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The Elliott Wave THEORIST

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INTERIM REPORT

The Stock Market

The stock market has been in an upward correction for over two months. Evidence is quite strong that the rally is over.

Form

Wave 1 down was a rollicking wave, in which wave iii, the so-called “flash crash,” fulfilled its third-wave role of being “strong and broad” (text, p.80) relative to the other waves in the sequence. Wave v had less downside momentum than wave iii, as is normal.

Wave 2 counts well in the Dow as a double three, subdividing flat-x-zigzag, labeled w-x-y, as shown in Figure 1. *Elliott Wave Principle* (Figure 1-48) depicts this form within a bull market. The S&P counts better as an expanded flat (see text, Fig. 1-36), per the labeling shown on the “Alt.” line and in the Short Term Update.

Long-time readers may recognize that this is the same pattern the Dow traced out between August 25 and October 2, 1987, as shown in *The Elliott Wave Theorist* the day before the Crash of ‘87 started. Wave 3, the next event, will be a powerful decline.

Elliott Wave Principle (p.68) explained that when a fifth wave is extended, the ensuing correction typically carries back to the extreme “of wave two of the extension.” Although wave v in this case was not longer than wave iii, it clearly subdivided as an extension. The dashed line in Figure 1 shows that wave 2 has carried right to the peak “of wave two of the extension,” labeled wave (ii). The two Dow readings are 10,719 and 10,720.

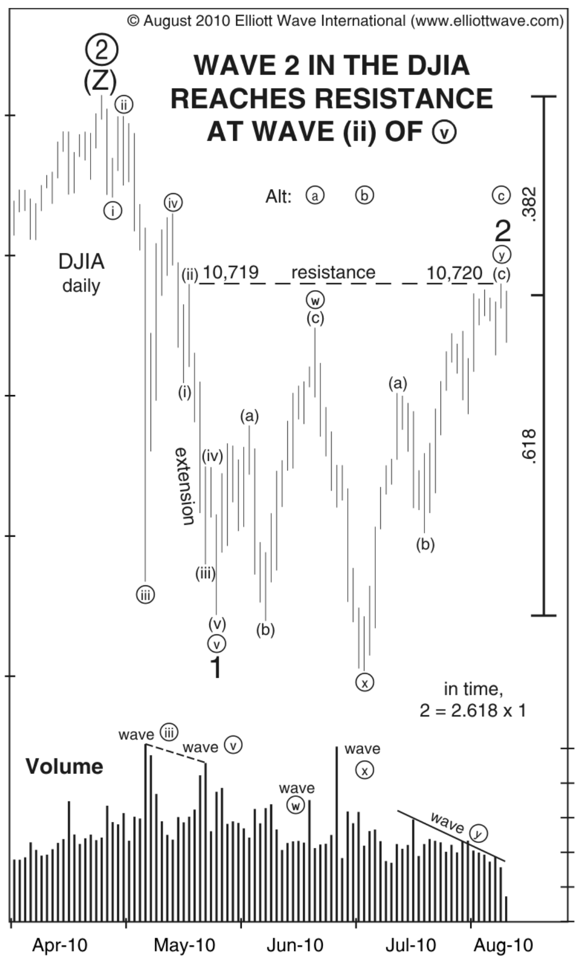

Figure 1

Price

Wave 2 has retraced 63.7% of wave 1 on an intraday basis and 58.9% on a closing basis. These ratios center around **61.3**%, approximating the Fibonacci ratio.

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Time

On an intraday basis, wave 1 down lasted 29 days, and wave 2 up has lasted 76 days, for a time ratio of **.382**, or ϕ^2. On a closing basis, the ratio is 30/75, or **.40** (**2/5**). In other words, wave 2 has lasted **2.618** times as long as wave 1 on an intraday basis and **5/2** as long on a closing basis.

Technical Features

Volume has behaved according to the wave interpretation. As shown in Figure 1, it reached its highest level in wave iii, peaked at a lower level in wave v, was lighter in wave w (or a), peaked again in wave x (or b), and has persistently slackened in wave y (or c). This behavior is entirely consistent with the upward correction as we label it.

The July-August rally is taking a wedge shape, especially in the S&P and NASDAQ. Wedge shapes are usually terminal. Times when they are not are resolved with huge breadth and volume in a continuation of the trend. A surge of that type is the only thing that can rescue this market from a downside reversal.

The U.S. Dollar

The U.S. Dollar Index presents nearly the same picture, inverted. Wave 1 traced out five waves, which I found no trouble counting in real time. Wave (1) in this case was the extended wave. It is only the second time in my career that I recall seeing an extended first wave large enough to be discernible on a weekly chart. The other one occurred in the DJIA in 1975.

Elliott Wave Principle (pp.67-68) explains exactly where the ensuing correction should carry in this situation:

> [I]n a clearly reasonable modification of the guideline, it is often the case that if the *first* wave in a sequence extends, the correction following the fifth wave will have as a typical limit the bottom of the *second* wave of lesser degree.

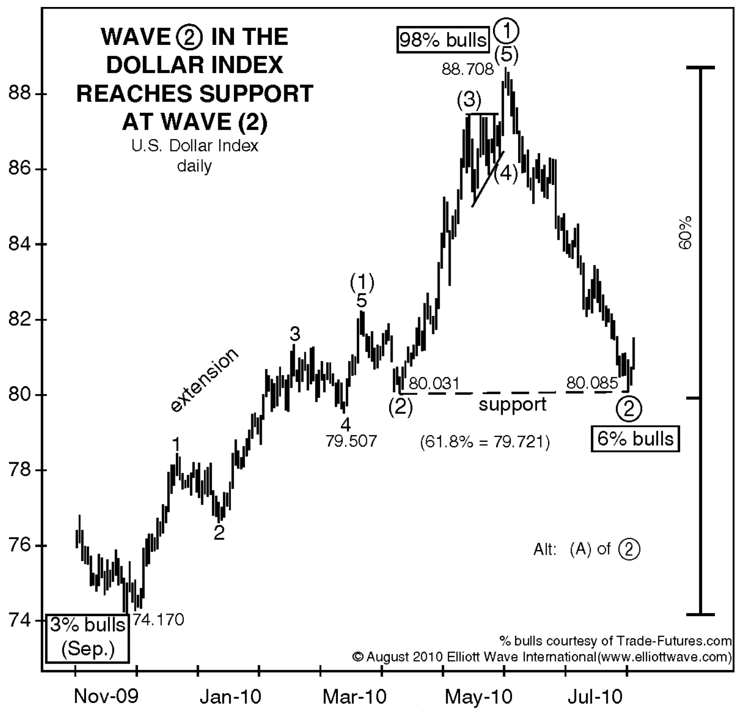

Figure 2

As shown in Figure 2, wave 2 has carried back almost precisely to the low of wave (2). The two readings are 80.031 and 80.085. In attaining this target, wave 2 has retraced 59.3% of wave 1, close to a Fibonacci **3/5**.

Naturally, traders once again are bearish on the dollar. As the dollar in the past nine months went from low to high to low, Trade-Futures' Daily Sentiment Index—a poll of traders—has recorded extremes of 3%, 98% and 6% bulls, respectively. Given the latest reading alone, it's probably time for wave 3 to begin.

The alternative possibility, noted on the bottom of Figure 2, is that this low is only wave (A), in which case waves (B) up and (C) down would be required to finish the pattern. Any such wave (C) would not likely carry more than slightly below the recent low, per the 61.8% retracement level noted on the chart. Since the Dow and the dollar have reached wave-two extremes simultaneously, it is much more likely—in concert with our All the Same Market thesis—that they are turning together now.