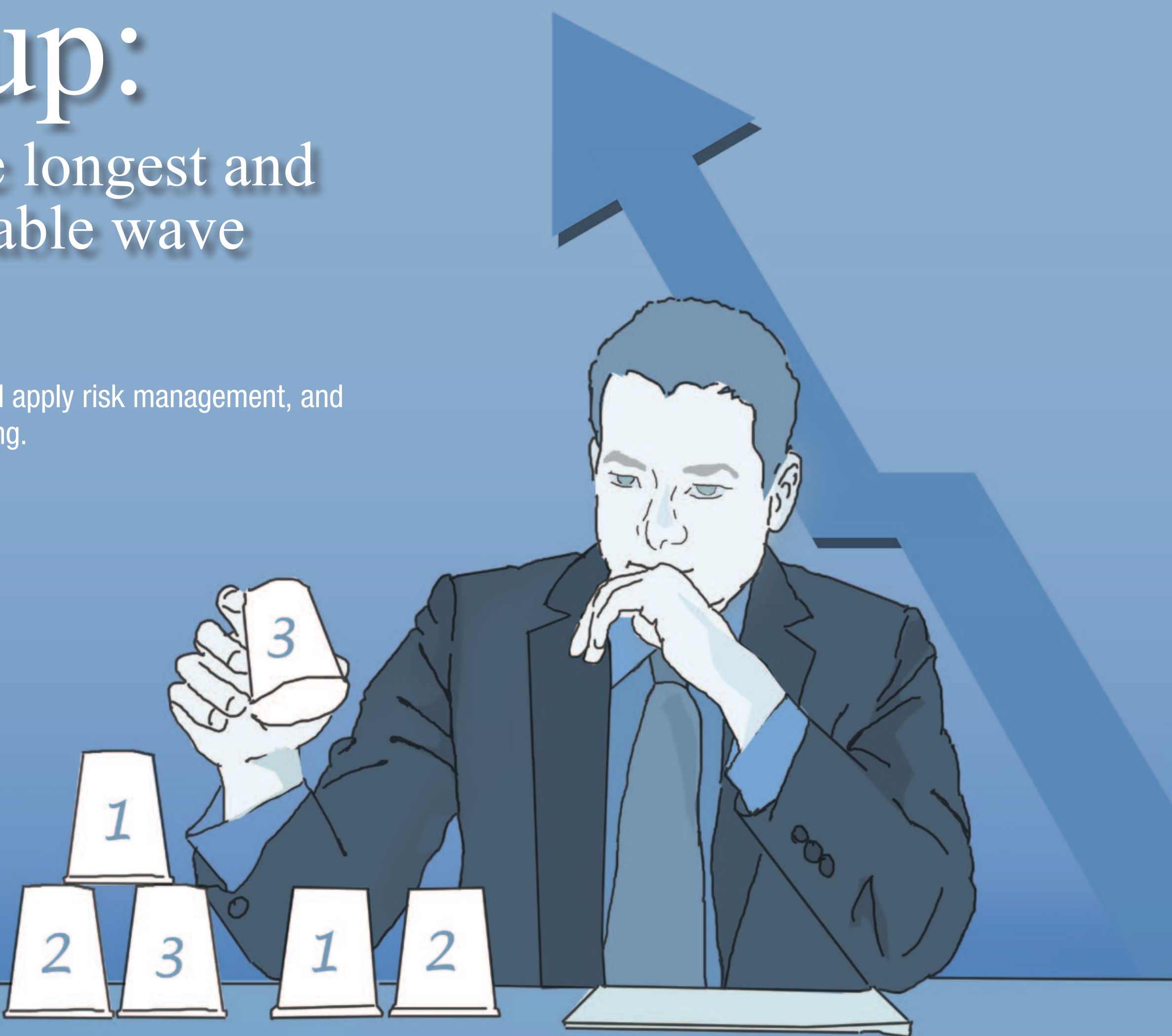
1–2–3 Reversal Set–up:

Capture the longest and most profitable wave

By Soh Tiong Hum

Recognize the set up and apply risk management, and you will succeed in trading.



The 1–2–3 Reversal Set–Up is a popular and effective trading set–up used by professional traders. This setup combines high reward–risk proposition, clear entry signal with the potential for the user to capture the third wave of an impulsive wave movement. The latter is frequently the meatiest wave that carries the most profit. Recognize this one set–up, apply risk management diligently and trading success is definitely within your grasp.

For the rest of this article I shall label the 1–2–3 Reversal Set–up the '1–2–3'. It is a natural outcome for technical analysts or chart readers who apply two principles in Technical Analysis, the Elliot Wave Principle (EWP) and Fibonacci Numbers (Fibs).

ELLIOT WAVE AND FIBONACCI GEOMETRY

The Elliot Wave Principle was discovered by Ralph Nelson Elliot in the late 1920s. He observed that stock markets moved in repetitive cycles that reflect the psychology of market participants. Simply said, price moved in waves. EWP was popularized by Frost and Prechter in the 1970s. The gentlemen published a book in 1978 where they predicted the great bull market in the 80s and Robert R. Prechter went on to predict the crash of 1987 as well as pinpoint the exact high.

Ralph N. Elliot's analysis on wave properties also led him to observe that the numbers in the Fibonacci sequence appeared repeatedly in Elliot wave structures.

In today's trading context, EWP and Fibs are widely applied by traders and technical analysts despite opponents and critics of the techniques. In terms of applicability and flexibility, their application has spread beyond the stock market into the world of trading commodities, forex and derivatives.

PREMISE FOR 1–2–3

Before we look at the 1–2–3, we should have a simple understanding of EWP and Fibs. These concepts are sufficient for traders who wish to apply them in an expedient way for trading. Others with a scholarly bent can delve into literature by Elliot, Frost and Prechter.

1. Prices travel in trends on one hand and corrections or sideways movement on the other.
2. Trends show the direction of price while corrections also known as retracements represent periods of profit taking or consolidation.
3. In other words, price move in a zigzag manner that are represented in charts.
4. Waves can happen within waves that

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is to say that if we break down a wave on the daily chart into hourly or even lower time intervals, more wave structures appear.

5. Retracements of a trend are likely to follow these percentages, 23.6 per cent, 38.2 per cent, 50.0 per cent, 61.8 per cent, 76.4 per cent and 100.0 per cent
6. After a retracement, the next trending wave is likely to move in an extension following these percentages, 138.2 per cent, 161.8 per cent, 200.0 per cent, and 261 per cent.
7. Although no studies have provided definitive levels that retracement or extension can go to, inspection of candlesticks can help to provide clue to market sentiment when prices reach these anticipated levels.
8. Lastly, concepts of chart patterns, trendline and horizontal support and resistance levels complement Fibs very well.

READY, AIM, CLICK

Now that we can put the theory aside, let's look at the trading.

First, let's form our trading plans.

Plan A. Use the 1–2–3 to identify major market tops or bottoms in order to trade the reversal.

Plan B. Look for 1–2–3 on a lower time frame at the end of a corrective wave in order to enter the start of a trending wave.

Regardless of which plan you intend to trade, the following rules will guide you:

1. 1–2–3 identifies a reversal; a bearish reversal is marked by a lower high whereas a bullish reversal is marked by a higher low.
2. The lower high in the bearish reversal complies to the Fibs; bearish candlesticks give us the sell signal as well as stop level.
3. The higher low in the bullish reversal complies to the Fibs; bullish candlestick patterns give us the sell signal as well as the stop level.
4. After a trade has been placed, take profit target can be determined by Fibonacci extension levels. Profit can be taken in part or entirely at any of these levels.
5. Some fibs are better than others. When multiple technical levels coincide in what we call a confluence, that price or price range becomes a strong level. Fibonacci levels that has confluence with other support and resistance are strong than those with none.

It is entirely possible to trade using a single set–up. It is important to master the set–up by recognizing the conditions when it works best, when it might fail. Lastly, the trader owes it to himself to check the reward–risk proposition of the whole set–up. In this respect, the 1–2–3 is irresistible. And like any other good set–up it has the "must–have" criteria of entry signal, stop level, and exit target.

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