LISA HANEY

Relearning Techniques Oft Forgot

Trading The Trend In Wave 3

Here's a refresher course on techniques you can use to trade wave 3, in part 2 of three.

by Mircea Dologa, MD

When trading wave 3, any number of methods could be used, so many that it's easy to overlook one or two. So which one would be best? Here are a few that may pique your interest, including some that you may have long forgotten.

PITCHFORKS AND CHANNELS

The pitchfork technique† should be a standard tool to use when trying to measure the slope of the trend of wave 3. The slope is important because its characteristics play a part in defining the exit. In the pitchfork method, a technician will

pick an extreme low or high to use as an anchor pivot point† and draw a median line. Action and reaction lines are drawn through high and low points, defining the support and resistance levels for the price channel. In Figure 1, the exit at 4135 takes place where the market price crosses with the first upper parallel line above the center line.

The channeling technique is another helpful tool for wave analysis. In this method, a price channel contains prices through the course of a trend; historically, this term has been used to denote the area between the base trendline and the reaction trendline defined by price moves against the prevailing trend. Channeling's main function is to delineate the exhaustion zones, where the local market will certainly perform, either as a reversal, an acceleration, or a consolidation move. Thus, it serves as an optimal timing guide, giving the trader a prolific competitive edge. The channeling technique is used on primary and lesser-degree waves:
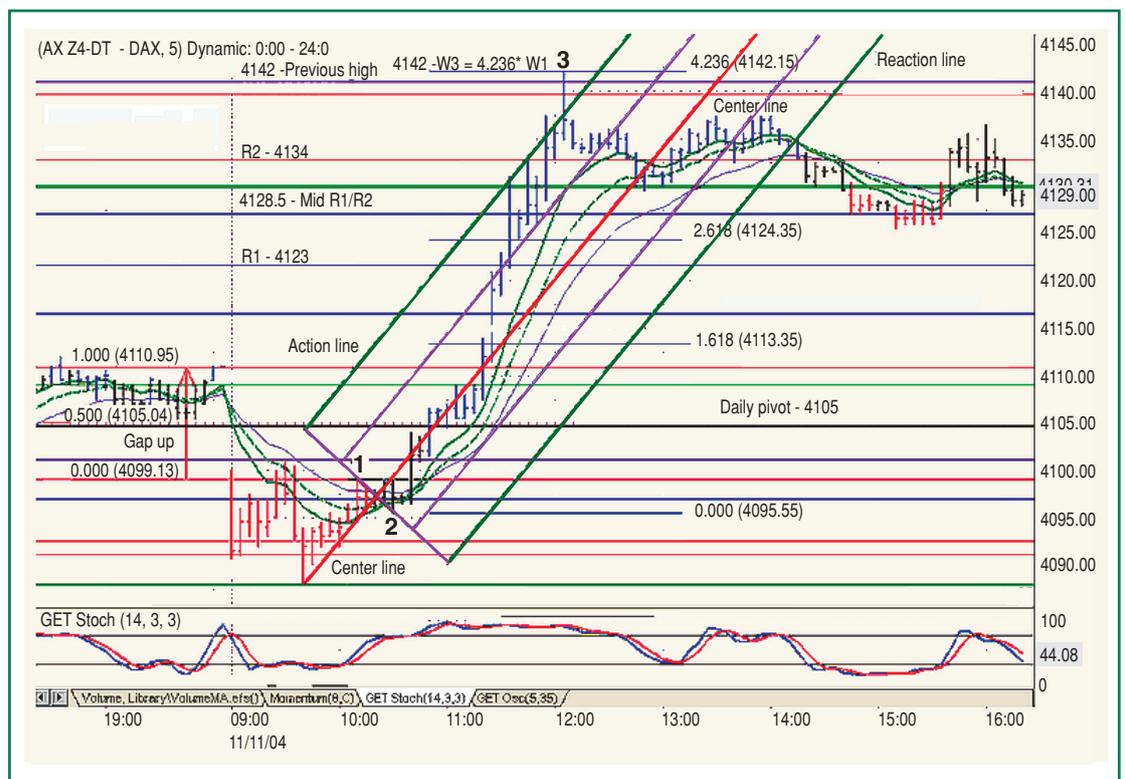
TRADING TECHNIQUES

FIGURE 1: PITCHFORKS AND PRICE CHANNELS. You can use pitchforks and channels to help determine your exits. In this example, the point where price crosses the first upper parallel line is where you should exit your trade.

- w2-4 base trendline (very important)
- w1 parallel trendline
- w3 parallel trendline
- w1-3 – 50% parallel trendline
- w1-3 nonparallel trendline

Even though these techniques can be used for multiple types of wave degrees, they are more important on lesser-degree wave levels.

Once w4:W3 has completed its retracement, you can draw the trendlines. These will determine the limits of W3 development. You can get additional and more precise information when:

- The distance between w1:W3 and w3:W3 parallel trendlines is greater than the distance between w2-4:W3 and w1:W3. You can then calculate the 50% Fibonacci ratios, and draw the "w1-3 – 50%" parallel trendline at this level. Often, w5:W3 ends around this level.

- Price breaks the w3:W3 parallel trendline with strong momentum. When this happens, draw a trendline linking the tops of w1:W3 and w3:W3. This gives you the w1-3 nonparallel trendline. An elongated w5:W3 may terminate at this level.

MULTIPLE TIME FRAMES

It's important to use multiple time frames when you are trading. So if you are trading on a five-minute time frame, you should choose two other time frames, one larger one and one shorter one.

The larger time frame chart should be used to identify the trend, verify the conditions, the current wave type, or whether prices are at or near a reversal. The smaller time frame chart should be used to identify and pinpoint your entry and exit, confirm if everything is going in the direction of the main trend (mandatory green light), or detect the inevitable reversal bar (optimal exit). So the smaller time frame is considered only for execution of entry and termination of a trade. Its function starts and ends with these two phenomena.

In this article, the five-minute chart in Figure 2 was used to make trading decisions; never trade W2 or W4, unless W1 and W3 are extended beyond 2.618 ratios. The larger and smaller time frames are there to ensure trade coherence and to avoid the dilution of the high probability of a trade.

To respect the intimacy of fractals, I use only Fibonacci numbers when it comes to selecting trading parameters, time frame charts, exponential moving averages (EMAs), setup numbers for indicators, and so forth.

TOOLS OF THE TREND

The most efficient trades are trend-related. If you observe enough charts of multiple time frames, especially hourly
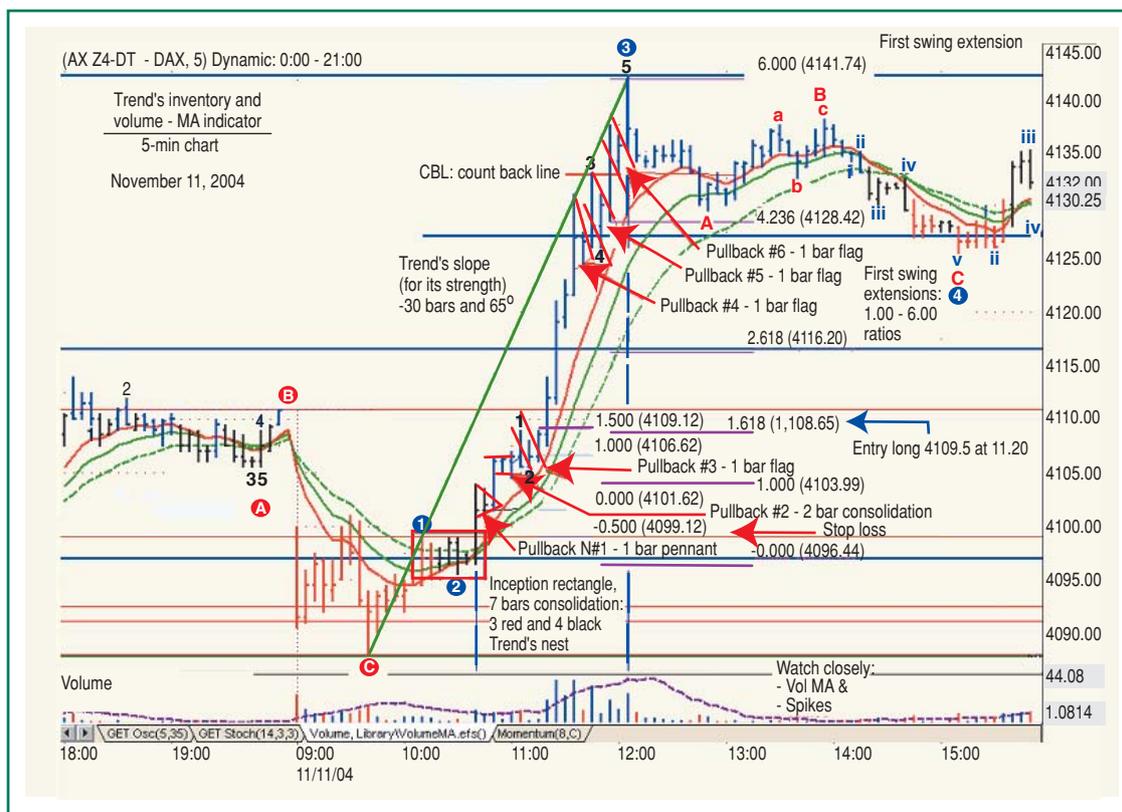
FIGURE 2: MULTIPLE TIME FRAMES. It's always a good idea to look at charts of various time frames when trading. A shorter and longer time frame than the one you are trading will give you an idea of the direction of the trend and when to make your entry and exit.

ones, you will become familiar with the inception, development, eventual extension, and completeness of the trend. In fact, taking apart trends will become second nature. Here are some methods I use to analyze trends.

■ *Exponential moving average (EMA):*
A simple and efficient tool
After analyzing the eight-, 13-, and 21-bar (Fibonacci numbers) EMAs as displayed in Figure 3, I found that the smallest, eight-bar EMA is very volatile and exposed to whipsaws. When pierced by a bar's tail, this EMA acts as a warning of a hesitation in the trend or for an eventual pullback if the close pierced but stayed above the eight-bar EMA.

The trend will continue if the close is above all three EMAs. But if the close is below the 21-bar EMA, it's a signal that an eventual reversal may be imminent. At this point, you will see a convergence and crossover of all three EMAs.

■ *Distance EMA and price:*
Probability gradient of trend strength
Monitoring the distance between the EMA and price will give you a probability gradient of the trend's momentum, which helps determine the strength of the trend (Figure 3). The further the price is from the EMAs, the stronger the trend. On a smaller time frame, you can observe that consolidations take place on the moving average without piercing it (distance between price and

EMA is zero). This indicates that another trend's swing is in the making. These consolidations may be considered to be the real catalysts of a trend's strength.

■ *Pullbacks: Main ingredient of a trend*
Pullbacks are minor corrections of the last swing less than 23.6%. They are usually at around 14.6% and often constitute an important factor to determine a trend's strength (Figure 2). They may be considered as resting areas, or halts, that are necessary to increase a trend's momentum.

The occurrence of the first pullback, called *inception pullback*, can be considered to be the beginning of a trend. Within an extended wave, these pullbacks may play the function of corrective waves. When a pullback leans closely against the EMA, it is likely that the trend will take off again. They typically take the shape of a flag, pennant, or a rectangle.

■ *Trend inception rectangle: Nest of the trend*
A trend is born from a breakout of a consolidation such as a rectangle, a rectangle within a trading range, or an upthrust of a triangle (Figure 2). By counting the number of bars that make up this accumulation zone, you can often forecast the length of the corresponding trend. The trend's measure could be 1.00, 1.50, 2.00, 2.50, 3.00, 3.50, and 4.00 ratios of the height of the consolidation, depending on the presence or absence of the extended process.
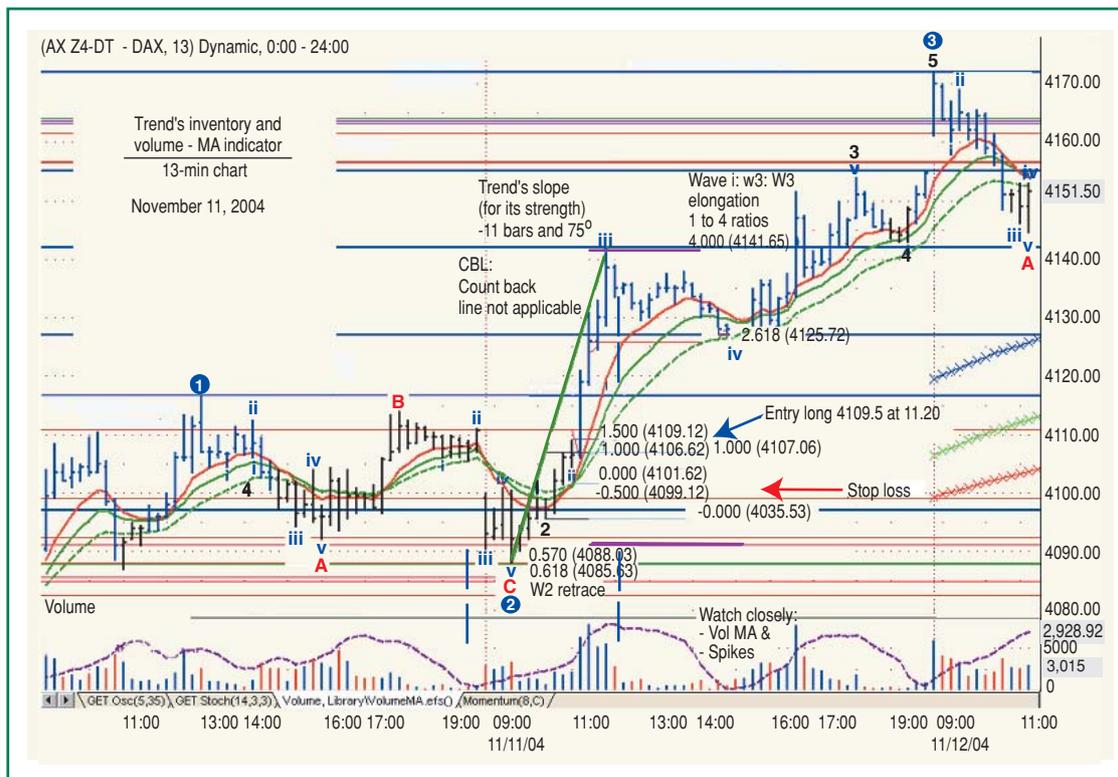
FIGURE 3: TOOLS OF THE TRADE. When trading during wave 3, there are various technical indicators and patterns that could be useful. Exponential moving averages, pullbacks, consolidation patterns, volume, momentum, and RSI are just a few of them.

■ *Volume: The balanced or overbalanced factor*
The multitude of buyers and sellers make up the heart of market price movements. The volume of a trade is the fuel of the entire mechanism (see Figures 2 and 3). When you compare volume with its own moving average, you'll see a significant swelling through the spiking process, especially at the level of the third of the third wave (Figure 3). The volume of subwave 5 is less important.

■ *Momentum (8) and RSI (13): Favored indicators*
When measuring the strength of the market, momentum often stays positive. Its inflections are synchronous with the occurrence of pullbacks. Although the RSI also measures market price momentum through the ratio of two moving averages, I recommend using it with a momentum indicator, especially at the forecasted end of wave 3. Using the next Fibonacci number, 13, for RSI rather than 8, enhances the synergy at the end of the wave.

■ *Pivots: Key levels*
Pivots are calculated empirically, like Fibonacci numbers. Floor traders calculate pivot levels on the basis of the prior day's market activity: high, low, and close. Once they obtain today's daily pivot (high+low+close)/3, they calculate upside resistance pivots (R1, R2, R3, R4, and R5), and also the downside support ones (S1, S2, S3, S4, and S5). For some markets, where the interpivotal distance is large, you could go even further and divide the space between

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two pivots into two smaller zones, thus getting the midpivot level.

Once these calculations are done, the current day's trading range chart is mapped into several zones with daily pivot levels as the borderline between the up and down market zones. Often, the activity of floor traders induce market moves that fluctuate between S2 and R2 levels, using the daily average. The true range (ATR) is taken from its 21-day moving average as the measure.

From Figure 4, you can see that the market prices of the DAX futures overlap less frequently above the R2 level (R2-R5 zone) or below S2 level (S2-S5 zone). When it does, non–floor traders invade the market. These types of moves are usually short in duration and prices eventually return to the R2/S2 zone.

On November 11, 2004, the market opened with a slight gap down (around 10 points, or 250 euros), fluctuated in a trading range for about 30 minutes, and at exactly 9:40 am, took off from the low of this range. Once waves 1 and 2 formed, the price broke out of the inception trading range with a big bar and went on its way to fill the gap, simulta-
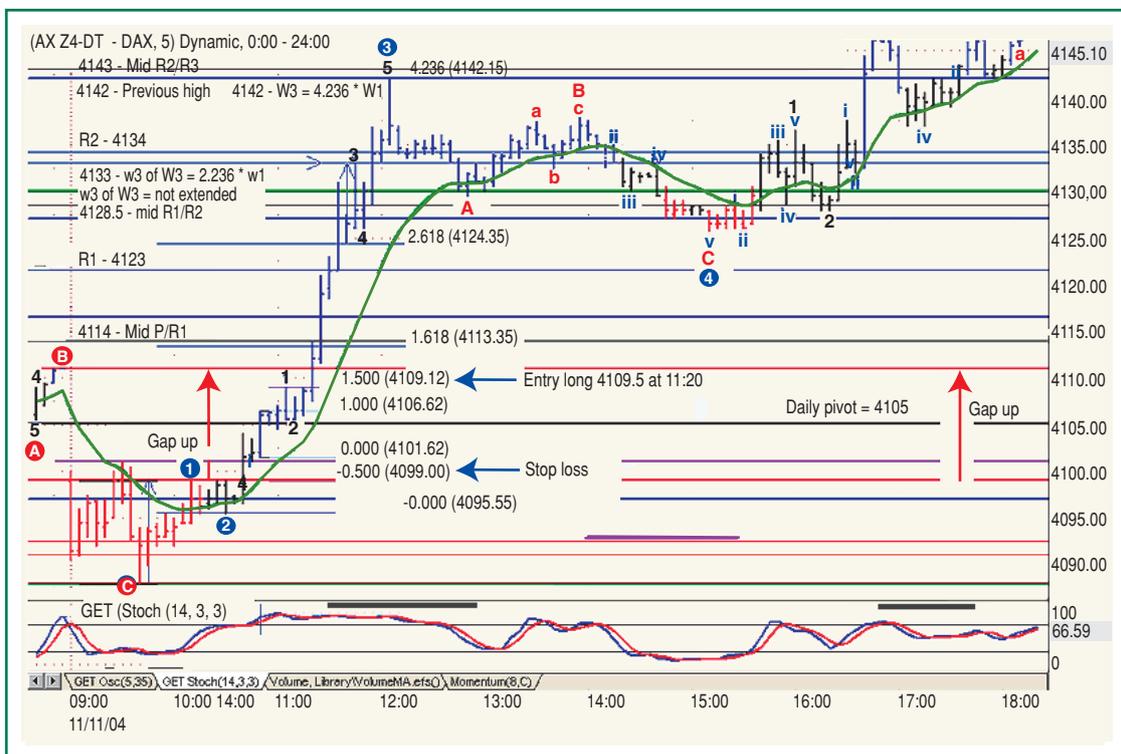
FIGURE 4: PIVOT POINTS. Pivot points can be used to calculate critical support and resistance levels. Here you see how these levels work.

neously developing wave 3.

Once W2 is completed, you should apply the wave 3 projections (1.618, 2.618, 4.236, 6.85), using wave 1 as the extension basis. The breaching of the daily pivot at 4105 takes place with a big upward bar (as a typical textbook example), and prices are on their way toward R2. At this stage, the market just changed from a downward to an upward bias.

At mid-P/R1 - 4114, one bar halted suddenly when the level was touched with its upper tail. The next bar pierces the midpivot level and hastily continued on its up move. Interestingly, the 1.618 * W1 level is 4113.5, or half a point away from the mid-P/R1 level. The R1 – 4123 pivot resistance level forced the incoming bar to close and served as a catapult for the low for the next bursting huge bar. Again, the textbook example applies to mid-R1/R2 – 4128.5 level. The market strength was so strong that the incoming bar that used the last pivot (R1) as a catapult traversed the interpivotal zone R1 – mid-R1/R2 during a single five-minute bar duration.

This bar gave us a vital tip. The accelerated piercing of 2.618 * W1 level (4124.35) meant that there was a very high probability that this market would reach the next Fibonacci 4.236 * W1, or go even higher to 6.85 ratios. This is so probable that you can bet that the non–floor trader's zone will be penetrated.

As you can see from the chart, this did indeed happen. Again, a huge bar traversed the R2 – 4134 pivot resistance level, and moved into the non–floor traders zone (R2 – R5). A detailed study of this wide-range bar reveals that the close is below its upper third, a sign that the market is waning.

Once you reach this level of trading, you are protected by

two stop-losses. One is a dormant price objective, at 4.236 ratios level – 4142 (profit nest). The other is a trailing stop-loss, at the 2.618 ratio level (4124.35) minus a tick to the current midpivot level (mid-R1/R2 – 4128.5).

When the R2 level is penetrated, you move on to the next target — mid-R2/R3 – 4143. Around this level, you have the 4.236 ratios at 4142, and the third all-time high of this contract at 4142. Once the market reaches 4142, your dormant price objective is attained. Sometimes it is better to establish this type of dormant price objective half a point or even a point before the projected value. It all depends on the type of market you trade and how familiar you are with it.

GAPS WITHIN THE TREND

Gaps express price pressure behind a new trend. They are frequently a part of the development of the Elliott wave 3.

Three types of gaps occur during this wave:
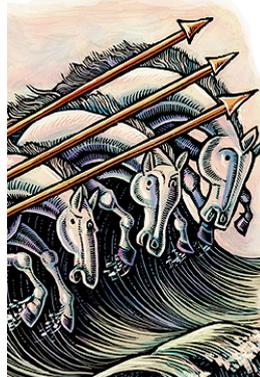
Breakaway gap: This type of gap tells you that prices have broken away from a pattern and are ready for a new trend. Like inception pullbacks, EMA crossovers, entry of stochastics into the overbought zone, and volume spike, a breakaway gap is the first sign of the commencement of a trend.

Breakaway gaps often form in

the process of breaking out of a trendline, an exponential moving average, or chart pattern. This type of gap is never filled.

Continuation gap: This type of gap occurs in the middle of the trend. You could say that it splits the third of the third wave in two parts. Its importance is that it may forecast the end of the trend, being just in the middle of wave 3. It may only be filled partially, thus becoming a very strong key level, or an area where you can add to your positions.

Exhaustion gap: This is a hallmark of the end of a trend. It is located on wave 5 of an impulse pattern. Compared with the two gaps mentioned before, and being part of wave 5, its volume is much lower. The exhaustion gap gets filled after the reversal once the two- to four-base trendline is broken. The duration of the formation of wave 5 should be greater than the duration of the price drop that breaks this trendline.

Strategically, it is an excellent signal for someone who establishes very tight stops and waits for the reversal bar. The occurrence of a divergence is a confirming factor, thus forcing you to exit.

HOW IT WORKS

Now that you know the ins and outs of wave 3, how will you use it for your trading? Next time, I will walk you through a trade using the techniques I discussed in parts 1 and 2.

Mircea Dologa began his investment and trading career in 1987. As a Commodity Trading Advisor, he subsequently founded a new teaching concept based on the practical aspects of trading.

SUGGESTED READING

Dologa, Mircea [2006]. "The Third Wave," *Technical Analysis of* STOCKS & COMMODITIES, Volume 24: May.

†See Traders' Glossary

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