FOREX FOCUS

Access to foreign exchange trading has opened up exciting trading options for the retail trader. You can now trade alongside corporations and institutions in a highly liquid market that is global, traded around the clock, and highly leveraged. Before jumping into this market, however, we must understand the factors that affect the forex market. With that in mind, STOCKS & COMMODITIES *has introduced* ***Forex Focus*** *to better prepare the retail trader to participate in the currency market.*

Profiting From The Gartley

By identifying advanced patterns in markets about to reverse, you can get a better idea when and where the next five-wave trend could emerge.

A distinctive and recognizable pattern occurs in the early stages of an emerging trend. Being aware of such a pattern can help you position yourself for the pending move. This article will detail the characteristics of that pattern, the *symmetrical price legs* contained within it, what the price implications may be, and how a trader can identify and profit from this powerful pattern, referred to as the *Gartley* pattern. We will also delve into Elliott wave theory to further substantiate the symmetrical price swings that accompany Gartley patterns and their relative location to the market trend.

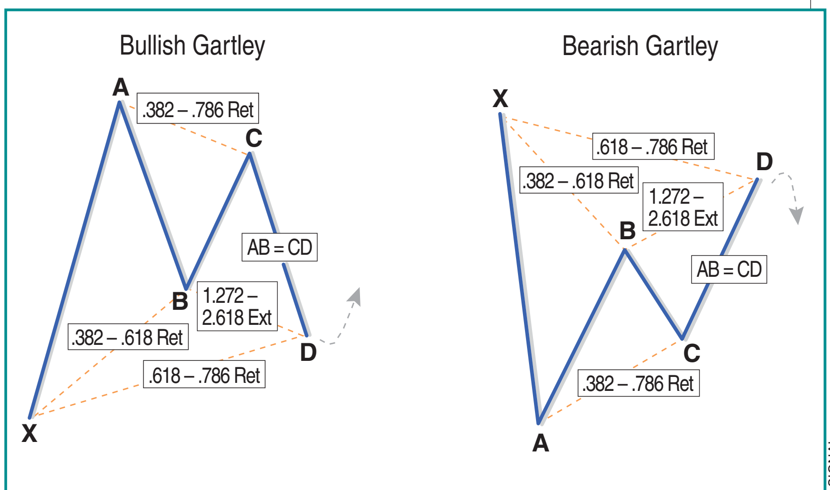

FIGURE 1: BULLISH AND BEARISH GARTLEY. Following the four legs and being aware of the corresponding Fibonacci ratios gives you an idea of where the trends correct.

THE GARTLEY PATTERN

H.M. Gartley first introduced the pattern in 1937, but it wasn't until the late 1980s, when trader Larry Pesavento assigned expected ratios to the four legs of the pattern, that its use became more widespread.

Essentially, the Gartley pattern uncovers the market's tendencies to take advantage of the trend-following crowd. Unknown to the trend-followers, Gartleys frequently appear at critical reversal levels. They begin to take shape in the consolidation zones following an extended trend and will often bait latecoming trend-followers into the market, to their dismay.

The key to this pattern, which will also help us pinpoint our relative location within the current trend, is the symmetry of neighboring price swings. The symmetry of price swings has been observed and traded in the markets since the earliest days of technical analysis.

by Todd Gordon

FOLLOWING THE GARTLEY

First, let's explore the four legs and corresponding Fibonacci ratios of the Gartley pattern. Examine the bullish Gartley in Figure 1 on the left-hand side to understand how they unfold. As you go along, note the required Fibonacci ratios for each leg that make this pattern complete. After an extended downtrend, price explodes higher in leg X–A, labeled as short-covering in the longer-term downtrend by the trend-following crowd. To align themselves with the trend, they begin reshorting the market as leg A–B unfolds. Low-point B sends the market slightly higher in minor retracement leg B–C, which (in the minds of the bears) is a golden opportunity to pick up some cash before the market breaks to new lows.

As soon as the market has pulled all of the latecoming shorts into their positions, the real buyers who originally reversed the market at point X jump back into the pit to buy at point D. The saturation point of sellers at leg C–D is often the same distance as leg A–B, which creates the symmetrical support level for the bullish Gartley.

The buying sends the late shorts running for cover, as well as the fresh longs into the market. These longs have been waiting patiently on the sidelines for a solid entry level. The combination of short-covering and fresh long interest creates long powerful trends that can often reverse a daily or weekly trend over the course of just a few days.

GARTLEY AND ELLIOTT

Now, it just so happens that at the same time H.M. Gartley was introducing his pattern to the charting world, Ralph Nelson Elliott began labeling stock market trends in waves of threes and fives. Modern-day chartist Robert Prechter, interpreting Elliott's work, stated that there are generally two situations where price legs can have a symmetrical relationship: trend phases and corrective phases. The basis for Elliott's work is that impulse, or trending, markets move in waves of 5, while corrective market phases often show waves of 3. Symmetry often occurs in the first- and fifth-wave positions of trend, and the A and C waves position of an A-B-C correction. You should see the similarity of the Gartley pattern's three-wave push lower preceded by a strong push up, and Elliott's three-wave A-B-C corrective move lower.

Further, in A.J. Frost and Prechter's classic *Elliott Wave Principle*, the guideline of alternation suggests: "If wave two of an impulse is a sharp correction, expect wave four to be a sideways correction, and vice versa." It goes on to say, "[Sharp corrections] are almost always zigzags (single, double, or triple) … and sideways corrections include flats, triangles, and double and triple corrections."

Further, "A triangle always occurs in a position prior to the final actionary wave in the pattern of one larger degree, that is, as wave four in an impulse, or wave B in A-B-C …" This notes that triangles, which can in no way be confused with Gartley patterns, or comparing to Elliott's zigzags, occur most often in the fourth wave of a five-wave impulse move, as well as the B wave of an A-B-C correction. The B wave on Elliott's A-B-C corresponds to the B-C leg of the Gartley example in Figure 1. It would be very difficult for a five-pointed triangle to occur in the B leg of a correction, so we can now default to a zigzag, and potential Gartley, in corrective wave 2. Following wave 2 is wave 3, and according to wave theory, wave 3 is the strongest and powerful market environment.

FINDING GARTLEY

Let's explore the specifics of how to spot a Gartley, and what to expect in the way of trade parameters. A Gartley pattern should become evident when leg C–D of the bullish Gartley approaches the projected absolute distance of leg A–B in the vicinity of leg X–A's required retracement levels of 0.618 or 0.786. Once you identify this zone of support, a partial position can be initiated with stops below the lows of point X. The remainder of your position can be initiated once the resistant lows at point B are cleared, and your stop for your entire position can then be moved to just below point D. The initial profit is the 0.618 retracement of leg A–D and the ultimate target is the distance of the previous wave 1 projected up from the low point D, which becomes the minimum target of wave 3.

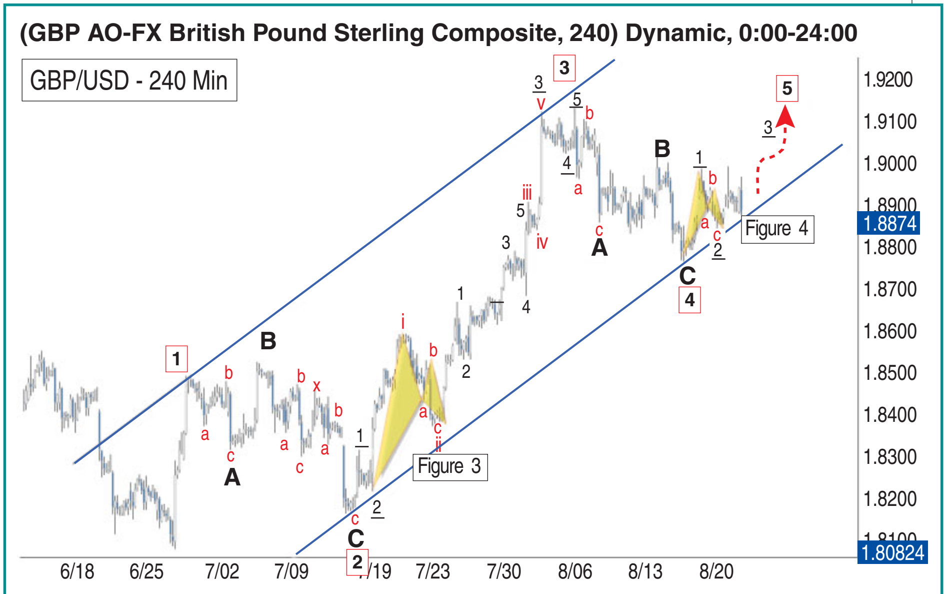

FIGURE 2: GARTLEY SETTING WAVE 3 INTO ACTION. On this 240-minute chart of the GBP/USD, you can see two occurrences of the Gartley setting wave 3 into action.

Let's look at the two highlighted examples of a Gartley setting wave 3 into action on the same 240-minute British pound/US dollar (GBP/USD) chart (Figure 2).

Even more powerful than a regular wave 3 is a third wave contained within wave 3. For our first example, let's take a look at a third of 3 that was started by a bullish Gartley. Note this chart corresponds to Figure 3.

The 16-point buy zone was created from the 0.618 retracement of X–A at 1.8368, the 1.0 projection of A-B-C-D at 1.8381, and the 1.618 extension of B–C at 1.8384 on this 240-minute chart. Price tiptoed across the top of the buy zone before the wave 3 of 3 all kicked into gear. Price climbed nearly 800 points in one week after 35 points of initial risk.

The second example (Figure 4) is a trade that was recently closed out. Wave 3 within the larger fifth wave appears to have just gotten under way. A tight 15-point buy zone triggered us long sterling at 1.8865 before price found resistance 134 points higher at wave 1 highs of 1.8999.

The jury is out on this wave 3 because we failed at the highs, but it doesn't matter if our wave count is correct. We identified symmetry between legs A–B and C–D after an extended downtrend, which offered a powerful long entry with a small 35-point stop-loss. Our potential reward was almost four times greater than our original risk at wave 1 high resistance, so the trade was certainly worth the risk.

Identifying price legs can help you uncover a pattern and keep you out of trend-following traps.

COUNTING WAVES

The identification of symmetrical price legs can not only help you uncover a classic reversal pattern that has been in existence for more than 70 years, but it can also keep you out of the trend-following trap that so many traders fall into. For those counting waves out there, look closely for symmetrical relationships and you'll find that labeling the waves will be much easier.

Todd Gordon is a currency strategist at FOREX*.com, a division of* GAIN *Capital Group. He produces "Strategy of the Day," a technical report that identifies price trends and trading opportunities for the major currencies and crosses.*

SUGGESTED READING

Frost, A.J., and Robert Prechter [1985]. *Elliott Wave Principle*, New Classics Library.

Gartley, H.M. [1981]. *Profits In The Stock Market*, Traders Press (reprint from 1935 original).

Gordon, Todd [2005]. "Are Fibonacci Levels Leading Indicators For Forex?" *Technical Analysis of* STOCKS & COMMODITIES, Volume 23: October.

Pesavento, Larry [2000]. *Profitable Patterns For Stock Trading*, Traders Press.

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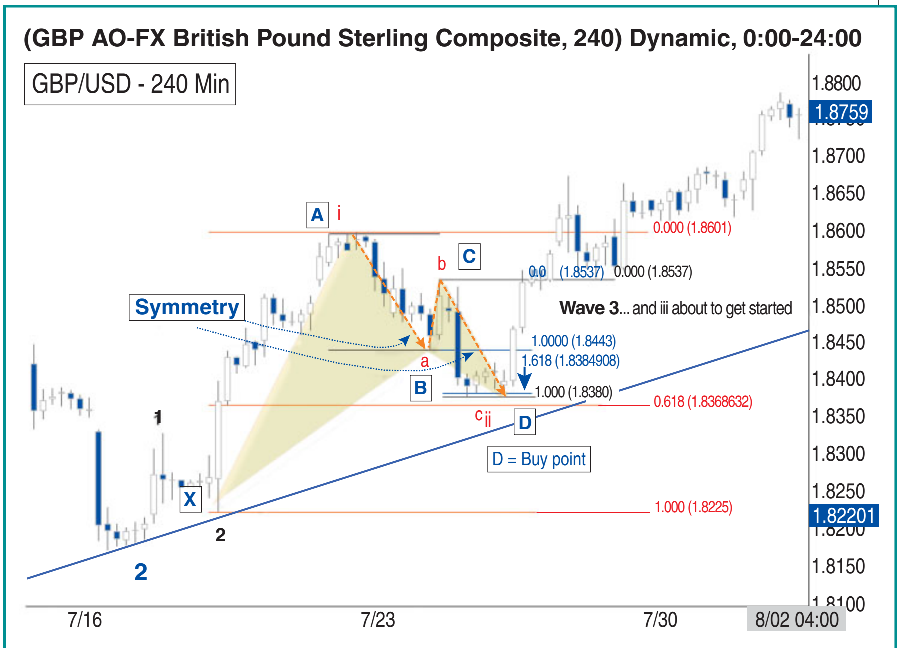

FIGURE 3: THIRD WAVE WITHIN WAVE 3. Although prices paused at the buy zone, once the third wave kicked into gear, prices climbed about 800 points in one week.

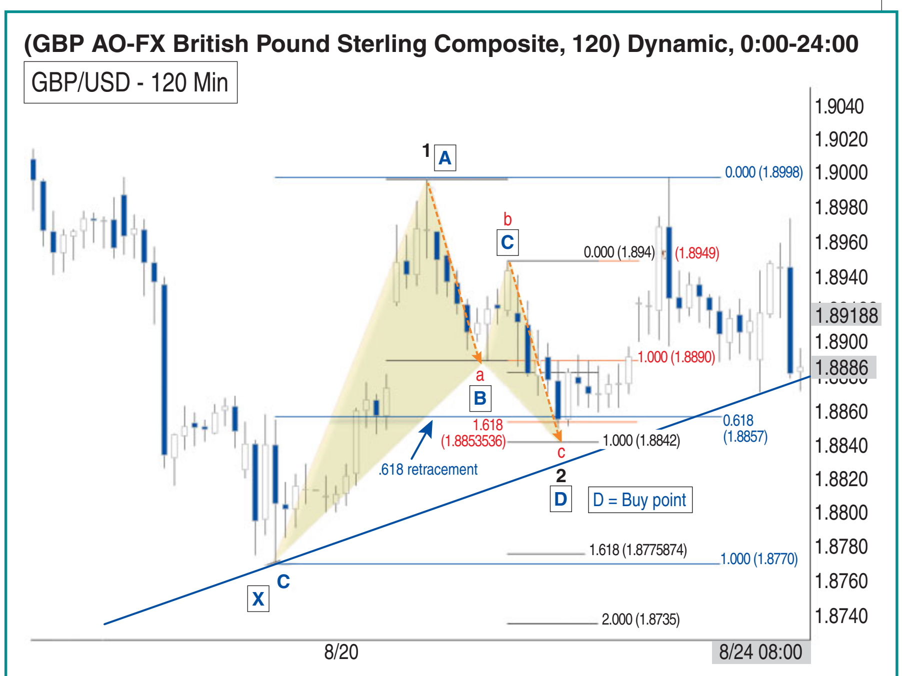

FIGURE 4: THIRD WAVE WITHIN WAVE 5. A long position was entered at 1.8865. Prices hit a resistance level at 1.8999, which is the high of wave 1.