

1.1 Introduction: The Broad Concept

In *The Elliott Wave Principle — A Critical Appraisal*, Hamilton Bolton made this opening statement:

As we have advanced through some of the most unpredictable economic climate imaginable, covering depression, major war, and postwar reconstruction and boom, I have noted how well Elliott's Wave Principle has fitted into the facts of life as they have developed, and have accordingly gained more confidence that this Principle has a good quotient of basic value.

"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 discovered that the ever-changing path of stock market prices reveals a structural design that in turn reflects a basic harmony found in nature. From this discovery, he developed a rational system of market analysis. Elliott isolated thirteen patterns of movement, or "waves," that recur in market price data and are repetitive in form, but are not necessarily repetitive in time or amplitude. He named, defined and illustrated the patterns. He then described how these structures link together to form larger versions of those same patterns, how they 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. Elliott's descriptions constitute a set of empirically derived rules and guidelines for interpreting market action. Elliott claimed predictive value for The Wave Principle, which now bears the name, "The Elliott Wave Principle."

1.2 Short History

Although it is the best forecasting tool in existence, the Wave Principle is not primarily a forecasting tool; it is a detailed description of how markets behave. Nevertheless, that description does impart an immense amount of knowledge about the market's position within the behavioral continuum and therefore about its probable ensuing path. The primary value of the Wave Principle is that it provides a context for market analysis. This context provides both a basis for disciplined thinking and a perspective on the market's general position and outlook. At times, its accuracy in identifying, and even anticipating,

changes in direction is almost unbelievable. Many areas of mass human activity follow the Wave Principle, but the stock market is where it is most popularly applied. Indeed, the stock market considered alone is far more important than it seems to casual observers. The level of aggregate stock prices is a direct and immediate measure of the popular valuation of man's total productive capability. That this valuation has form is a fact of profound implications that will ultimately revolutionize the social sciences. That, however, is a discussion for another time.

R.N. Elliott's genius consisted of a wonderfully disciplined mental process, suited to studying charts of the Dow Jones Industrial Average and its predecessors with such thoroughness and precision that he could construct a network of principles that covered all market action known to him up to the mid-1940s. At that time, with the Dow in the 100s, Elliott predicted a great bull market for the next several decades that would exceed all expectations at a time when most investors felt it impossible that the Dow could even better its 1929 peak. As we shall see, phenomenal stock market forecasts, some of pinpoint accuracy years in advance, have accompanied the history of the application of the Elliott Wave approach.

Elliott had theories regarding the origin and meaning of the patterns he discovered, which we will present and expand upon in Lessons 16-19. Until then, suffice it to say that the patterns described in Lessons 1-15 have stood the test of time.

Often one will hear several different interpretations of the market's Elliott Wave status, especially when cursory, off-the-cuff studies of the averages are made by latter day experts.

However, most uncertainties can be avoided by keeping charts on both arithmetic and semilogarithmic scale and by taking care to follow the rules and guidelines as laid down in this course. Welcome to the world of Elliott.

1.3 Basic Tenets

Under the Wave Principle, every market decision is both produced by meaningful information and produces meaningful information. Each transaction, while at once an effect, enters the fabric of the market and, by communicating transactional data to investors, joins the chain of causes of others' behavior. This feedback loop is governed by man's social nature, and since he has such a nature, the process generates forms. As the forms are repetitive, they have predictive value.

Sometimes the market appears to reflect outside conditions and events, but at other times it is entirely detached from what most people assume are causal conditions. The reason is that the market has a law of its own. It is not propelled by the linear causality to which one becomes accustomed in the everyday experiences of life. Nor is the market the cyclically rhythmic machine that some declare it to be. Nevertheless, its movement reflects a structured formal progression.

That progression unfolds in waves. Waves are patterns of directional movement. More specifically, a wave is any one of the patterns that naturally occur under the Wave Principle, as described in Lessons 1-9 of this course.

The Five Wave Pattern

In markets, progress ultimately takes the form of five waves of a specific structure. Three of these waves, which are labeled 1, 3 and 5, actually effect the directional movement. They are separated by two countertrend interruptions, which are labeled 2 and 4, as shown in Figure 1-1. The two interruptions are apparently a requisite for overall directional movement to occur.

The Basic Pattern

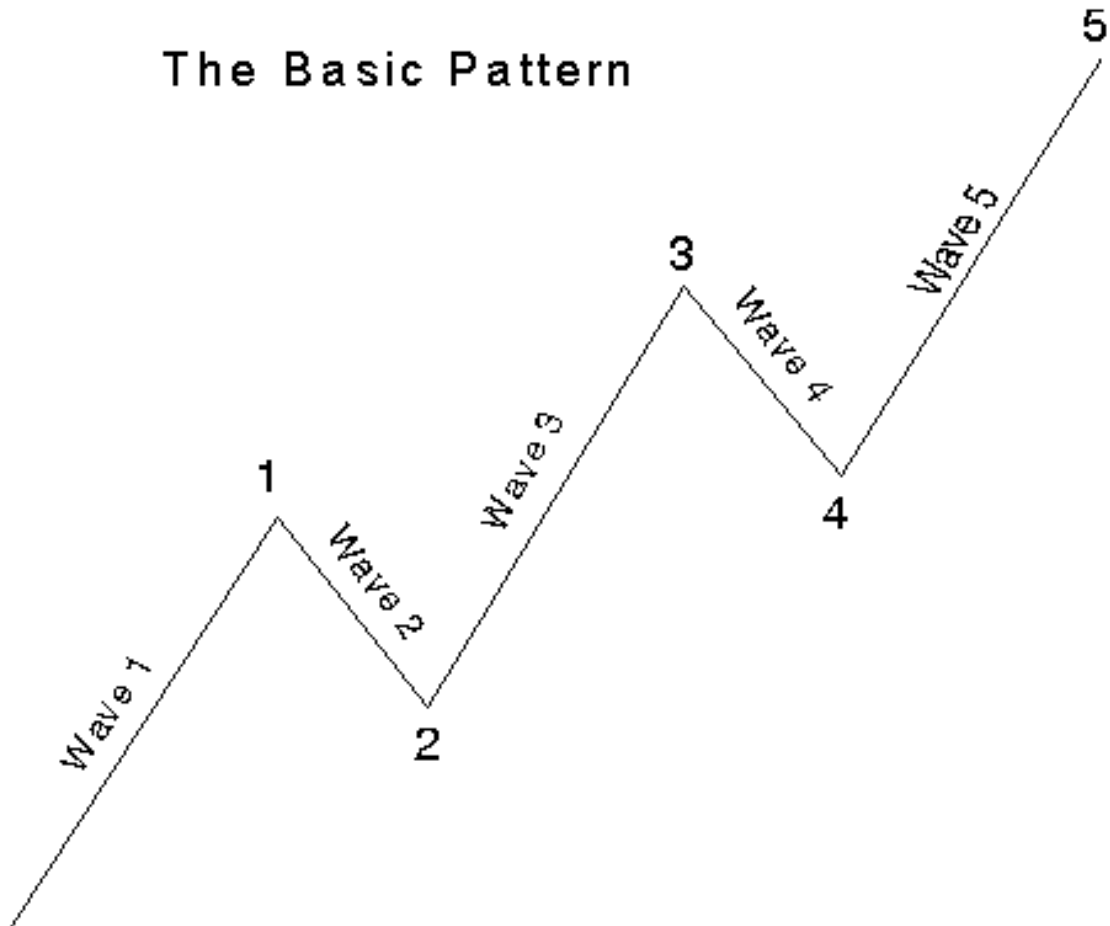


Figure 1-1

R.N. Elliott did not specifically state that there is only one overriding form, the "five wave" pattern, but that is undeniably the case. At any time, the market may be identified as being somewhere in the basic five wave pattern at the largest degree of trend. Because the five wave pattern is the overriding form of market progress, all other patterns are subsumed by it.

1.4 Wave Mode

There are two modes of wave development: motive and corrective. Motive waves have a five wave structure, while corrective waves have a three wave structure or a variation thereof. Motive mode is employed by both the five wave pattern of Figure 1-1 and its same-directional components, i.e., waves 1, 3 and 5. Their structures are called "motive" because they powerfully impel the market. Corrective mode is employed by all countertrend interruptions, which include waves 2 and 4 in Figure 1-1. Their structures are called "corrective" because they can accomplish only a partial retracement, or "correction," of the progress achieved by any preceding motive wave. Thus, the two modes are fundamentally different, both in their roles and in their construction, as will be detailed throughout this course.

In his 1938 book, *The Wave Principle*, and again in a series of articles published in 1939 by *Financial World* magazine, R.N. Elliott pointed out that the stock market unfolds according to a basic rhythm or pattern of five waves up and three waves down to form a complete cycle of eight waves. The pattern of five waves up followed by three waves down is depicted in Figure 1-2.

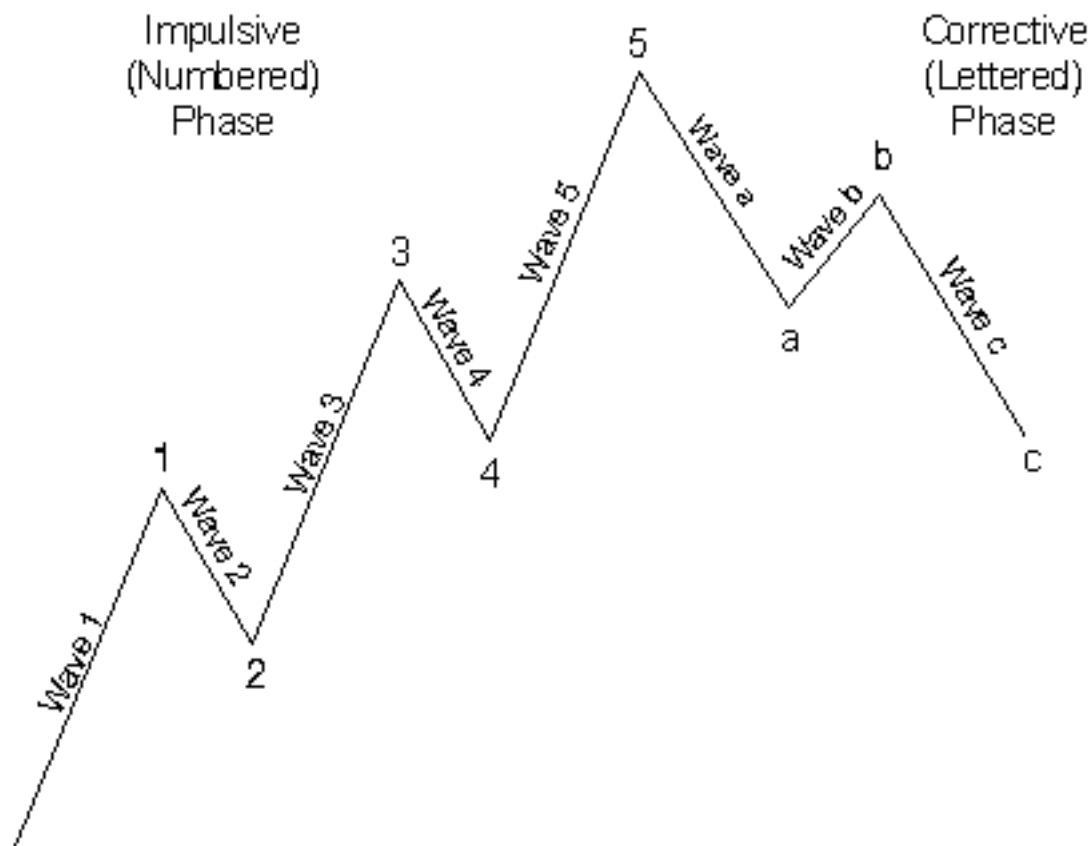


Figure 1-2

One complete cycle consisting of eight waves, then, is made up of two distinct phases, the motive phase (also called a "five"), whose subwaves are denoted by numbers, and the corrective phase (also called a "three"), whose subwaves are denoted by letters. The sequence a, b, c corrects the sequence 1, 2, 3, 4, 5 in Figure 1-2.

At the terminus of the eight-wave cycle shown in Figure 1-2 begins a second similar cycle of five upward waves followed by three downward waves. A third advance then develops, also consisting of five waves up. This third advance completes a five wave movement of one degree larger than the waves of which it is composed. The result is as shown in Figure 1-3 up to the peak labeled (5).

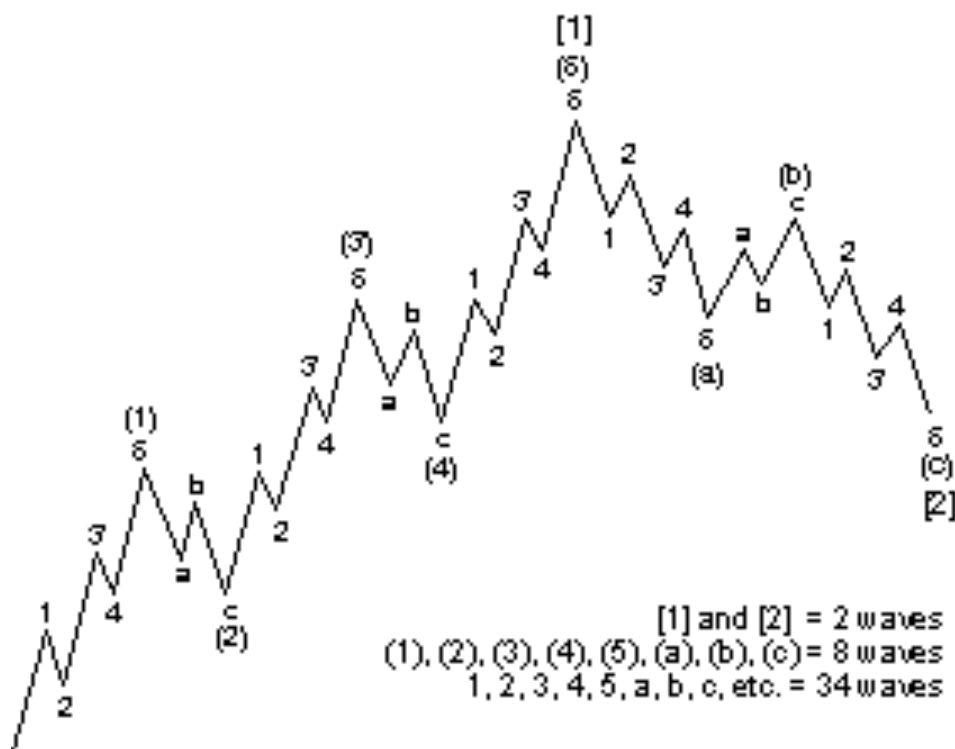


Figure 1-3

At the peak of wave (5) begins a down movement of correspondingly larger degree, composed once again of three waves. These three larger waves down "correct" the entire movement of five larger waves up. The result is another complete, yet larger, cycle, as shown in Figure 1-3. As Figure 1-3 illustrates, then, each same-direction component of a

motive wave, and each full-cycle component (i.e., waves 1 + 2, or waves 3 + 4) of a cycle, is a smaller version of itself.

It is crucial to understand an essential point: Figure 1-3 not only illustrates a larger version of Figure 1-2, it also illustrates Figure 1-2 itself, in greater detail. In Figure 1-2, each subwave 1, 3 and 5 is a motive wave that will subdivide into a "five," and each subwave 2 and 4 is a corrective wave that will subdivide into an a, b, c. Waves (1) and (2) in Figure 1-3, if examined under a "microscope," would take the same form as waves [1]* and [2]. All these figures illustrate the phenomenon of constant form within ever-changing degree.

1.5 Essential Design

The market's compound construction is such that two waves of a particular degree subdivide into eight waves of the next lower degree, and those eight waves subdivide in exactly the same manner into thirty-four waves of the next lower degree. The Wave Principle, then, reflects the fact that waves of any degree in any series always subdivide and re-subdivide into waves of lesser degree and simultaneously are components of waves of higher degree. Thus, we can use Figure 1-3 to illustrate two waves, eight waves or thirty-four waves, depending upon the degree to which we are referring.

Now observe that within the corrective pattern illustrated as wave [2] in Figure 1-3, waves (a) and (c), which point downward, are composed of five waves: 1, 2, 3, 4 and 5. Similarly, wave (b), which points upward, is composed of three waves: a, b and c. This construction discloses a crucial point: that motive waves do not always point upward, and corrective waves do not always point downward. The mode of a wave is determined not by its absolute direction but primarily by its relative direction. Aside from four specific exceptions, which will be discussed later in this course, waves divide in motive mode (five waves) when trending in the same direction as the wave of one larger degree of which it is a part, and in corrective mode (three waves or a variation) when trending in the opposite direction. Waves (a) and (c) are motive, trending in the same direction as wave [2]. Wave (b) is corrective because it corrects wave (a) and is countertrend to wave [2]. In summary, the essential underlying tendency of the Wave Principle is that action in the same direction as

the one larger trend develops in five waves, while reaction against the one larger trend develops in three waves, at all degrees of trend.

*Note: For this course, all Primary degree numbers and letters normally denoted by circles are shown with brackets.

Essential Concepts

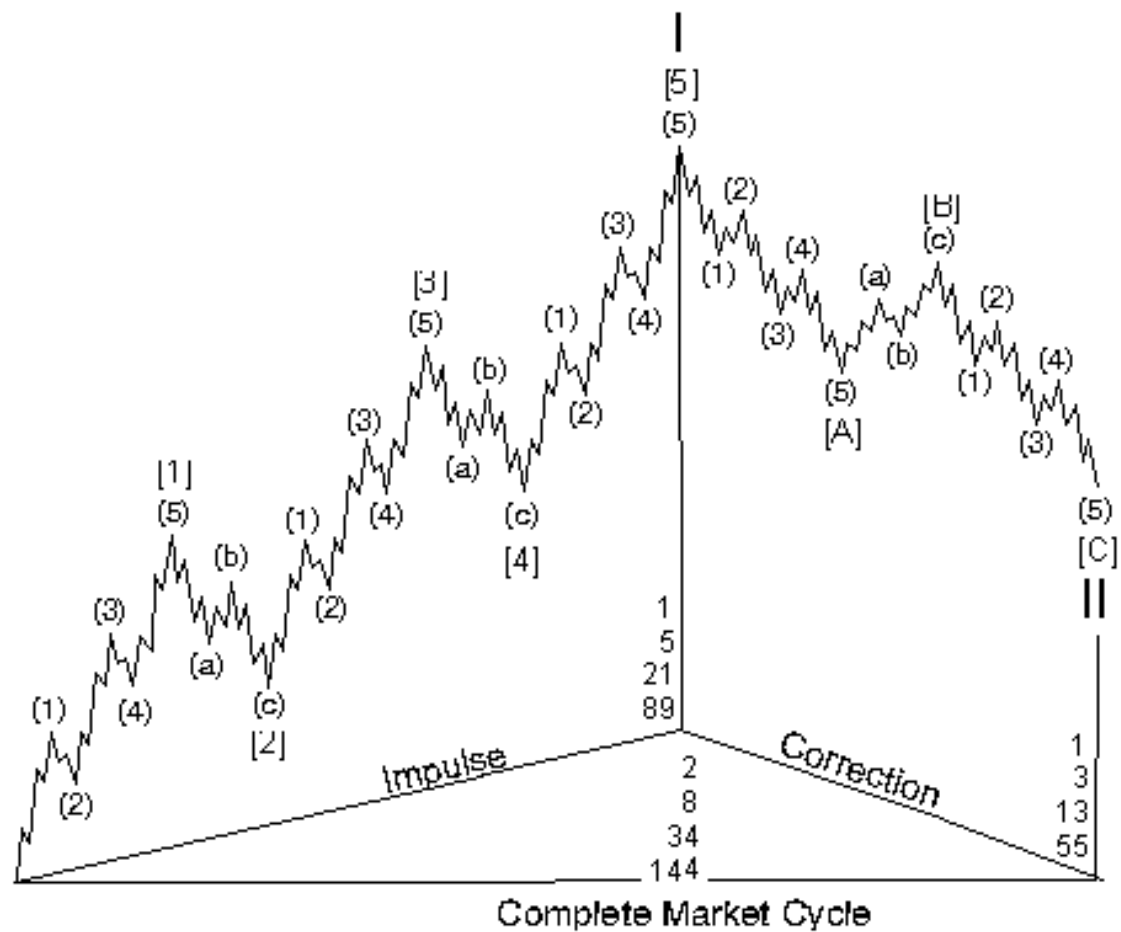


Figure 1-4

The phenomena of form, degree and relative direction are carried one step further in Figure 1-4. This illustration reflects the general principle that in any market cycle, waves will subdivide as shown in the following table.

1.6 Wave Numbers

Number of Waves at Each Degree

Impulse + Correction = Cycle

Largest waves $1+1=2$

Largest subdivisions $5+3=8$

Next subdivisions $21+13=34$

Next subdivisions $89+55=144$

As with Figures 1-2 and 1-3 in Lesson 2, neither does Figure 1-4 imply finality. As before, the termination of yet another eight wave movement (five up and three down) completes a cycle that automatically becomes two subdivisions of the wave of next higher degree. As long as progress continues, the process of building to greater degrees continues. The reverse process of subdividing into lesser degrees apparently continues indefinitely as well. As far as we can determine, then, all waves both have and are component waves.

Elliott himself never speculated on why the market's essential form was five waves to progress and three waves to regress. He simply noted that that was what was happening. Does the essential form have to be five waves and three waves? Think about it and you will realize that this is the minimum requirement for, and therefore the most efficient method of, achieving both fluctuation and progress in linear movement. One wave does not allow fluctuation. The fewest subdivisions to create fluctuation is three waves. Three waves in both directions does not allow progress. To progress in one direction despite periods of regress, movements in the main trend must be at least five waves, simply to cover more ground than the three waves and still contain fluctuation. While there could be more waves than

that, the most efficient form of punctuated progress is 5-3, and nature typically follows the most efficient path.

Variations on the Basic Theme

The Wave Principle would be simple to apply if the basic theme described above were the complete description of market behavior. However, the real world, fortunately or unfortunately, is not so simple. From here through Lesson 15, we will fill out the description of how the market behaves in reality. That's what Elliott set out to describe, and he succeeded in doing so.

WAVE DEGREE

All waves may be categorized by relative size, or degree. Elliott discerned nine degrees of waves, from the smallest wiggle on an hourly chart to the largest wave he could assume existed from the data then available. He chose the names listed below to label these degrees, from largest to smallest:

Grand Supercycle

Supercycle

Cycle

Primary

Intermediate

Minor

Minute

Minuette

Subminuette

It is important to understand that these labels refer to specifically identifiable degrees of waves. For instance, when we refer to the U.S. stock market's rise from 1932, we speak of it as a Supercycle with subdivisions as follows:

1932-1937 the first wave of Cycle degree

1937-1942 the second wave of Cycle degree

1942-1966 the third wave of Cycle degree

1966-1974 the fourth wave of Cycle degree

1974-19?? the fifth wave of Cycle degree

Cycle waves subdivide into Primary waves that subdivide into Intermediate waves that in turn subdivide into Minor and sub-Minor waves. By using this nomenclature, the analyst can identify precisely the position of a wave in the overall progression of the market, much as longitude and latitude are used to identify a geographical location. To say, "the Dow Jones Industrial Average is in Minute wave v of Minor wave 1 of Intermediate wave (3) of Primary wave [5] of Cycle wave I of Supercycle wave (V) of the current Grand Supercycle" is to identify a specific point along the progression of market history.

1.7 Degrees

When numbering and lettering waves, the scheme shown below is recommended to differentiate the degrees of waves in the stock market's progression:

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	Ⓘ	Ⓜ	Ⓢ	Ⓧ	Ⓨ	Ⓐ	Ⓑ	Ⓒ
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

The most desirable form for a scientist is usually something like 1_1 , 1_2 , 1_3 , etc., with subscripts denoting degree, but it's a nightmare to read such notations on a chart. The above table provides for rapid visual orientation. Charts may also use color as an effective device for differentiating degree.

In Elliott's suggested terminology, the term "Cycle" is used as a name denoting a specific degree of wave and is not intended to imply a cycle in the typical sense. The same is true of the term "Primary," which in the past has been used loosely by Dow Theorists in phrases such as "primary swing" or "primary bull market." The specific terminology is not critical to the identification of relative degrees, and the authors have no argument with amending the terms, although out of habit we have become comfortable with Elliott's nomenclature.

The precise identification of wave degree in "current time" application is occasionally one of the difficult aspects of the Wave Principle. Particularly at the start of a new wave, it can be difficult to decide what degree the initial smaller subdivisions are. The main reason for the difficulty is that wave degree is not based upon specific price or time lengths. Waves are dependent upon form, which is a function of both price and time. The degree of a form is determined by its size and position relative to component, adjacent and encompassing waves.

This relativity is one of the aspects of the Wave Principle that make real time interpretation an intellectual challenge. Fortunately, the precise degree is usually irrelevant to successful forecasting since it is

relative degree that matters most. Another challenging aspect of the Wave Principle is the variability of forms, as described through Lesson 9 of this course.

1.8 Wave Function

Every wave serves one of two functions: action or reaction. Specifically, a wave may either advance the cause of the wave of one larger degree or interrupt it. The function of a wave is determined by its relative direction. An actionary or trend wave is any wave that trends in the same direction as the wave of one larger degree of which it is a part. A reactionary or countertrend wave is any wave that trends in the direction opposite to that of the wave of one larger degree of which it is part. Actionary waves are labeled with odd numbers and letters. Reactionary waves are labeled with even numbers and letters.

All reactionary waves develop in corrective mode. If all actionary waves developed in motive mode, then there would be no need for different terms. Indeed, most actionary waves do subdivide into five waves. However, as the following sections reveal, a few actionary waves develop in corrective mode, i.e., they subdivide into three waves or a variation thereof. A detailed knowledge of pattern construction is required before one can draw the distinction between actionary function and motive mode, which in the underlying model introduced so far are indistinct.