Riding the Waves

Applying Elliott Wave Theory to the Financial and Commodity Markets

By Robin Wilkin, Global Head of FX and Commodity Technical Strategy, JPMorgan Chase

JPMorgan has been providing Elliott Wave-backed analysis and strategies for our client base since the 1980s, when David Murrin started the technical division. My former colleague Jordan Kotick gave an excellent introduction to the Elliott Wave principle in Alchemists 40 and 41. This article shows how we at JPMorgan apply this theory to developing winning trading strategies for the metals and financial markets.

"A successful trader needs to have an edge" is a phrase that you have probably come across before. Ours is the Elliott Wave principle, as it lets us piece together the global market jigsaw and provides a probability framework as to when to enter a particular market and where to get out, whether for a profit or a loss.

As Jordan pointed out, the Wave Theory is not for everybody: many have tried and failed. The author and technical trader Connie Brown sums up the reason very well: "Traders/analysts can be 'Wave Deaf'. In much the same way that you can teach a person how to read music and the right keys on the piano, when you put a piece of Beethoven in front of them they can't make it sound right." Elliott Wave is therefore a blend of science and art. The distinguishing factor between a good and bad Elliotician – or any technical analyst for that matter – is their ability to correctly interpret.

We live in a world where a large proportion of the speculative risk is placed by the same player across a variety of markets; therefore, even those markets that are not normally correlated can briefly become intrinsically linked. For example, a sharp move in Emerging Markets can often trigger a move in metals, as players look for either a safe haven for their money or – more often than not – need to book profits to offset losses on a surprise move elsewhere. So if we can see the potential that a big C Wave washout or 3rd wave will develop in one market, that often gives us a clue as to what will happen in others, and we can gradually fit the entire jigsaw together. While a strong wave count can always be relied upon, we rarely look at an individual market in isolation.

Most manuals show you how to trade a 5-wave sequence, which is pretty straightforward, except during correction phases, when trading becomes a little trickier and the inexperienced and ill-disciplined trader can lose a lot of money. For this article, we will use the gold market at the end of 2004/beginning of 2005. The market had developed a significant base in 1999 at $251, and had arguably already seen a strong 3rd-wave rally. We believed early on that a 5-wave sequence was developing to re-test the 1983 and 1987 highs at $500/$510, and in that regard a decent 4th-wave correction was due.

The Triangle

For anybody familiar with technical analysis, the triangle is probably one of the easiest patterns to spot, especially towards its maturity stage. Triangles in Elliott Wave are a series of five contracting waves of three. Whereas the normal technician generally has to wait for the breakout (up or down) to occur to confirm the direction and provide a trade signal, Elliotticians have the opportunity to buy into Wave E with confidence that a return to trend will occur, and soon. An interesting development in recent years is that Wave E more often than not has been truncated (especially in the FX markets) and never manages to reach and test the bottom of the triangle.

Chart 1– The triangle support

In this instance, the triangle support in gold was coming in around $415 and the low in Wave E was $419 (Chart 1). This is our best risk/reward trading opportunity, so stops were placed under Wave C ($414). We were then looking for a 5-wave rally to confirm a return to the underlying trend (Wave 5), which is in fact what happened. Even if you had missed Wave E, we had a perfect 5-wave advance through the top of the triangle, followed by a classic 3-wave (abc) pullback, which re-tested the original triangle top at $430, giving another strong risk/reward buying opportunity.

What was sentiment at the time? After basing out around $251, the gold market had been in a very strong bull phase, and this was one of four major corrections – the other three being from $340 to $254 (an almost 100% 2nd-wave pullback), $389 to $319 in 2003 and $430 to $371 in 2004, which formed the basis of a long-term channel (Chart 2) that provided additional support for a bullish outlook. But because the triangle took quite a while to play out, traders started to get jittery about whether the trend was over and the market was actually starting to build a top for a much deeper decline and hence sentiment had changed and long positions where reduced with some players going short.

Chart 2 – Long-term channel

In the early stages, even the Elliotician could not really know how the correction would play out. We firmly believed that the bull trend that had started in 1999 was going to re-test the $500/$520 previous highs and that the declines were corrective, but corrections can 'mutate', and are therefore very difficult to trade. The key to trading with Elliott successfully is to always remember that it may take a few attempts to pick a turning point – and therefore not to get overly piggish in your positions during a correction phase (remember the old adage: "bulls win, bears win, pigs get slaughtered"). Because the risk/reward ratio is so high, when your winning trades kick in, they will far outweigh a few small losses.

Back to our scenario: by the time Wave E was in play, we knew a triangle was developing. Even if you missed it, the pullback to test the breakout zone offered another buying opportunity. Looking for confirmation of a bullish scenario from correlated markets, silver and platinum had similar corrective processes playing out and lent support to this view (Charts 3 and 4). However, our favourite supporting factor came from the HUI (or gold bug stock) Index, which is great for pre-empting future moves in gold.

Chart 3 – Platinum correction

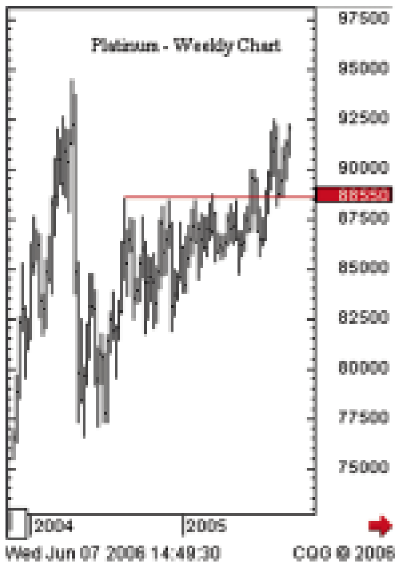
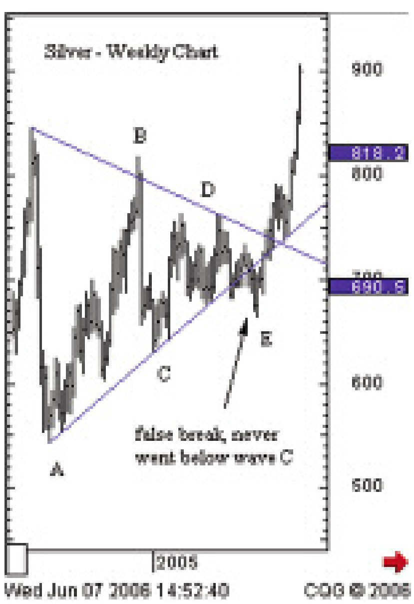


Chart 4 – Silver correction

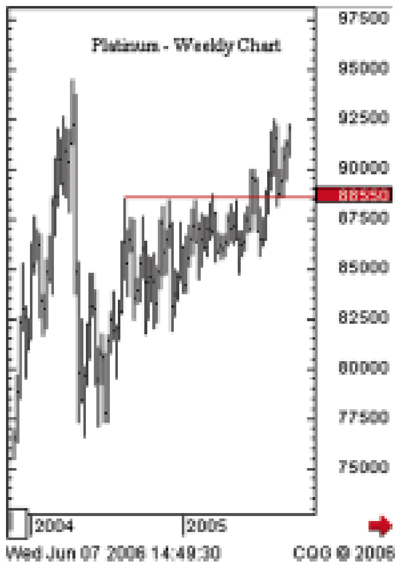


A Breakout for Bulls

Once the breakout occurred from such a major consolidation phase, we knew we were heading back into bull trends for metals – for gold towards the $500- $515 highs – which brings us to our next key correction process from $480. A long-term trader could just sit back and hold onto longs until the $500/$520 target is met, but they often suffer larger drawdowns, which can be painful. The correction from $480 to $455 would have been one – over a 20% drawdown in this position's p/l.

We doubted that prices would race straight to and through $500, as it was such a key psychological resistance zone. We also believed a 5-wave rally had developed after the triangle breakout (remember that Wave 1 was from $419 to $450, then a 2nd-wave pullback re-tested the breakout point at $429, then there was an aggressive 3rd-wave move to $480).

Chart 5 – Failure high and expected correction



We therefore suggested traders should beware a decent correction before $500 was tested and broken. The failure to extend through $480 and the subsequent pullback through $470 confirmed that to be a failure high, followed by the expected correction (Chart 5). This developed into an equal swing low at $460 (which in the chart is labelled Wave a). At this point you might suspect that the correction was too short, but it was a clear 3-wave decline and could easily have just turned around and rallied to our $500-$515 target, and was our first buy entry signal. So we went long around $461.

Chart 6 zooms in to the intra-day time frame and helps explain how corrections mutate.

Chart 6 – The intra-day timeframe

The market rallied nicely at first, then stalled around $473/$475. It was a tough call whether this was Wave 1 of a new bull phase to our medium-term targets, or a B wave. At this point, the trader has to decide what timeframe to use, as a shorter-term player might have thought Wave 1 or B had finished and some profits should be taken. I firmly believe that the shorter the timeframe, the more the wave counts can become cloudy, and the greater the margin of error. At the time we were bullish, and if the correction from $475 was going to be a shallow 2, we probably would not have bought back any partial profit taken in the $473- $475 area and missed our core opportunity.

We preferred to give the move the benefit of the doubt, but under the rules of Elliott, the market cannot go back through the Wave 1 low at $460, so we put stops under that level. The pullback should really have been limited to around $465, but when another sell-off started in early November 2005, we felt something was wrong. Indeed it was, as our stops were hit at 459.50, which only cost around $2, but felt worse after having been up $14 – welcome to the wonderful world of wave trading. However, to us that did tip the market's hand, as it became clear that $480 to $460 was Wave A and we were now in a C-Wave decline. We could draw in a bear channel and project down a target area for Wave C. More often than not, Wave C equals the length of Wave A, which in this case was $20, giving us a $455 target. That just so happened to be our channel base, and was exactly the 50% Fibonacci retracement to boot.

Once a correction is seen to this zone, the wave trader should be at his most confident and aggressive, having a clear entry zone and being able to place a pretty close stop as well. The market based and rallied in five waves back to channel resistance. This time around we were far more bullish and believed we were moving into the underlying 5th wave, which itself breaks up into 5 waves. So with Wave 1 (of 5) now in place, we knew that an aggressive Wave 3 was coming up and put out a report on Friday afternoon suggesting that $500+ would be seen the following week. I remember the timing distinctly, as early on Monday morning a trader from another bank rang up our trading desk and asked if the JPMorgan technical strategist was on drugs.

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Not only did we reach our $500-$510 target (originally expecting the old highs to be marginally breached), but the rally accelerated, and the rest is history.

Will the Bubble Burst?

What of our old long-term bull channel? That was the reason we realised that the market was going to accelerate further in the months ahead and that we were not finishing a 5-wave sequence, but rather seeing a major 3rd-wave extension – and therefore raised our targets. Something to bear in mind is that when a market breaks through a bull or bear channel in the direction of that channel, the price action often goes parabolic.

As we have seen, Elliott Wave can not only highlight key turning points in the markets, but also some of the pitfalls that can be encountered, especially in corrective phases. What about today's markets – has the bubble burst in metals? In the short term, yes, but we doubt it in the long run. The market has topped out pretty much on the 78.6% retracement zone at 722, but we are now approaching important Fibonacci support in the $608 to $570 region. We also suggest keeping an eye on the HUI Index for an early heads-up of a turn – or not. ■

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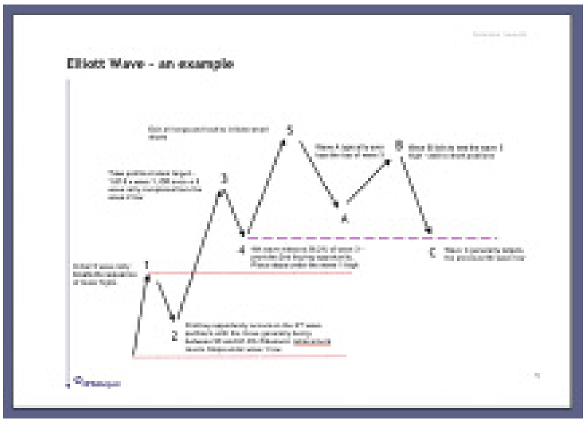
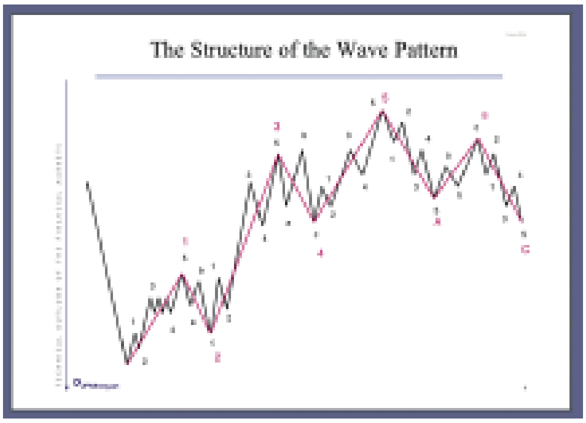
Diagrams of Elliott formations





Elliott Wave in Brief

The Theory – Trends develop in waves of fives and threes. Waves 1, 3 and 5 are in the direction of trend. Waves 2 and 4 are corrections within that process.

Once a 5-wave sequence completes, the market develops a 3-wave correction of the entire move, which we label Waves A, B and C (there are more complex counts in corrections, but for ease we will keep to ABC).

Positives – It filters out high and low probability trades in the markets. It provides an exact framework for entry, stop and profit levels. It can highlight triggers in other markets and fit together the Global Market Jigsaw.

Pitfalls – The shorter the timeframe, the higher the margin of error. Contrary to popular belief, trading the 4th wave can cost you a lot of money. Corrections can 'mutate' and make you look/feel stupid and – of course – cost you money.

The Second LBMA Assaying and Refining Seminar

28-29 November 2006
Armourers' Hall, London

Following on from last year's event, the seminar is designed principally for refiners on the Good Delivery List and others interested in the technical aspects of the assaying and refining of gold and silver bullion.
Suggestions for topics to be included would be welcome – please contact the Executive.