Wave-C or Wave-3?

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Is a market in a correction or a new impulse trend? Sometimes it is difficult to discern.

An important weakness of Elliott wave obsessives is that they will often determine what they think is the proper wave count and ignore the consequences or potential missed opportunities if their wave count eventually proves incorrect. I encourage those that use Elliott wave pattern analysis to consider the potential alternate wave count right from the beginning. That way you can adjust your trading strategy depending on the market activity that confirms or invalidates a wave count.

One of the practical applications of Elliott wave analysis is the market activity will provide the signals if a wave count is correct or not as it unfolds. Once an Elliott wave trader has considered what he or she believes is the most probable wave count, he or she should immediately identify the following benchmarks:

1. If the trend is a correction, what is the typical price objective?

2. What is the signal that indicates the trend is not a correction, but an impulse trend?

Let's compare what the time and price targets are likely to be for a correction or an impulse trend. In the early stages, an A-B-C and a 1-2-3 pattern will usually have very similar characteristics. From a practical trading strategy perspective, they are initially traded the same way. What are the signals that will indicate if a market is in a Wave-C or a Wave-3? Two current examples will help us to learn this lesson.

Chart 1 below is daily July beans through April 29. The Feb. 26 low to March 31 high appears to be a five-wave advance. If this is the case, beans would typically make an ABC correction followed by a continued rally to above the March 31 high. It is possible that the Feb. low to March high is a correction and beans will continue the impulsive bear trend from the March 31 high. How can the market activity signal if the decline is now in a Wave-C or Wave-3?

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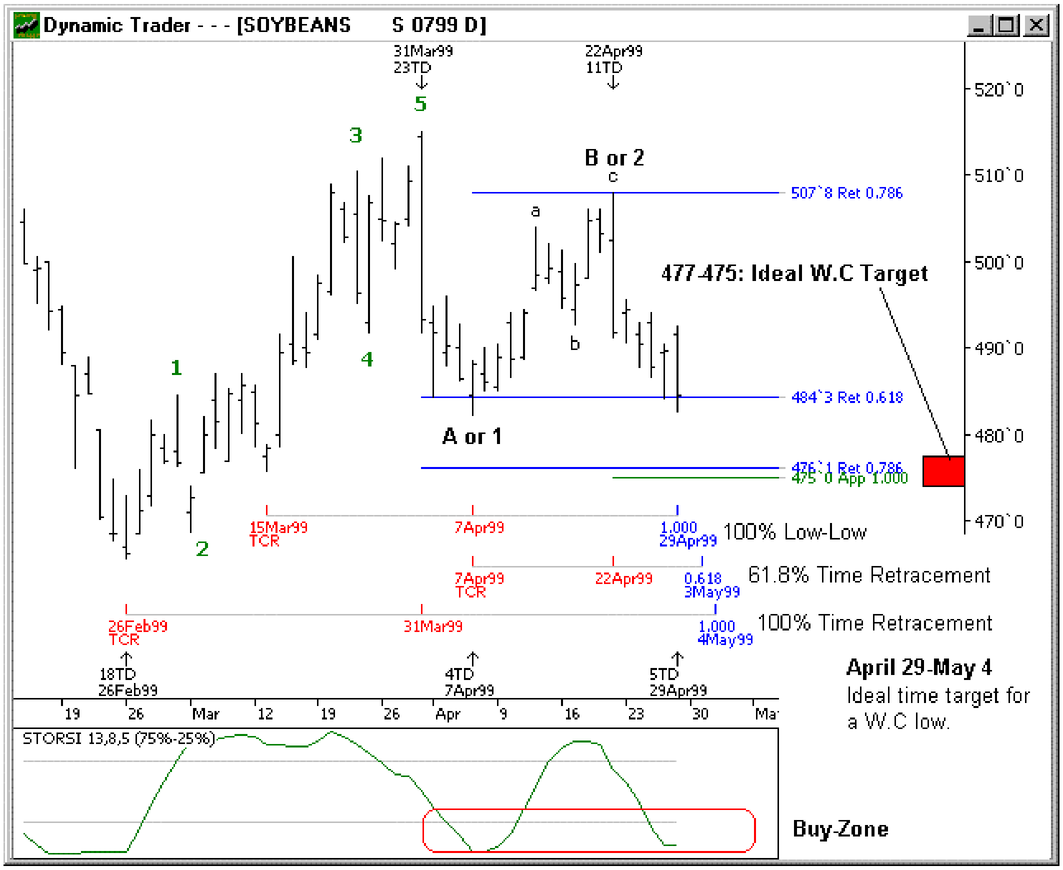

If the decline is an ABC, there are well defined time and price target zones which should not be exceeded for the Wave-C low. The 477-475 price zone includes where Wave-C is 100% of Wave-A, 127% of Wave-B and the 78.6% retracement. This should be the maximum price zone for a Wave-C. If beans close below 475, the bottom of this zone, the odds are the decline is not an ABC correction but the beginning of a five-wave impulsive bear trend.

The April 29-May 4 time zone includes the most recent 100% low-low projection and the 61.8% time retracement of Wave-B. More importantly, this time zone includes the 100% time retracement of the Feb. low to March high. If the decline is an ABC, Wave-C should complete its low no later than May 4. If beans make new daily and closing lows after May 4, it is an important time signal that the decline from the March 31 high is an impulsive bear trend, not a correction.

While the "preferred" wave count may be beans are near the completion of an ABC correction, a close below the maximum time and price zones projection for a Wave-C low will immediate cause the trader to change opinions of the market position and change trading strategies.

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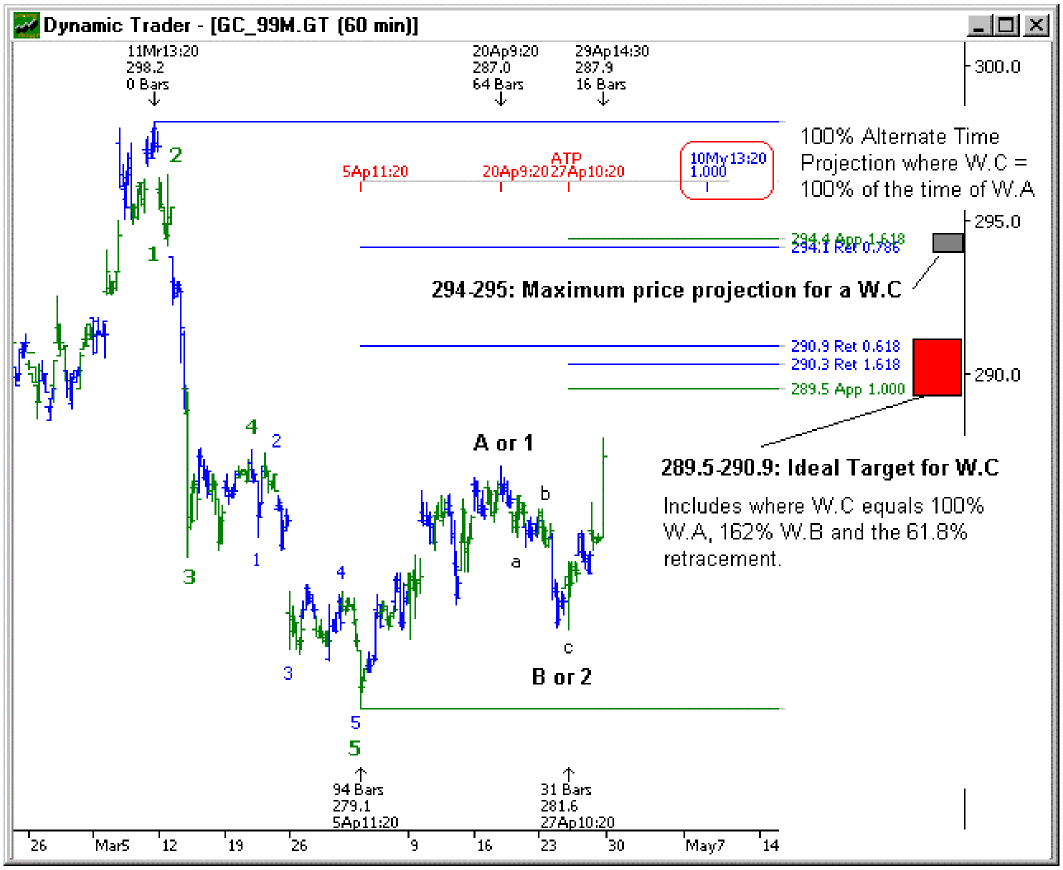
Chart 2 is an hourly chart of June gold. It appears gold completed a five-wave decline from the March 11 high to the April 5 low. Is the rally from the April 5 low a correction are the beginning of an impulsive bull trend that will take gold above the March 11 high? Is gold currently in a Wave-C or a Wave-3? What are the time and price signals that will confirm one or the other?



The 289.5-290.9 price zone includes all of the typical projections for a Wave-C. This zone includes where Wave-C equals 100% Wave-A, 162% Wave-B and the 61.8% retracement. If the rally is an ABC correction, the odds are it will not close above this zone. A close above 290.9 is the initial warning gold is not making a correction from the April 5 low, but is making a new bull trend that will eventually exceed the March 11 high.

What is the maximum price target anticipated if the rally is an ABC correction? The 294-295 zone includes where Wave-C would equal 162% of Wave-A, 262% of Wave-B and the 78.6% retracement. This should be the maximum price target for a Wave-C. A close above 294.4 provides a firm signal that the rally from the April low is the initial stages of a bull trend and gold is making a Wave-3 not a Wave-C.

May 10 is the 100% Alternate Time Projection where the time range of Wave-C would equal the time range of Wave-A. This should be the maximum time target for a Wave-C high.

While the "preferred" wave count may consider gold is making an ABC corrective rally, a close above 290.9 will be the initial signal the rally is not a correction and trading strategies will be adjusted accordingly.

The time and price targets for these two markets are very well defined to alert us to the larger degree pattern position of either of these markets. How do we use these targets to make specific trading decisions? The first step is to determine the current position of the market as best we can and identify the signals that will confirm or invalidate our opinion of the market position. The next step is to identify the specific trading strategies to take advantage of the technical analysis. Next month's tutorial will identify the specific trading strategies that we use when we suspect a market is in either a Wave-C or Wave-3.

Chapter 7 of the Dynamic Trading book called Putting It All Together shows how the trading strategies are originally developed and adjusted as a market progresses. If you don't have the DT book, that chapter alone is worth its words in gold. A practical and reliable technical analysis approach is necessary to determine the high probability position of a market. Knowing the low-risk and low-capital exposure trading strategies for each market condition is how we put that market position to our profitable advantage.