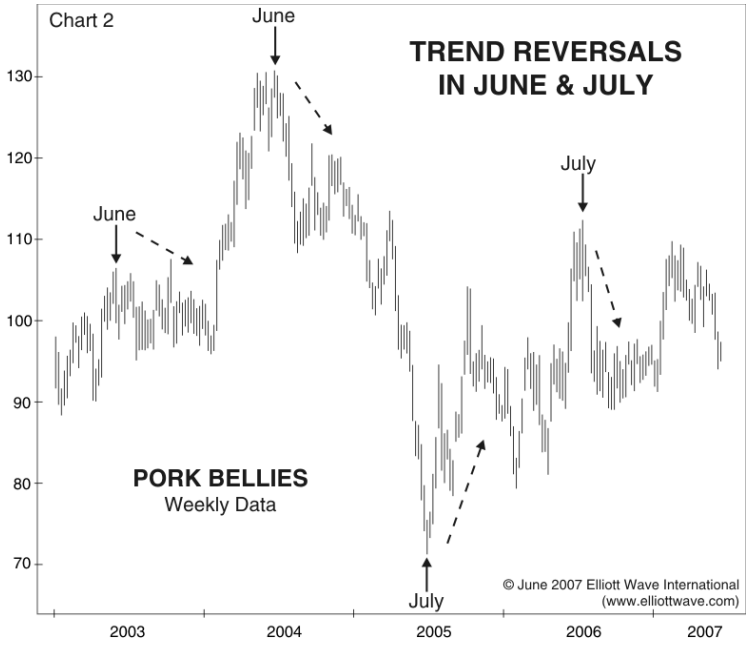
2. Trends and Turns

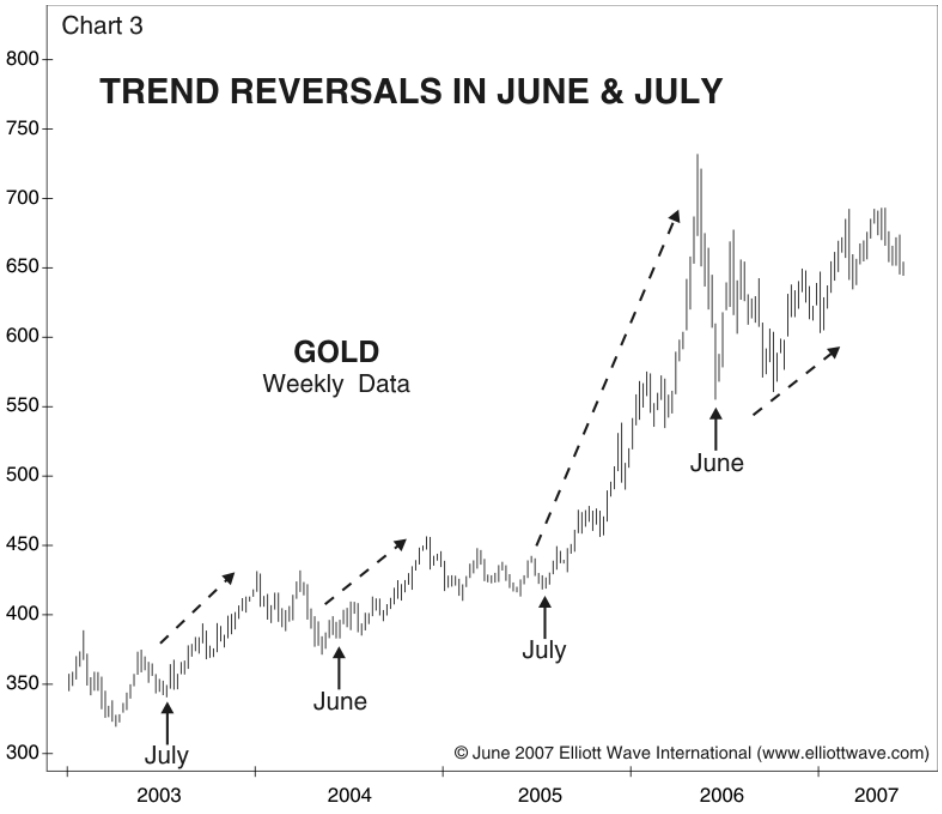
Seasonal Tendency of Markets To Reverse in June and July
June 2007

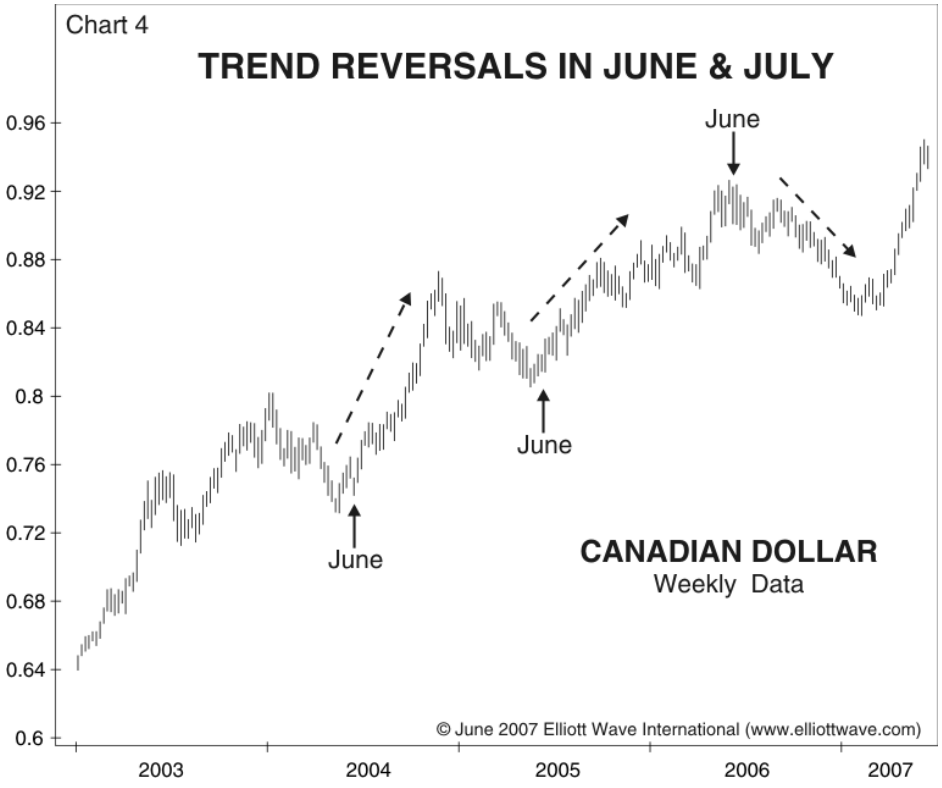
When June and July roll around, I like to write about the seasonal tendency of financial markets to stage reversals in price. In the Soybeans chart (Chart 1) that goes back to 2003, notice that prices tended to reverse direction in the months of June and July. Sometimes, these reversals were dramatic, as they were in 2003 and 2004. Other times, the moves that follow these months were modest, such as in 2005 and 2006.

If you examine Charts 2, 3 and 4, you will see this seasonal tendency repeated time and time again. More importantly, this tendency is not isolated to commodities: It's equally applicable to other markets as well, such as Gold and the Canadian Dollar (Charts 3 and 4).



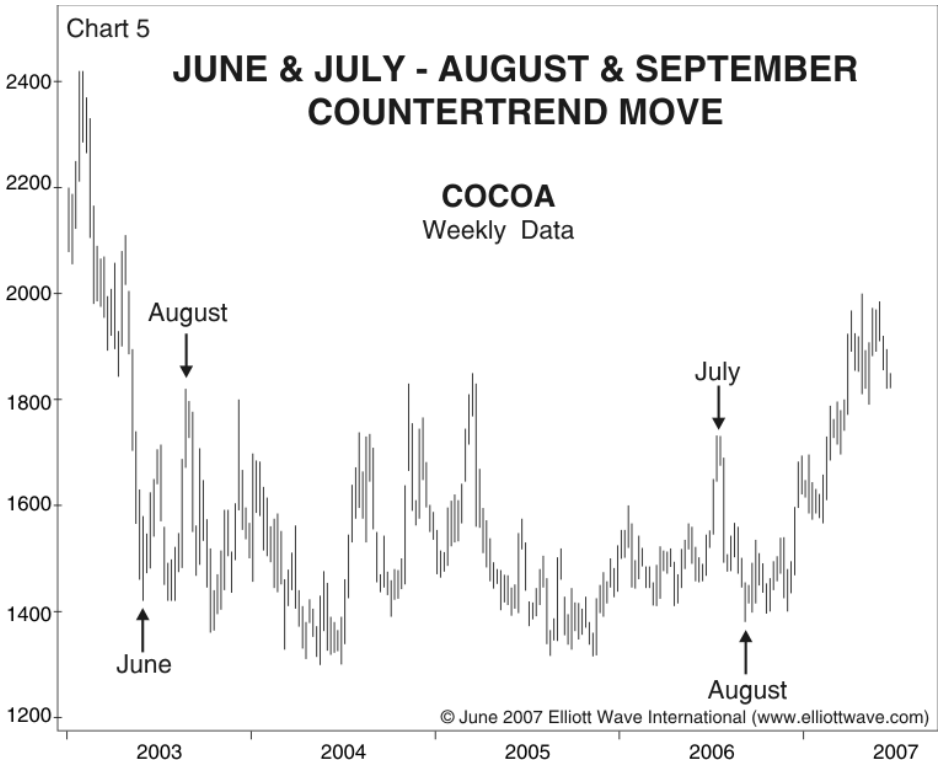


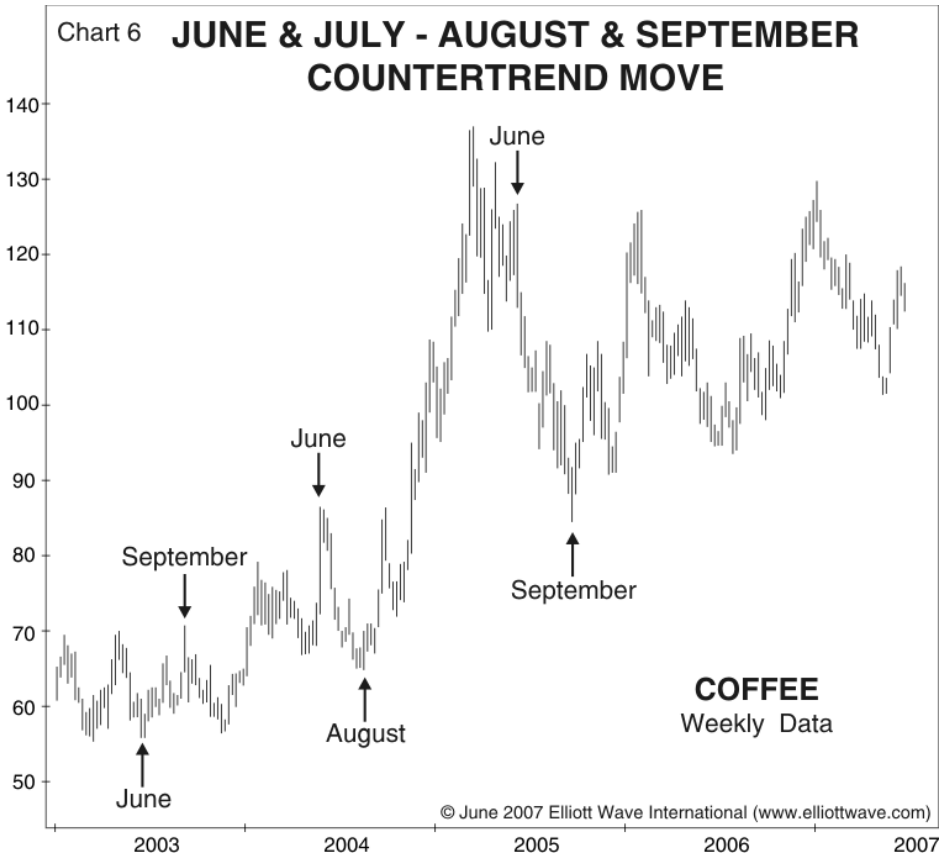

Chart 3
TREND REVERSALS IN JUNE & JULY
GOLD
Weekly Data
800
750
700
650
600
550
500
450
400
350
300
July
June
July
June
© June 2007 Elliott Wave International (www.elliottwave.com)
2003
2004
2005
2006
2007


Chart 4
TREND REVERSALS IN JUNE & JULY
0.96
0.92
0.88
0.84
0.8
0.76
0.72
0.68
0.64
0.6
June
June
June
CANADIAN DOLLAR
Weekly Data
© June 2007 Elliott Wave International (www.elliottwave.com)
2003
2004
2005
2006
2007

While I was performing my research for this column about seasonal price reversals, I noticed that this pattern doesn't always work; in many instances, the months of June and July yield *no* change in trend whatsoever. But when price doesn't reverse, I noticed that two distinct seasonal price patterns emerge instead – *countertrend moves and double tops/double bottoms*.

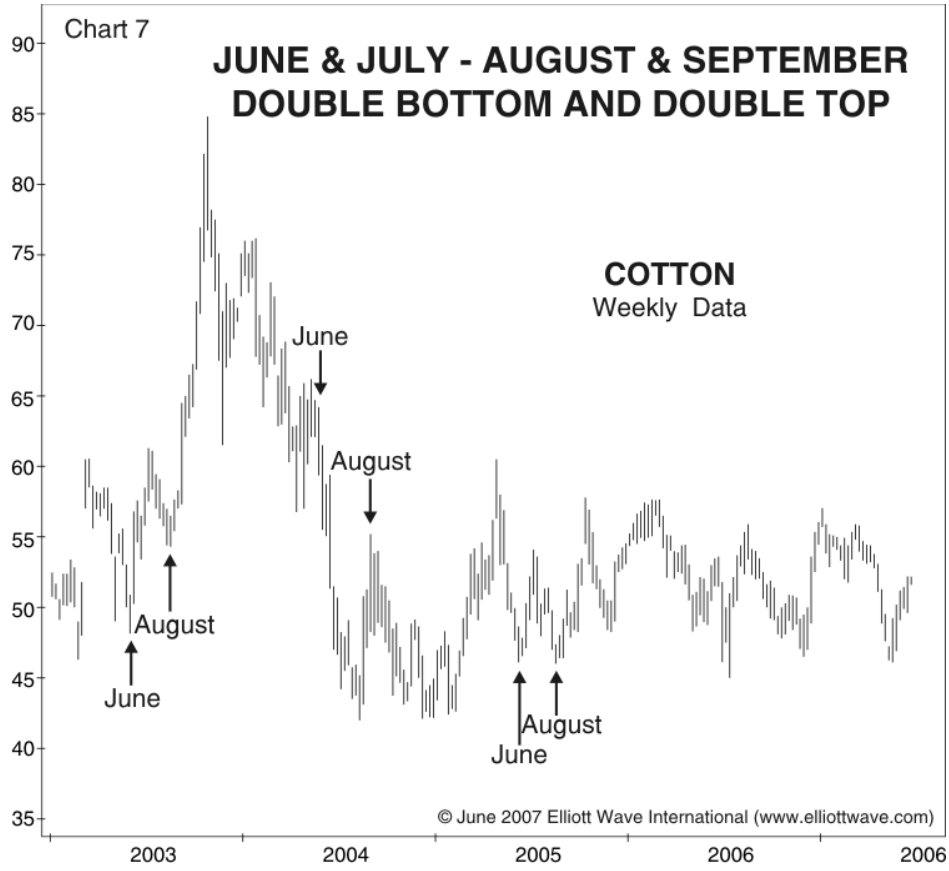
First, let's examine the countertrend seasonal pattern I uncovered by examining Chart 5 (Cocoa). Notice that turns in price that *began* in June or July sometimes *ended* in August or September. When they did, the advance or decline between the months of June/July and August/September were significantly retraced. And, as you can see in Chart 6 (Coffee), this pattern did indeed repeat. Simply put, while the months of June and July often produce significant changes in trend for the remainder of the year, they sometimes result only in a weeks-long *countertrend* move.

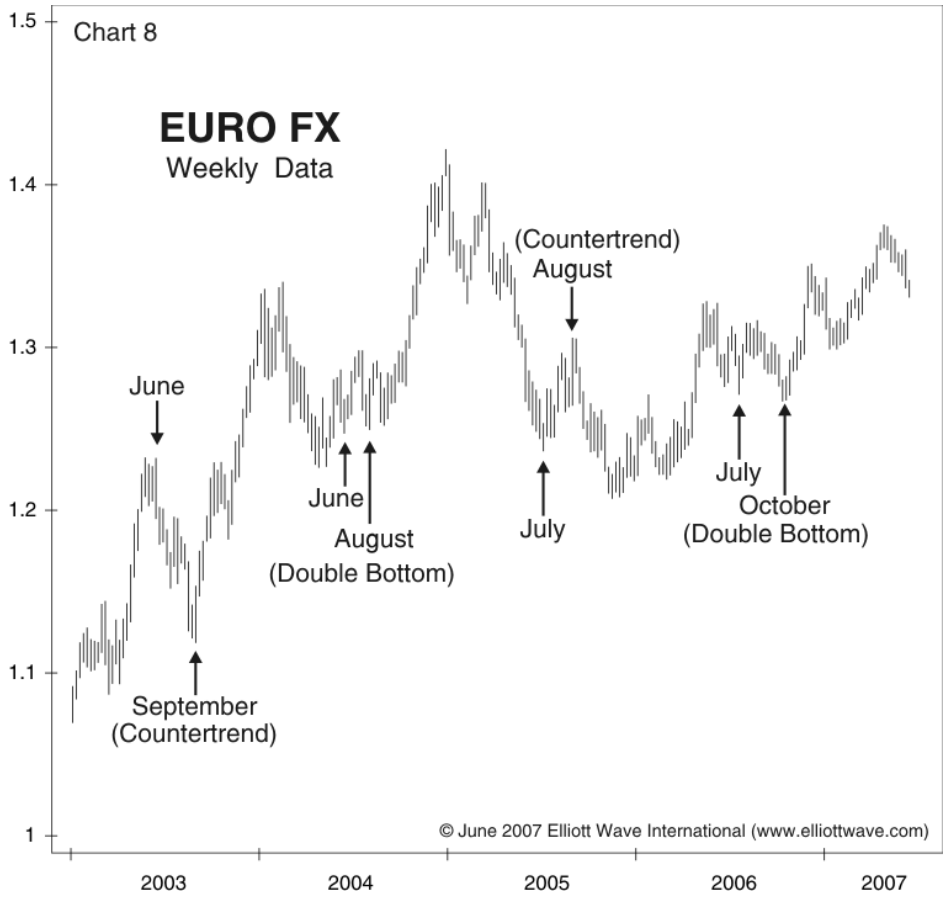




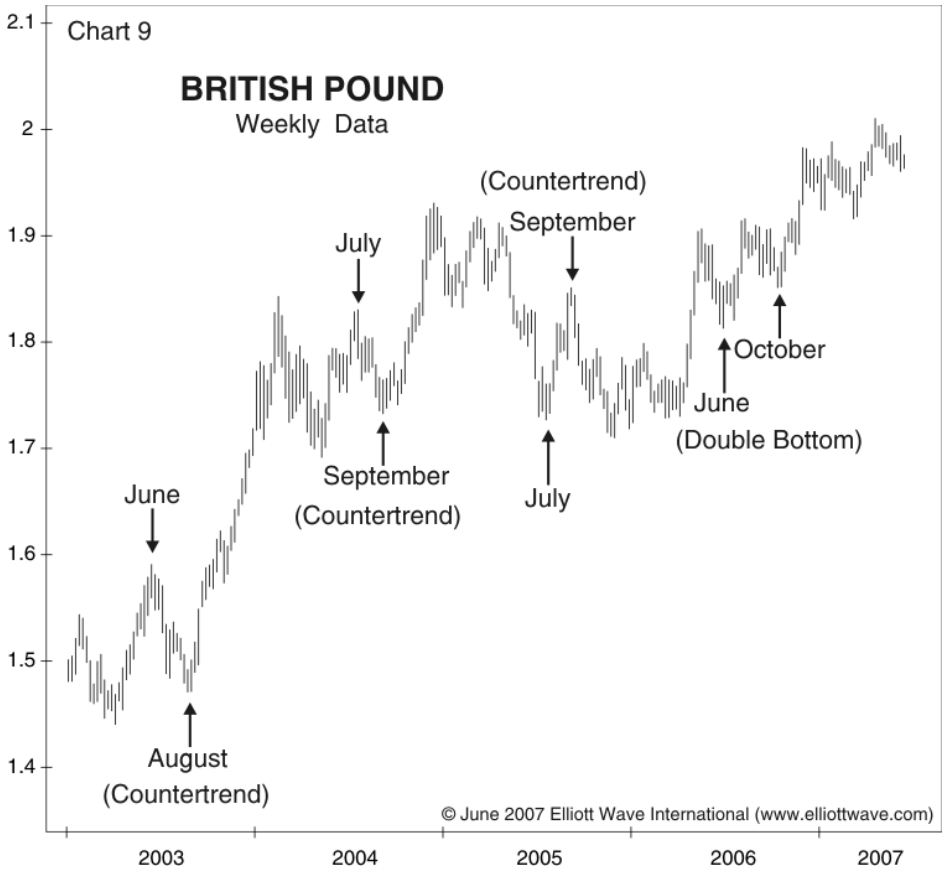
The second seasonal pattern I observed was the *double top* and *double bottom* formation. Notice in Chart 7 that Cotton bottomed in June and again in August 2003. The ensuing advance was sizable and lasted many more months. Again, in 2004, Cotton formed a top in June and another one in August. The result of this seasonal double top pattern was a down-trending market for the remainder of the year.

Now let's combine these two patterns and see how they apply to the price chart for Euro currency (Chart 8). In 2003, we see that the move that began in June and ended in September was indeed a countertrend move and that the Euro rallied from its September low into December. In 2004, a double bottom seasonal pattern occurred that resulted in a sizable advance into the end of the year. This same pattern repeated again in 2006. And notice that in 2005, there was a countertrend move between the months of July and August that was more than fully retraced in the months that followed.





The British Pound price chart exhibits some of the same patterns. In Chart 9 (British Pound), we can see that countertrend seasonal patterns occurred in 2003, 2004 and again in 2005. Each of these moves was more than fully retraced in the months that followed. And, similar to the Euro currency, the British Pound also formed a double bottom seasonal pattern in 2006 that led to further advance into year's end.



Seasonally, price action at the midpoint of the trading year in June and July is important for two reasons:

1. Highs and lows that occur during this time frame often lead to trend reversals and significant moves for the remainder of the year.
2. And when that's not the case, we can rely on two additional seasonal patterns – countertrend moves and double tops/double bottoms – to help us figure out the direction prices will take in the following months.

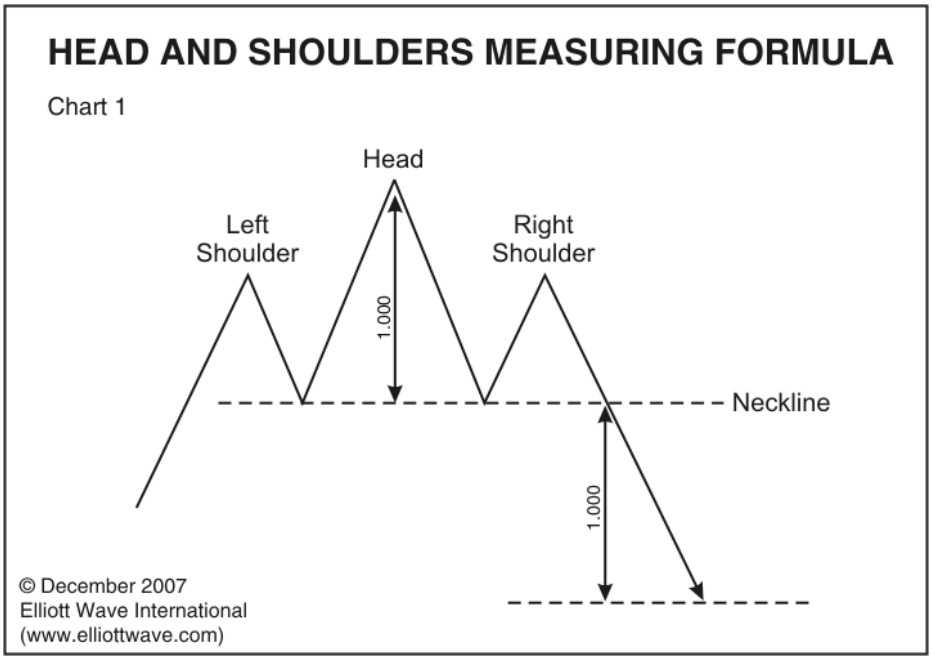
3. Head and Shoulders: An Old School Approach

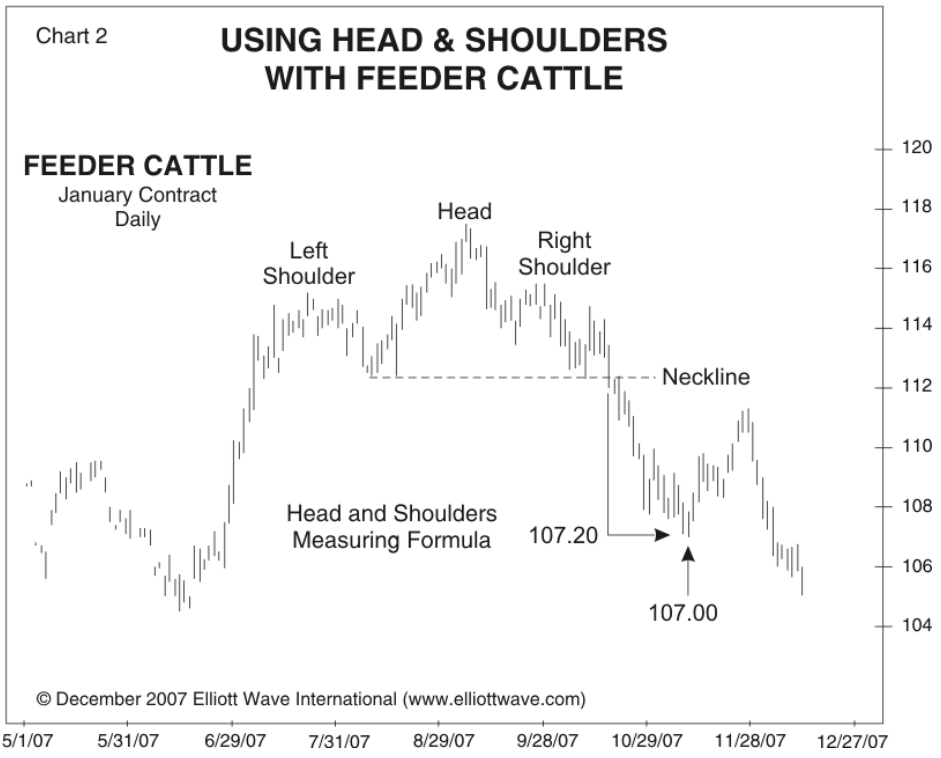
Watching This Signal for a Reverse in Trend
December 2007

After years of chart-labeling and forecasting, I find myself becoming an even bigger believer in the Wave Principle. Even so, while searching for the next big trading opportunity, I use everything from old-school technical analysis to computerized trading systems of my own design. In the old-school area falls the Head and Shoulders pattern, which is a price pattern that often signals a reversal in trend.

I don't know who gets the credit for initially identifying the pattern, but its roots can easily be traced back to Charles H. Dow, Richard Schabacker, Robert D. Edwards and John Magee. The last two names on this list you might recognize as the Edwards and Magee who wrote what some consider to be the bible of technical analysis, *Technical Analysis of Stock Trends*. (First published in 1948, it's a must-read for the serious technician.)

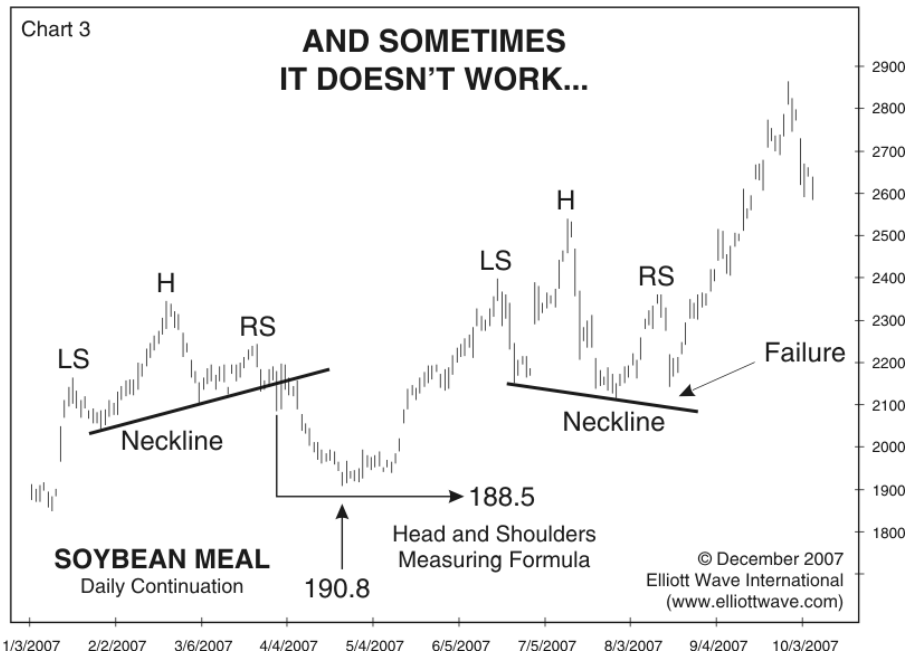
So what exactly is a Head and Shoulders pattern? As you can see in figure 1, it is a price pattern consisting of three up-and-down moves that make up the Left Shoulder, the Head and the Right Shoulder. The initial price move up is called the Left Shoulder, after which a small correction unfolds and introduces an even higher price high, called the Head. Following the secondary price peak, prices decline and then rally without achieving a new price extreme to complete the Right Shoulder. It's uncanny how similar, both in duration and extent, the Left and Right Shoulders often appear.





Once the Right Shoulder has finally formed, a trendline can be drawn connecting the initial reaction low with the one following the formation of the Head – aptly called the Neckline.

When prices penetrate the Neckline, a change in trend is believed to have occurred, at which point it's possible to apply the Head and Shoulders Measuring Formula. To identify a high probability price target for the move following the break of the Neckline, measure the distance between the Head and the Neckline and then project that distance down from the point at which the Right Shoulder breaks the Neckline. Notice how effective this technique was in identifying the early November low in Feeder Cattle at 107.00 (Chart 2).



Fitting Head and Shoulders into Wave Analysis

So how does this traditional chart pattern fit into the Wave Principle? Quite easily. Just imagine that the Left Shoulder represents the extreme of a third wave, and its subsequent correction, wave four. Wave five is the Head, and the selloff following the push to new price extremes is either wave A or wave one. The Right Shoulder fits into our basic building block of the Wave Principle by representing a B wave advance or second wave, followed by a wave C or wave three decline, which of course penetrates the Neckline.

Traditional technical analysis fits into the Wave Principle so much so that Robert Prechter has this to say about it in *Elliott Wave Principle* (pg 185).

> "...technical analysis (as described by Robert D. Edwards and John Magee in their book, *Technical Analysis of Stock Trends*) recognizes the 'triangle' formation as generally an intra-trend phenomenon. The concept of a 'wedge' is the same as that for Elliott's diagonal triangle and has the same implications. Flags and pennants are zigzags and triangles. 'Rectangles' are usually double or triple threes. 'Double tops' are generally caused by flats, "'double bottoms' by truncated fifths."

It is important to remember that no chart pattern, indicator or trading system is going to be 100% accurate. For example, in Chart 3 (Soybean Meal), the Head and Shoulders pattern that occurred in early 2007 did an excellent job of indicating the April selloff and its likely extent. However, the Head and Shoulders pattern that formed in June, July and August initially appeared to foretell a bearish change in trend that did not transpire. In fact, this particular pattern introduced a sizable advance in Soybean Meal prices instead.

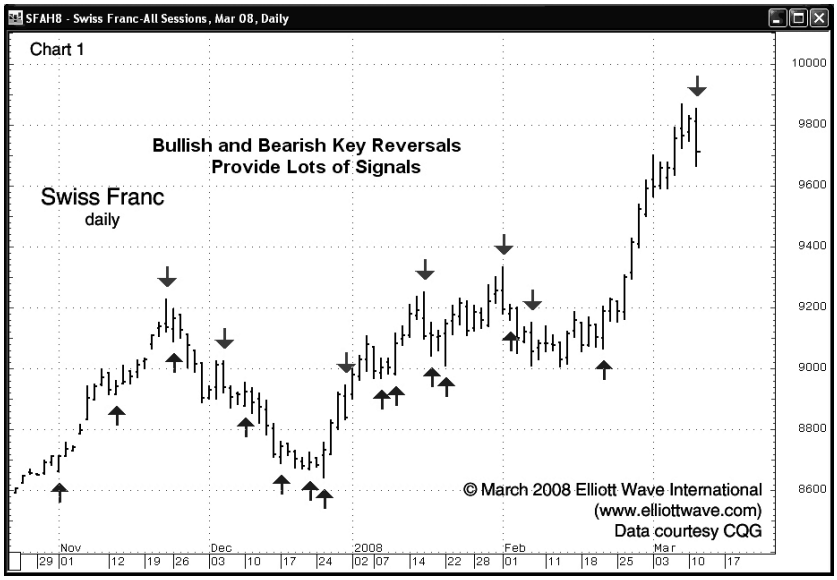
Final Note

They say a cat has nine lives and that there are numerous ways to skin one. (And just so that I don't anger PETA, the previous sentence is just a figure of speech, and I would absolutely never skin a cat or even think about testing the nine lives theory.) My point is that there are many ways to analyze financial markets and that no one technique or approach is infallible, whether it's old school or new school. What is most important though is that you adopt a style of analysis that works best for you.

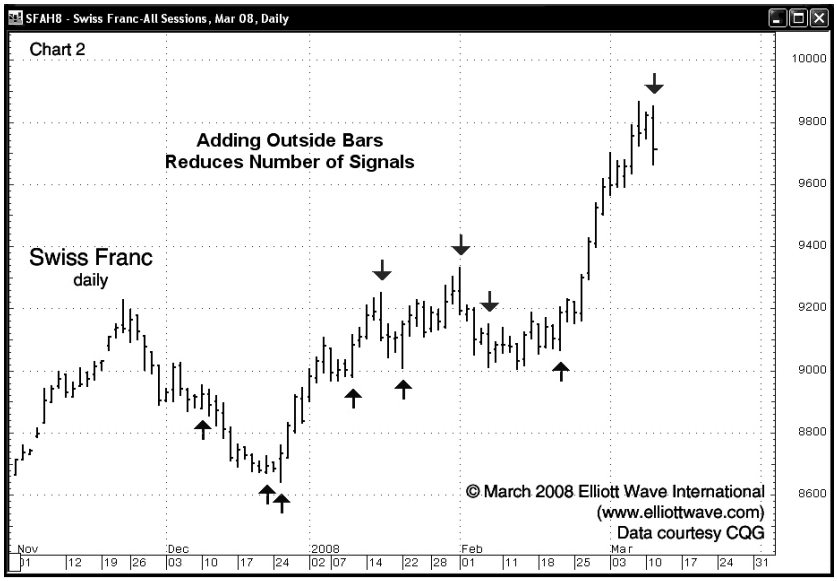
4. How Creating Hurdles Can Help To Make Better Trade Signals

Adding Three Conditions to a Favorite Trade Signal
March 2008

If you have ever tried to create your own trading system or identify a specific bar pattern that alerts you to trend changes, you've no doubt encountered the same problem I have. And that problem is – too many low-quality signals.



For example, a popular bar pattern that many technicians keep an eye out for is a Key Reversal. (Time out here for a brief description: A bullish Key Reversal occurs when a price bar makes a new low below the previous price bar's low, but manages to close above the previous bar's close. Conversely, a bearish Key Reversal occurs when a price bar makes a new high above the previous bar but the close of that bar is below the close of the previous bar.) In the chart of the daily Swiss Franc (Chart 1), I identified both bearish and bullish Key Reversals, using up and down arrows. As you can see, although they identified many significant turning points that pointed to tradable moves in price, they also either gave false signals or failed to identify significant turning points. In other words, this signal creates a lot of noise that can confuse and distract you by blinking on and off too often.



Adding the First Hurdle

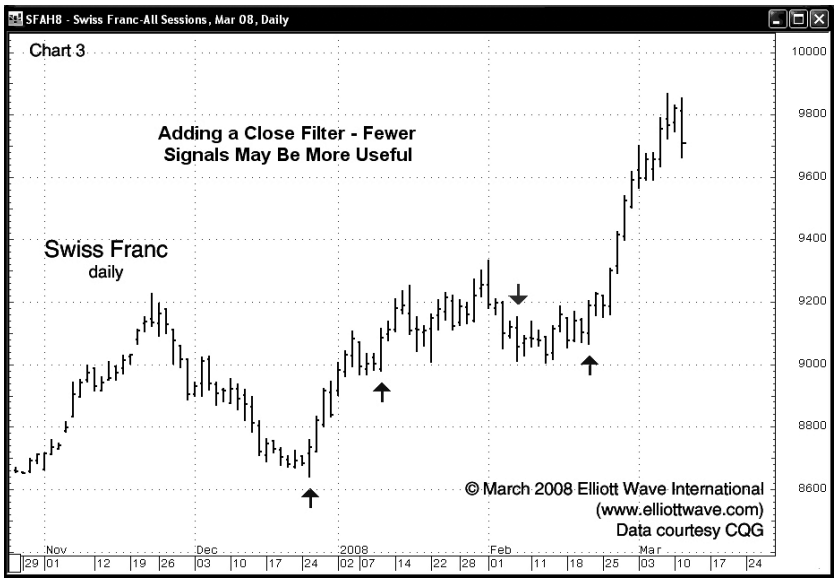
So, how do you overcome such a problem and better separate the wheat from the chaff? Answer: You create your own hurdles to try to get fewer yet better-quality signals. Notice in Chart 2 that the number of arrows, both up and down, dramatically decreased. Why? I added a hurdle to make it more difficult for the signal to flash by stipulating that in addition to being a Key Reversal, the bar must also be an Outside bar. (An Outside bar occurs when the range of the current bar encompasses the range of the previous price bar.)

Notice that by including this one hurdle, the number of turning points identified decreases. Even so, the important ones remain, specifically, the December 2007 low, the February selloff and the start of the current rally.

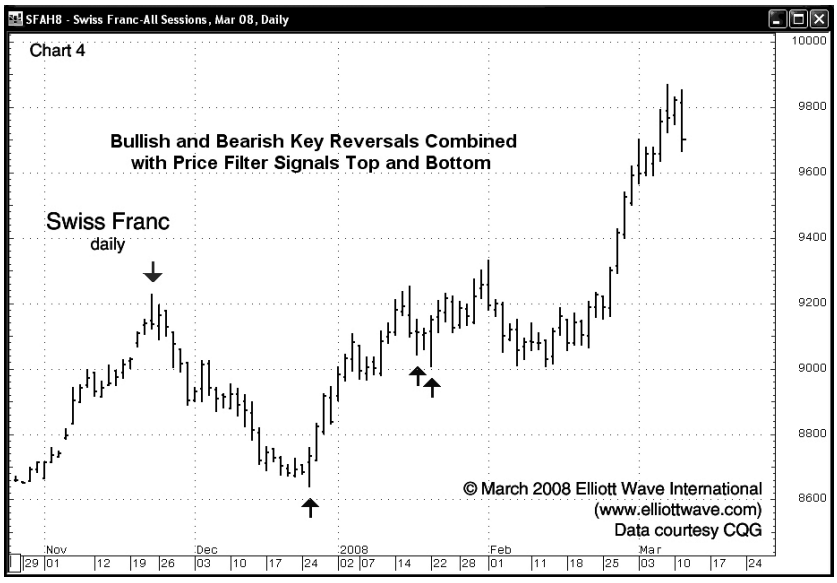
Adding the Second Hurdle

What would happen if we added another hurdle, such as a close filter, which has to do with the close of a price bar? In this instance, the close filter I employed stipulates that the current close must be the highest or lowest close within five trading days.

Obviously, adding another criteria on top of the Key Reversal and Outside bar combination will decrease the number of signals even more. However, the real question is, does the addition of this new hurdle focus your attention on the price chart when it's most timely and important?



The answer to this question is, "Yes." Notice that in Chart 3, only four signals were generated, using the combined criteria of Key Reversal, Outside Bar and Close filter. And of the four, two signals were indeed significant, tradable moves – the ones that identified the December 2007 low and the February breakout. Of the two remaining signals, the one that occurred in January did lead to additional rally, while the one that occurred in early February had little or no value.



Adding a Different Hurdle

Another idea for an added hurdle is that of a Price filter, which is illustrated in Chart 4. The Price filter I used stipulates that the open and close of a price bar must be within the upper or lower 40% of its range. The arrows shown in Chart 4 identify bullish and bearish Key Reversals days within the price filter. As you can see, when these conditions were met in January, they proved to be of little worth. However, this approach marked the top in the Swiss Franc in November 2007 and the low in December 2007, both of which were very tradable moves.

I believe that within the realm of technical analysis, the best is yet to come, because we have only scratched the surface of this fascinating field. Not just because of the advances in technology over the past 20 years but mainly because I believe that using your imagination in the way you view price action is what creates new and exciting advances in our methods. I encourage you to try out some of your own ideas for hurdles and filters to see whether you can tighten the signals you get from your favorite patterns.

1. The Three-in-One Bar Pattern

Jeffrey Kennedy's Favorite Bar Pattern
August 2007

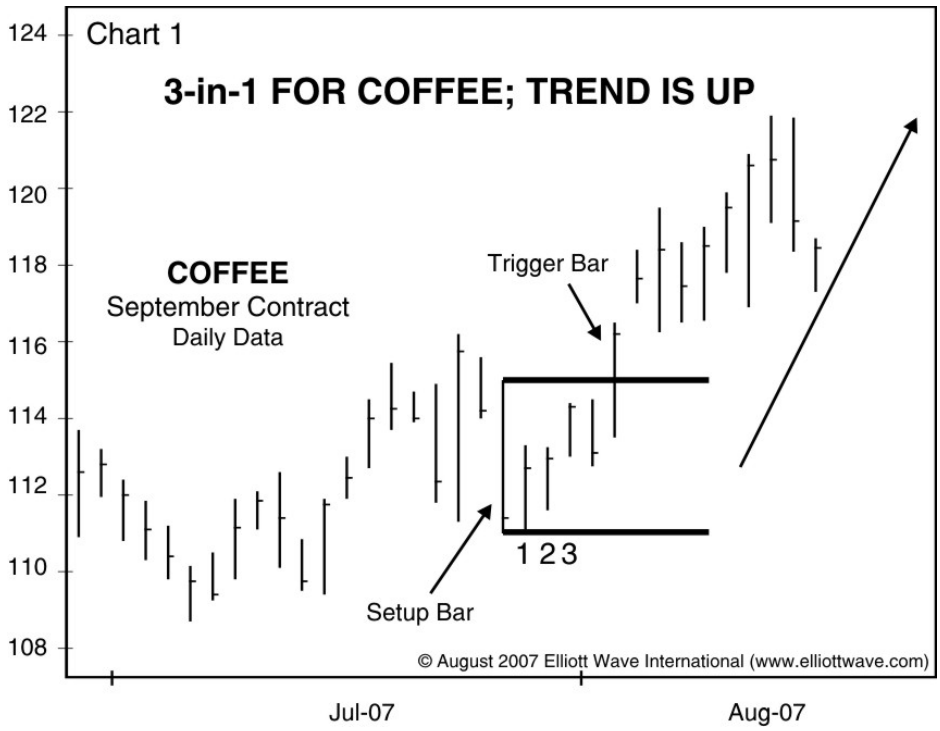
As a trader, it is important to know who you are. And what I mean by this is, "**What is your trading style?**" For instance,

- Do you like to picks tops and bottoms?
- Or do you prefer trading with the trend?
- Is your discipline strictly technical (i.e., MACD, Stochastics)?
- Or do you incorporate price patterns?

If you haven't already defined your trading style, I encourage you to do so, because it is a key to becoming a consistently successful trader.

As I mentioned before, my trading style is that of a trend trader. I use the Wave Principle as my primary tool, along with a few secondary tools of select technical studies that I designed to augment my approach. Since the Wave Principle is a pattern-based form of technical analysis, I also include single-bar and multiple-pattern-bar analysis to identify high probability trade setups.

One such bar pattern that I run across on occasion is the 3-in-1. A 3-in-1 occurs when the price range of the fourth price bar (i.e., the setup bar) engulfs the highs and lows of the last three price bars. What exactly does that mean? Well, we all know what an inside bar is. An inside bar occurs when the high of the bar is less than the high of the bar from one period ago, and the low is above the low from one period ago. For example, if today's high is less than yesterday's high, and today's low is above yesterday's low, that would mean that today is an inside day. A 3-in-1 bar pattern is somewhat similar in that it utilizes stagnant or contracting price ranges to identify high probability trade setups.



Let's use Coffee as an example (Chart 1). The high of the engulfing bar or setup bar is 115.00, and the low is 111.00. And as you can see, the highs and lows of the following three trading periods are both below the 115.00 high and above the 111.00 low. This is a 3-in-1 trade setup.

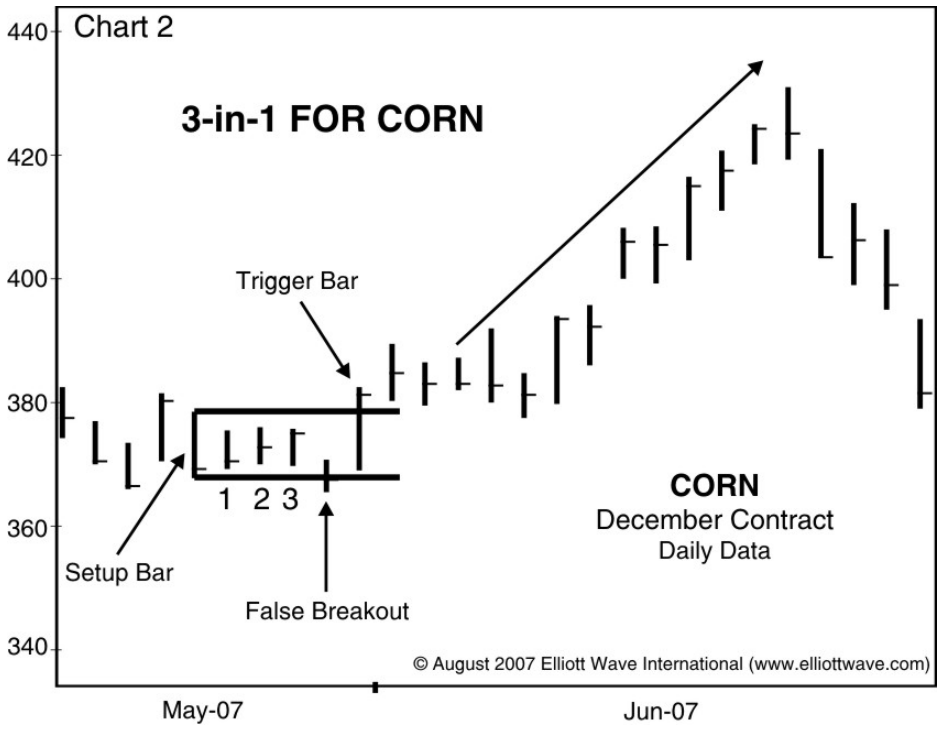
Here's what I notice when this bar pattern occurs: A move above or below the high or low of the setup bar signals that the larger trend is about to resume.

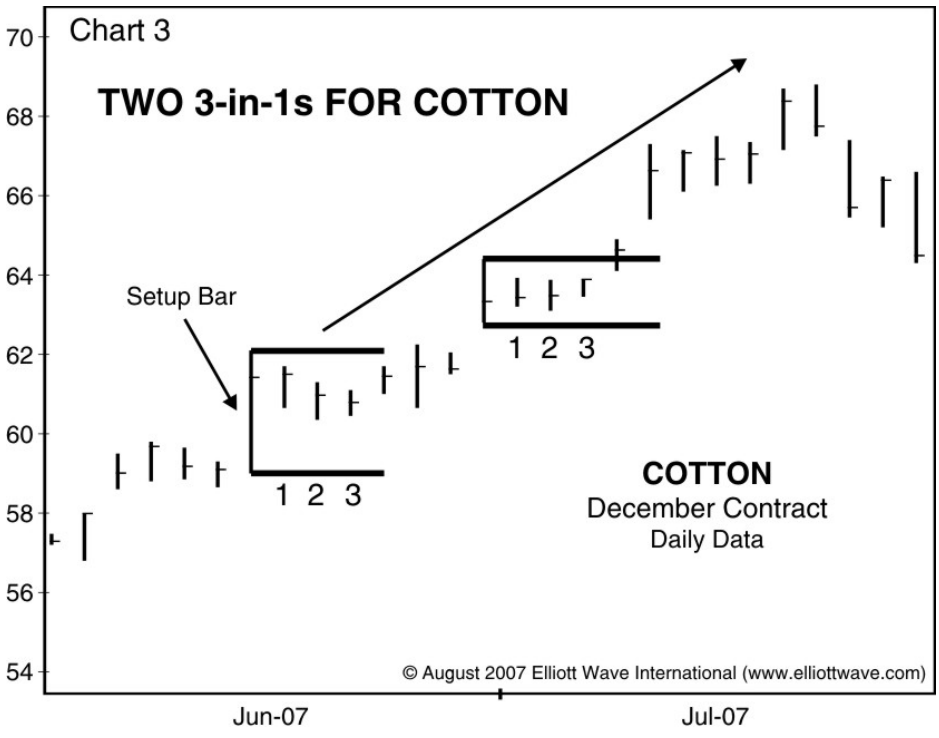
I call the bar that does the penetrating the trigger bar. I find it best to insist on a close above the high or low of the setup bar by the trigger bar before attempting a trade. Doing so prevents false breakouts, such as that which occurred in Chart 2 (Corn).

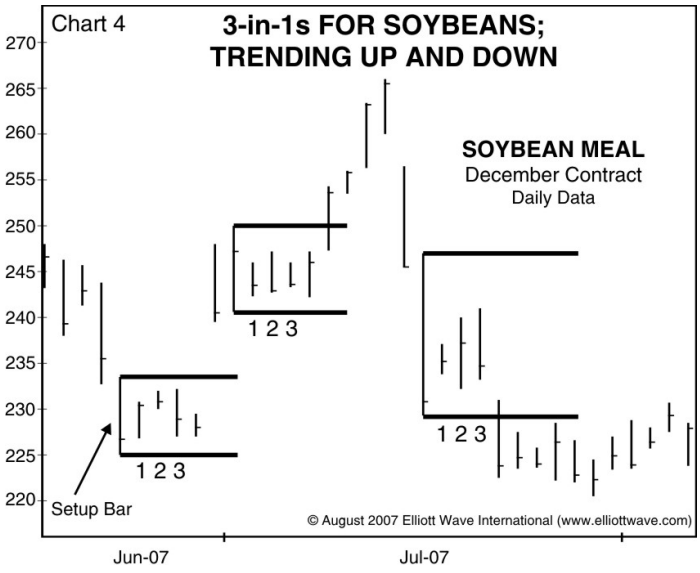
This 3-in-1 bar pattern fits my trading style nicely as a trend trader, because it allows me to know when the larger trend is resuming. You can find similar tools to fit your own trading style that will work just as well for you. That is, once you define your trading style.

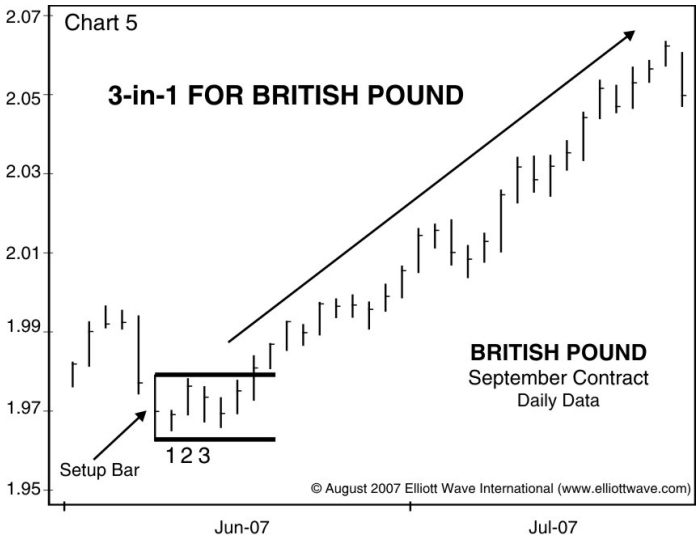
Editor's Note:

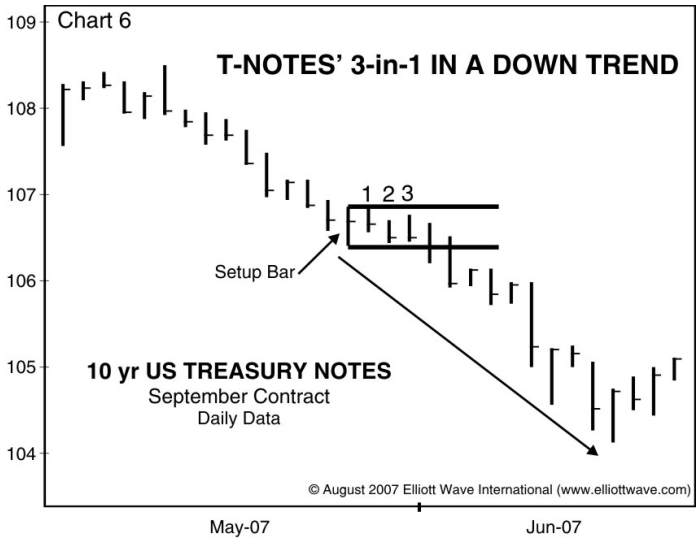
Charts 3-6 provide more examples of 3-in-1 bar patterns.






Chart 4
3-in-1s FOR SOYBEANS;
TRENDING UP AND DOWN
SOYBEAN MEAL
December Contract
Daily Data
270
265
260
255
250
245
240
235
230
225
220
1 2 3
1 2 3
1 2 3
Setup Bar
© August 2007 Elliott Wave International (www.elliottwave.com)
Jun-07
Jul-07


Chart 5
3-in-1 FOR BRITISH POUND
BRITISH POUND
September Contract
Daily Data
2.07
2.05
2.03
2.01
1.99
1.97
1.95
1 2 3
Setup Bar
© August 2007 Elliott Wave International (www.elliottwave.com)
Jun-07
Jul-07


Chart 6
T-NOTES' 3-in-1 IN A DOWN TREND
109
108
107
106
105
104
1 2 3
Setup Bar
10 yr US TREASURY NOTES
September Contract
Daily Data
© August 2007 Elliott Wave International (www.elliottwave.com)
May-07
Jun-07

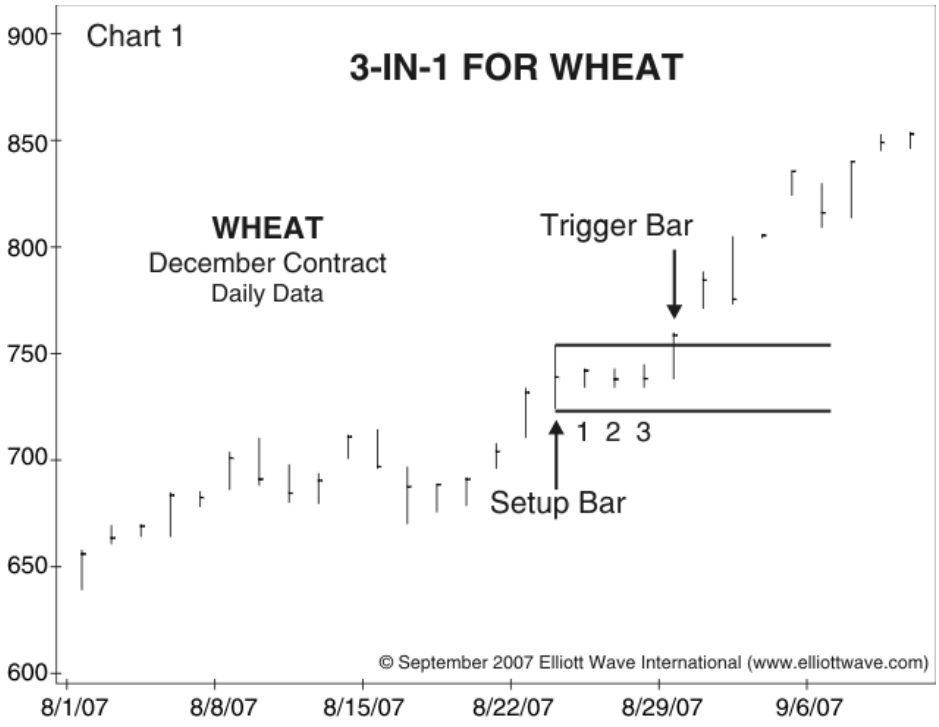
2. Forward and Reverse

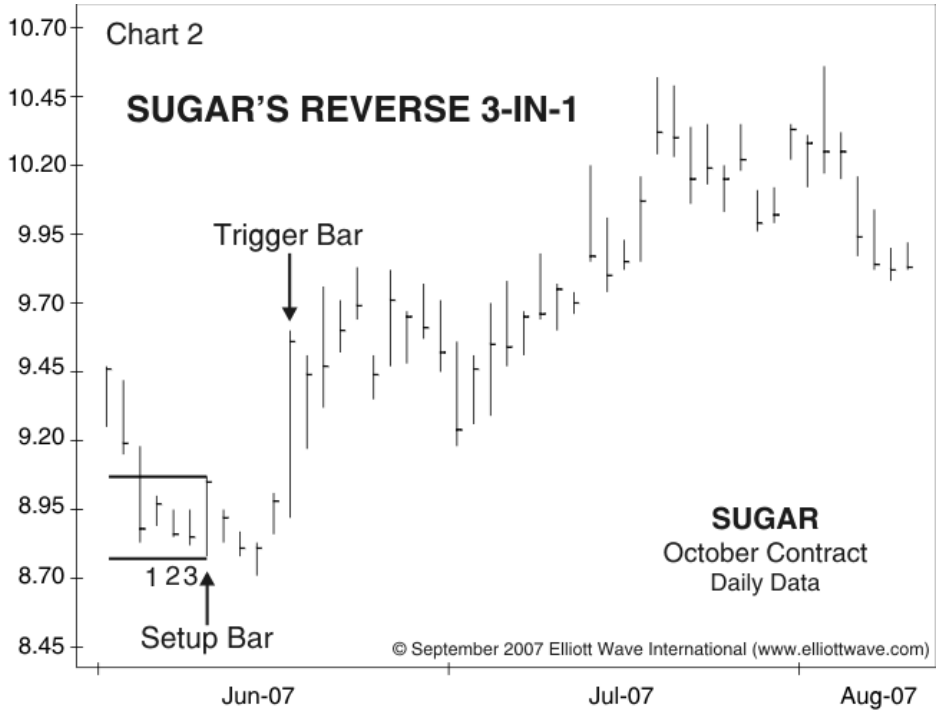
The Three-in-One Bar Pattern Revisited
September 2007

In last month's Trader's Classroom (August 2007), I discussed a bar pattern that I look for that often ignites sizable moves in price, called a 3-in-1. A 3-in-1 occurs when the price range of the first of four price bars (i.e., the setup bar) engulfs the highs and lows of the next three price bars. Then, when the high or low of the setup bar is penetrated on a closing basis, I consider it to be a trigger bar that indicates that a sizable price move has just begun.

Even recently, notice how effective the 3-in-1 price pattern was. In the Wheat chart (Chart 1), the 3-in-1 price pattern was a precursor to a price move in Wheat of more than $1.00 a bushel.

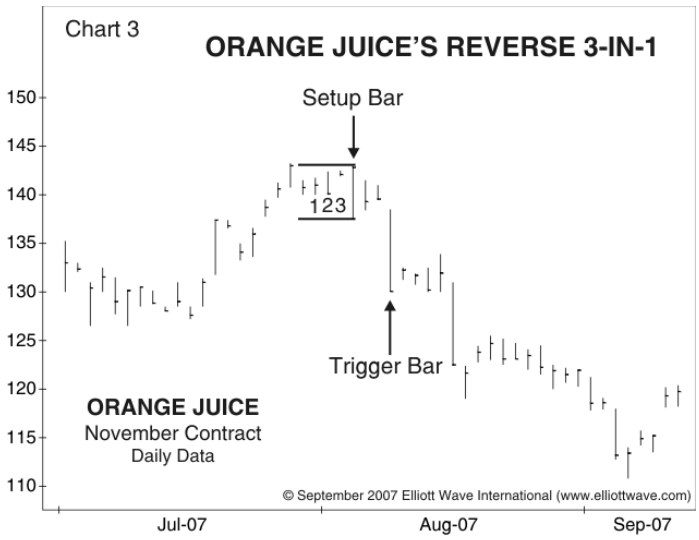
This month, I'd like to discuss a variation on the 3-in-1 that leads to similar outcomes: It's called the Reverse 3-in-1. How do you reverse a 3-in-1 bar pattern? Simple. The current period's high must be greater than the previous three highs, while the current period's low must be less than the previous three lows. In other words, look for an outside price bar that encompasses at least the three previous price bars. And similar to the 3-in-1, the price bar that does the encompassing is called the setup bar. A close above the high or below the low of the setup bar is the trigger bar, which signals the direction of the ensuing price move.

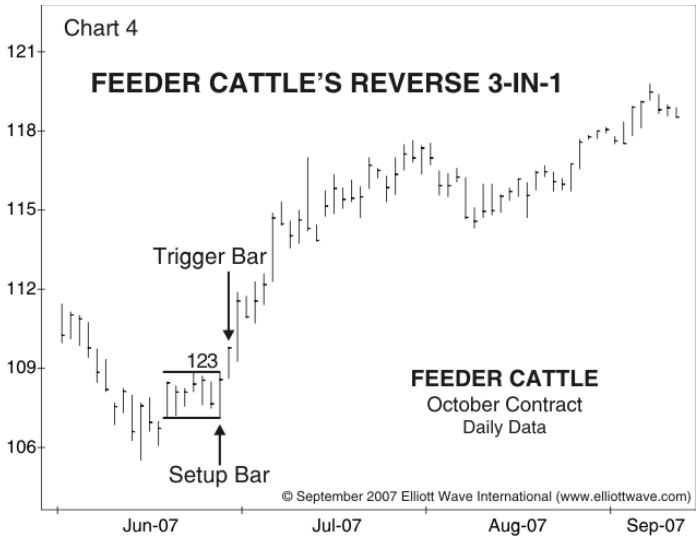


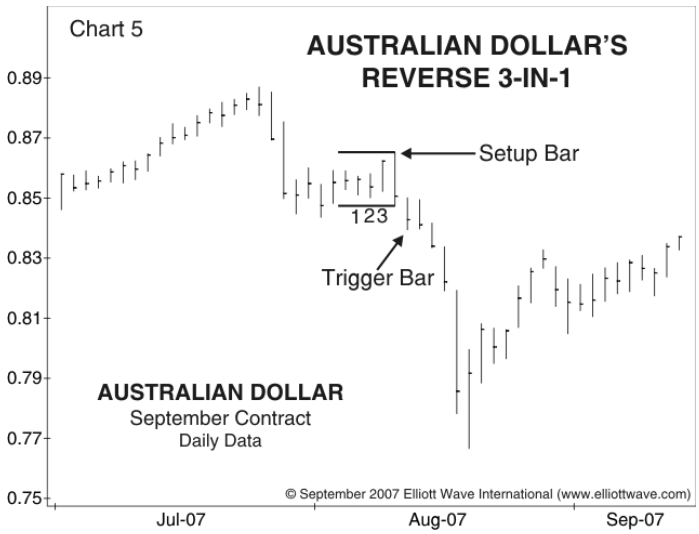


Just to be clear about what a Reverse 3-in-1 looks like, I am including examples taken from Sugar, Orange Juice, Feeder Cattle and the Aussie $ (Charts 3-5). In each of these, you will see a sizable move in price as a result of the Reverse 3-in-1 bar pattern.

So, if bar-pattern analysis fits into your style of analysis – as it does mine – you may want to add this 3-in-1 bar pattern to your repertoire. Even though it doesn't work 100% of the time (but, then again, nothing does), both the 3-in-1 and the Reverse 3-in-1 can alert you to potential trading opportunities that you may have previously overlooked.







3. How To Use An Outside-Inside Reversal To Spot Trade Setups

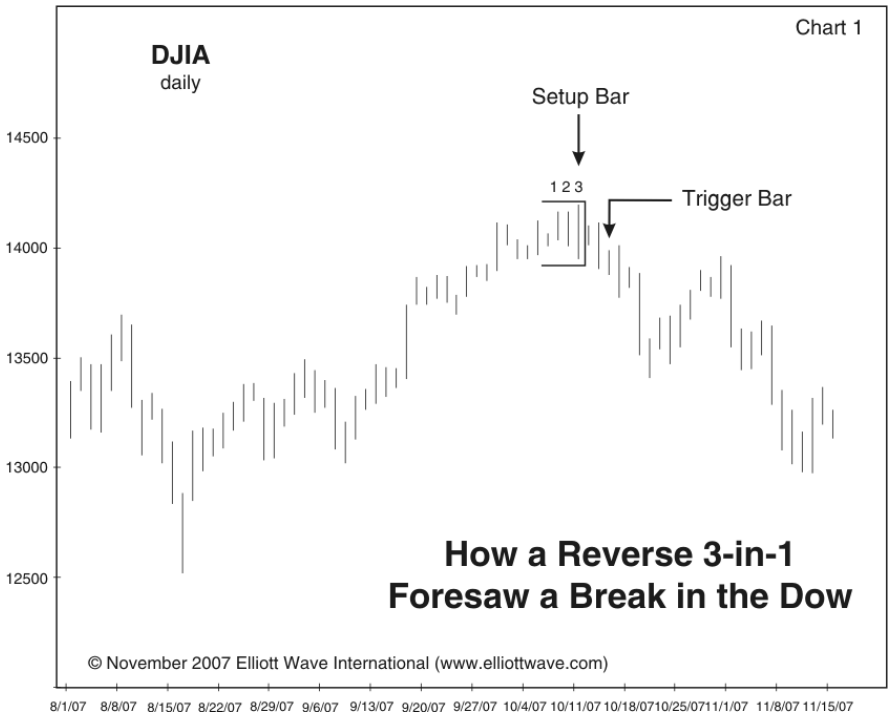
A Third Useful Bar Pattern
November 2007

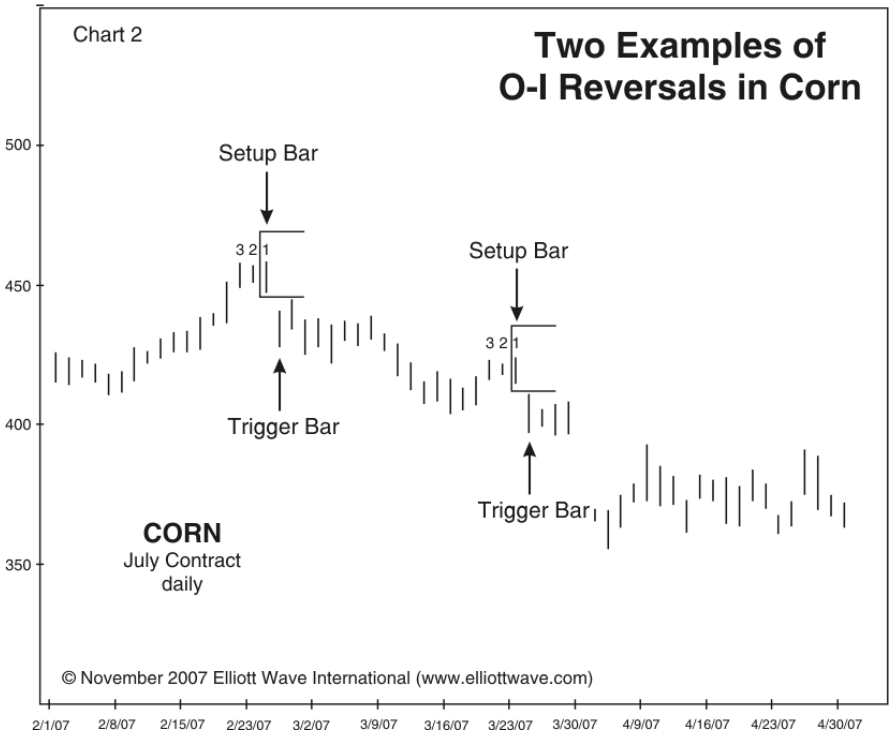
Even if commodities are your passion, I encourage you to apply some of the tools and techniques you read about in Trader's Classroom to other financial markets. If you do, you'll find them equally applicable. For example, in the August and September Trader's Classrooms, I mentioned two bar patterns that often introduce sizable moves in price: the 3-in-1 and the Reverse 3-in-1. [See the sidebar for a refresher on these patterns on page 37.]

Here's an example taken from the Dow's price action in October 2007 (Chart 1) to show you how this technique gave a heads-up on a change in the Dow's direction. In this chart, you can see that a Reverse 3-in-1 setup bar occurred in the Dow on October 11, the day it registered its all-time high. Three days later, on October 16, a trigger bar formed when the close of that day was below the low of the setup bar. As you can see, since then, the Dow has declined more than 1,000 points.

So now that we've established the usefulness of this Reverse 3-in-1 pattern, what do I have up my sleeve this month? It's another bar pattern that I believe identifies high probability trade setups. I call it an O-I Reversal, which stands for an "outside-inside" reversal. This three-bar pattern consists of an outside bar, an inside bar and a third price bar that makes a new five-period extreme.

Now before I get much farther, let's focus on bars one and two, the outside and inside price bars. An outside bar occurs when the current period's high is above the previous period's high, and the current period's low is below the previous

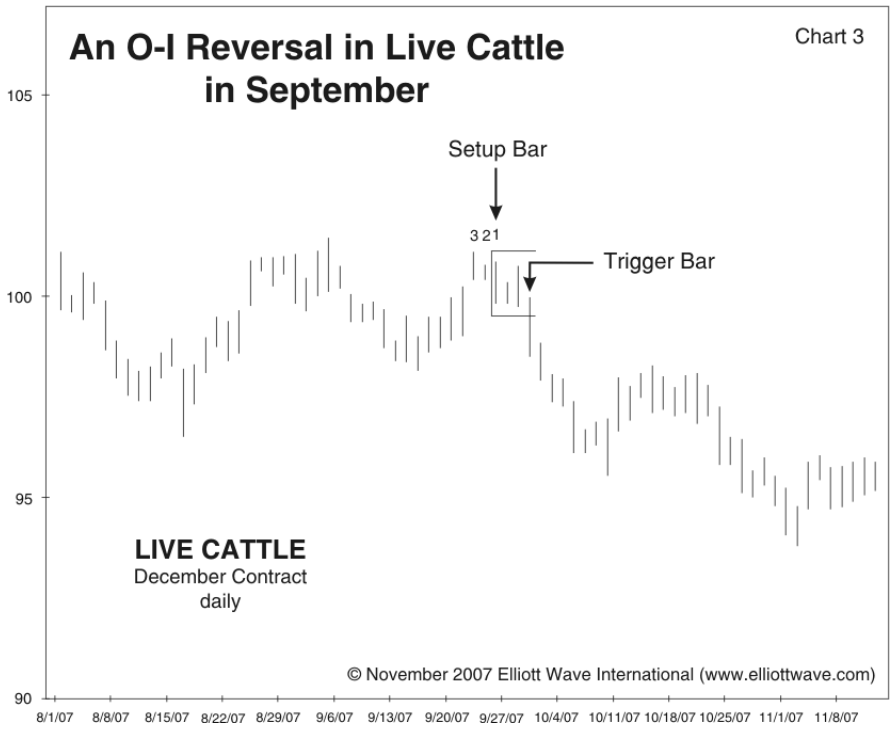


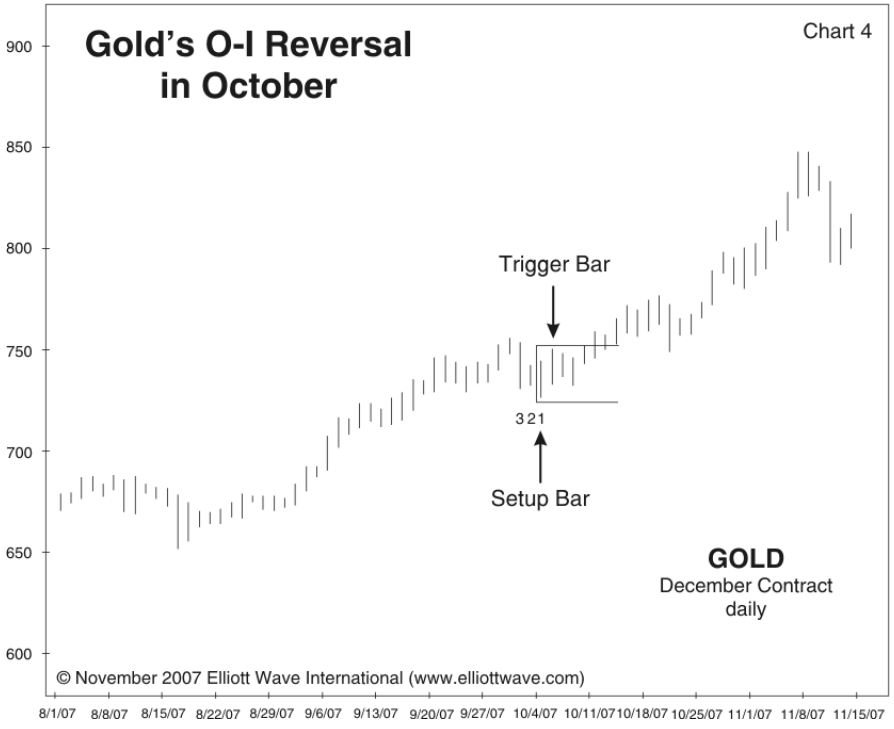


period's low. An inside bar is just the opposite – the current period's high is below the previous period's high and the current period's low is above the previous period's low. Simply put, bar one, which I also call the setup bar, is an outside bar, and bar two is an inside bar. Bar three is a price bar that makes a new five-period price extreme. In other words, the third price bar incorporates either a new five-period high or low.

Now let's take a look at a few examples of O-I Reversals so that you can visualize this bar pattern. In Chart 2 (Corn), I identified two O-I Reversals that formed in February and March. Beginning with the O-I Reversal that occurred in February, notice that bar number 3 made a new five-day price high, bar two was an inside day and bar one was an outside day – this is an O-I Reversal. I consider the outside day of this pattern, bar number 1, to be the setup bar. Why? Similar to the 3-in-1 and Reverse 3-in-1 patterns, I insist on a close above or below the high or the low of the setup bar before this bar pattern becomes actionable. Thus, the price bar that includes a close above the high or low of the setup bar is called the trigger bar.

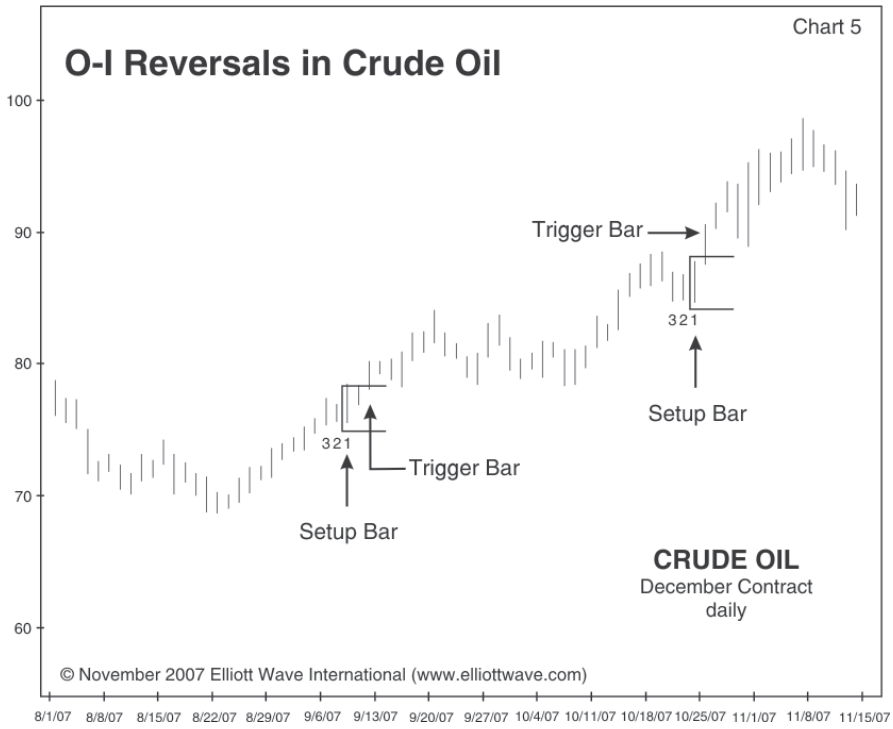
Similarly, in March, the high of bar three was the highest high within five trading days, while bar two and bar one were inside and outside days. Once prices closed below the setup bar the following day, the pattern became actionable, portending further decline. And if you were following July Corn earlier this year, you'll remember that in the days that followed this O-I Reversal bar pattern, Corn opened down two days in a row.

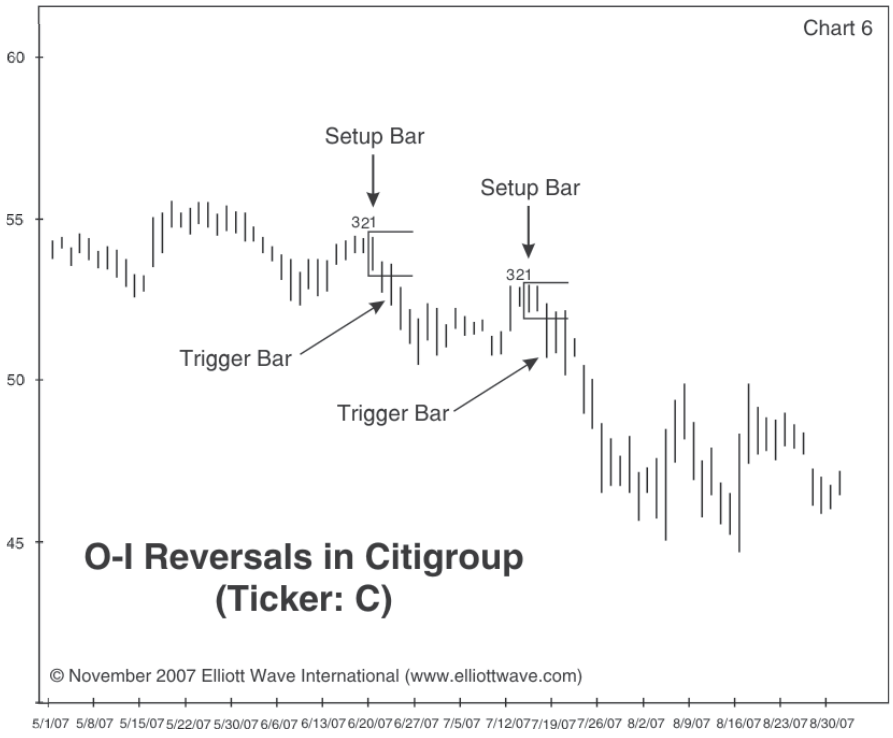




As you examine charts of Live Cattle, Gold, Crude Oil and Citigroup (Charts 3-6), you'll find additional examples of O-I Reversals that I marked. And in each instance, you'll notice that this bar pattern did indeed prove timely in identifying tradable moves in price.

It's always worth trying to find new patterns that help give clues to future price moves. That's one reason why I find technical analysis to be so fulfilling. Remember, even though technical analysis has been around for some time, more discoveries continue to be made. Just as I sometimes wonder what R.N. Elliott would have discovered if he had lived another 20 years, I also wonder where the field of technical analysis will be in 20 years. Moreover, who will be the next generation's Nison, Murphy, Bollinger, Appel or Prechter ... will it be you?





Refresher Course on 3-in-1s

A **3-in-1** occurs when the price range of the first of four price bars (i.e., the setup bar) engulfs the highs and lows of the next three price bars. Then, when the high or low of the setup bar is penetrated on a closing basis, I consider it to be a trigger bar that indicates that a sizable move in prices has just begun.

A **Reverse 3-in-1** is similar in that the current period's high must be greater than the previous three highs, while the current period's low must be less than the previous three lows. And just like the traditional 3-in-1, the price bar that does the encompassing is called the setup bar. A close above the high or below the low of the setup bar is the trigger bar, which signals the direction of the ensuing price move.

Appendix A

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 A-1 shows, these basic patterns link to form five- and three-wave structures of increasingly larger size (larger "degree" in Elliott terminology).

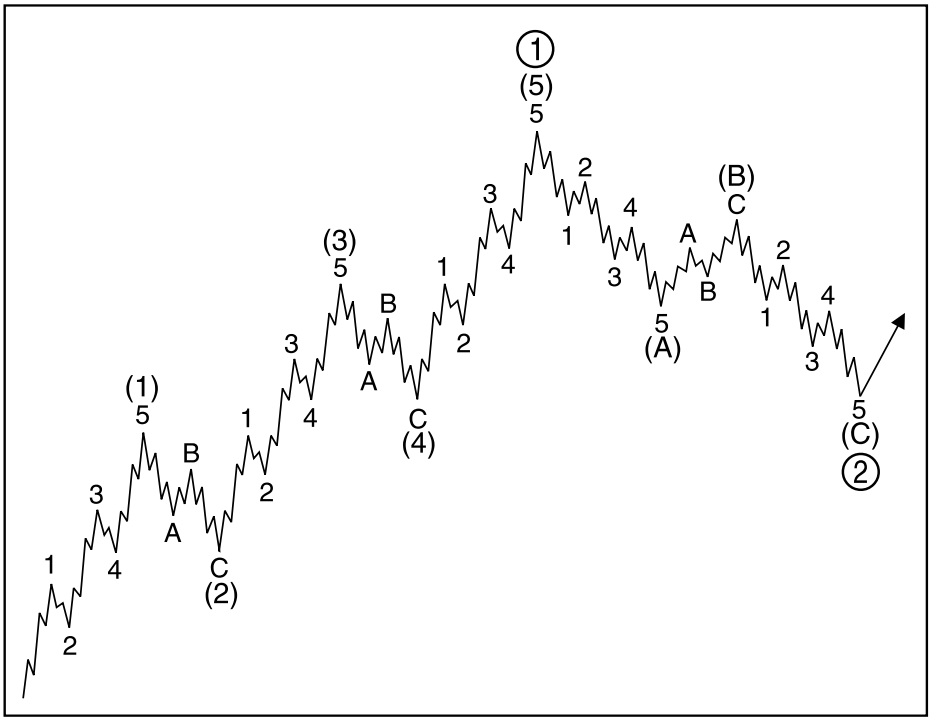


Figure A-1

In Figure A-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 A-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	ⓘ	ⓘⓘ	ⓘⓘⓘ	ⓘⓥ	ⓥ	ⓐ	ⓑ	ⓒ
Minuette	(i)	(ii)	(iii)	(iv)	(v)	(a)	(b)	(c)
Subminuette	i	ii	iii	iv	v	a	b	c

Figure A-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.

Appendix B

Glossary of Terms

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.