Understanding the Three Phases of Every Market and the Best Trading Strategies for Each

Trading Advice for Today's Difficult Markets

An Interview with Glenn Neely, Founder, NEoWave Institute

Transcript

Interviewer: Today we're speaking with Glenn Neely, who is internationally regarded as an Elliott Wave innovator and creator of NEoWave. Today, we'll discuss the three types of market activity, the type of market analysis that is best for each phase, and specific trading strategies for the current market phase. In our previous interview, we talked about predictability and unpredictability. Glenn, can you refresh our memories regarding this topic?

Glenn Neely: On the previous chart, which can be found on the NEoWave website, we talked about the three phases of market predictability. Specific Predictability occurs between the beginning or end of any large to medium-size Wave pattern.

As you move away from the very first to last Wave of a pattern you go into a period where you can generally, but not specifically, predict what's going to happen. In this phase of General Predictability, you can say a trend is up or down, but you're not going to know exactly how it will go up or down.

In the middle of a formation, especially in the middle of a consolidation, you reach the Unpredictable phase – you might not be able to say whether the market will go up or down or how much it will go up or down. It could be extremely random, and it's a dangerous time to trade. That's a brief overview of what we talked about in our last interview. Today we'll talk about how this connects to the different phases of market activity.

Interviewer: Right now, it's my understanding that we're in a highly unpredictable phase in a 20-year correction.

Neely: That's correct. We're just passing the dead center of a 20-year consolidation. Back in 2000 when I first talked about the market going into a 20-year correction, people thought I was out of my mind. It's already been 10 years, and we clearly are nowhere near the end of this overarching bear market. There is no end in sight with the problems, international turmoil, and banking turmoil that have been going on.

Interviewer: We talked about how we're in a highly Unpredictable phase, plus there are three phases of market activity. Please give us an overview of the three phases of market activity: (1) Bottoming/Topping, (2) Accumulation/Distribution, and (3) Trending (up or down).

Neely: The three phases of market activity directly correlate to the Specific, General, and Unpredictable phases of markets. The top and bottom phase of a market is obviously when a market is making its highest high or its lowest low. This tends to be a brief period, and is typically associated with hyperactivity or panics and a lot of media coverage. The high in February 2000 and the low in March 2009 are examples of these extreme public-participation and high-media-interest events.

If you're at the end of an expanding environment, picking a market top or a market bottom can be very difficult – but it can be extremely profitable if you're right, because this can produce a lot of return on capital very quickly. But it's one of the most dangerous trading activities, and it can produce repetitive losses. For example, a trader may think the market is topping and keep trying to pick a top. But it turns out he's wrong, and keeps losing over and over. It's a very dangerous activity because tops and bottoms are very rare. Yet many people trade as if they happen all the time. They're doing the exact opposite of reality.

Interviewer: In this bottoming and topping phase, you can "strike it rich," but there's a strong chance you'll guess wrong, again and again. There's a possibility of guessing wrong – and guessing wrong in a big way!

Neely: What defines a top or bottom is that it's major and it lasts a long time. You can't have a major top or major bottom every few days or every few weeks. Otherwise, it doesn't qualify. Most people trade as if major tops or bottoms happen often, and that's why they end up losing so much money attempting to pick tops and bottoms.

This correlates to the specific phase of Predictability under Wave theory, because NEoWave and Elliott Wave are best at predicting market tops and bottoms. This would be right at the point where Wave theory is the most useful. Unfortunately, due to human nature, it's the point where most people are the least likely to believe what Wave theory or a Wave analyst might tell them, because everyone else is doing the opposite.

An example is the high in 2000. Everyone thought the internet was going to allow the market to go up forever. It was a period of seemingly endless prosperity. That belief was contrary to what Wave structure tells you at the termination of a trend. This makes it difficult for you to act alone against the huge crowd and media roar that's telling you to do exactly the opposite, such as buying near the highs instead of selling, which is what I was telling people to do at the high in 2000.

Interviewer: In the three different phases of market activity, we just talked about the Bottoming/Topping phase. Let's discuss the next phase: Accumulation/Distribution.

Neely: The Accumulation/Distribution phase relates to the more general predictability phase of a market. Let's say for accumulation, after the low, the market may bounce off the low and go through a back-and-forth period of consolidation as powerful traders accumulate positions, preparing for a market advance. At that same time, the public thinks the worst is not finished and the market is still in a downtrend.

The powerful, wealthy traders are accumulating positions, while the less experienced public traders are still selling into the market's decline, thinking it's going to go lower. That's an accumulation phase: A lot of positions are being hoarded by a few very wealthy people in contrast to the public, who are taking the opposite side of that trade.

Interviewer: Let's discuss third phase of market activity: Trending (up or down).

Neely: Once you've gone through accumulation or distribution and have everyone set in their position, they've either gone long or short. Now everyone's waiting for something to happen, then the market starts to trend. That's when you've had all the buying or selling that's going to happen.

Regarding volume, there's very little order flow taking place between one area of consolidation or the next. The market tends to zoom through this low-order concentration zone. The market has bottomed, and then it's gone through a period of accumulation. During that accumulation phase, nearly all the positions that can be bought have been purchased, and there's virtually nothing left to purchase. If there's any demand that comes from the public at that point to start buying, there's nothing to buy. This starts to mark up the price quickly, because there is no supply. All of a sudden, you have a lot of demand with no supply, because the supply is being held by the wealthy traders who have accumulated positions during the accumulation phase.

Once the public starts to realize the trend really is up and they want to buy stocks, the market will start moving up very quickly, because there is high demand and very limited supply. This starts marking up the prices and creates a quick uptrend. By the way, the trending phase lasts the shortest period of time. Generally, it's the hardest to catch for most people, because they're uncomfortable getting in after a market top or a market bottom.

Interviewer: Which phase of predictability does that correlate with?

Neely: From a Wave theory standpoint, the trending phase would be the least predictable because it occurs long after the market top or market bottom, which means you have a limited amount of Wave structure to work with. There's a lot of variability to the market structure. This makes it impossible to know exactly what's going to happen.

The Trending phase is the least predictable under Wave theory. It's the phase where you're generally going to make the most money the fastest, but you're the least likely to know it's happening, because that doesn't allow you to accurately predict trends. You're looking mostly at trying to pick the top or the bottom.

Interviewer: It'd be a great time to have that crystal ball to know exactly what the market is doing!

Neely: That's why you need to have other types of techniques to deal with these middle or trending phases of markets that Wave theory doesn't deal with very well.

Interviewer: Glenn, let's discuss the most effective type of market analysis and best trading strategies to employ for each of the three phases: (1) Bottoming/Topping, (2) Accumulation/Distribution, and (3) Trending (up or down).

Neely: During the Top/Bottom phase, it's best to use NEoWave or Elliott Wave. This is by far the most useful technique, and it trumps all other types of technologies or techniques in market analysis. At extremes, Wave theory is by far the best.

Wave structure often tells me to do things that are so contrary to the majority and to what you're hearing in the news and reading in the papers that it's difficult for the average person to emotionally do what they should be doing at those points. But Wave theory makes it very clear exactly what you should be doing. That's when you're selling into new market highs and buying into lows. That's what a lot of people like to do and the vast majority of inexperienced traders do, but it also happens to be the phase of the market that lasts the shortest period of time because you can only top or bottom once.

Interviewer: What is the most effective market analysis and best trading strategies for the Accumulation/Distribution phase?

Neely: After a major top or bottom, the market goes into a choppy period above the low or below the highs. Wave theory can still be useful, but its usefulness starts to decline at this point. Oversold and overbought market indicators tend to be more useful during this period, allowing you to get in or out at each market oscillation.

Generally, you'd be looking to buy on pullbacks. Let's say the market has bottomed at 900 in the Gold market, has rallied to 1,000, and will pull back to 950. You would get in on a market pullback, trying to prepare for the next advance. You're waiting for the sell-offs to create an oversold condition after the low to buy in, and as it gets overbought on a rally you look to get out. These overbought and oversold indicators can work well during the Accumulation or

Distribution phase after the market tops or after the market bottoms, but before it starts to trend really well.

Interviewer: What is the best type of market analysis and trading strategies for our final phase: Trending (up or down)?

Neely: This is where Wave theory is the least useful. This is the Unpredictable phase of markets that we discussed in detail in the previous interview. During the Trending phase, this is when it's most useful to do what most people are very afraid to do: buy into market strengths. Are you buying into new highs? Are you selling into market weakness, which mean selling into new lows?

The Trending phase happens infrequently. Strong market trends aren't that common, especially ones where you can buy into any new high or sell into any new low. When the strong market trends do happen, they can yield a tremendous return in a very short period of time, far outweighing the results you might get in any other market phase.

Interviewer: We talked about the three phases of market activity and the type of market analysis that's best for each phase. Which phase are we in right now? What specific trading strategies are useful in this phase?

Neely: As I mentioned in our previous interview, on a grand scale and from a Wave theory perspective, we're just past the dead center of a 20-year correction. We're in the most unpredictable phase of market action. The predictability of the markets will start to get better over the next few years.

The phase of market action we're going through right now is most likely Distribution. We've rallied off a major low. The market is preparing for a top within this larger bear market, which started at the high in 2008, so we're in a Distribution phase. The focus should be selling into strengths as the market finalizes this top over the next few weeks to few months.

Then get ready for the acceleration phase downward. That means we'll be moving into a trending market to the downside sometime in the next few months. I can't say exactly when this will be, because the market is too unpredictable right now. It should get clearer as the current pattern gets closer to an end, which I think will be in a few weeks to a few months.

Interviewer: We're in a Distribution phase right now, knowing that within a few weeks or a few months, we'll be trending down.

Neely: We'll be *accelerating* down.

Interviewer: It's another rollercoaster ride! What kind of trading strategies should we employ?

Neely: This is a period where overbought and oversold indicators would work the best. In this case, the market should be preparing for a top and eventually trending downward, because we're in distribution. The best way to focus on this would be looking for overbought signals to sell into those overbought conditions with stops above the market, preparing for another sell-off. Get out of the short positions when the market is oversold. Only look into short on an overbought condition and get out of an oversold condition, and do that over and over until the Elliott Wave structure becomes clear.

When it gets really clear, then most likely the downtrend will start to accelerate, because we would have finished a pattern. We would start the next new downtrend. That's when we'll go into a Trending phase, which should produce the quickest return and the biggest potential profits at the lowest risk over a short period of time.

Interviewer: At this point right now in the Distribution phase of the market activity, we should focus on protecting capital and not making any big, risky moves.

Neely: Absolutely. This is a high-risk environment. You definitely want to focus on capital preservation. If you're going to trade, risk a lot less than normal. I typically risk 1% of capital per trade. In this environment, I might risk 0.5%. When Wave structure and risks are really clear, I might risk 1.5% to 2%. But for now, I recommend 50% of the normal risk you would take.

Your focus should be on trading less, protecting capital, and only getting in when things look really good and you can control risk. And don't risk too much in case you're wrong.

Interviewer: In addition to risking less with each trade, you're recommending we make fewer trades and be very selective.

Neely: Being selective is very important in this environment. We can make an analogy to weather. If you're in an environment where there's a possibility of a tornado, you don't know exactly where a tornado is going to touch down. You don't know exactly what's going to happen. Your primary focus is preservation of life and property, and not getting too anxious and running outside to see how a tornado works.

In this market phase, you have to be very risk averse and extremely cautious about the risks you're taking. Capital preservation is the primary focus, then take very careful, cautious trades when it makes sense.

Interviewer: Glenn, we've discussed the three different phases of market activity, and we understand the different kinds of analysis and trading strategies for each phase. As market conditions change, how do we know which phase are we're in?

Neely: This is something I've been working on developing for about 10 years. Many of my customers have heard me mention Neely River Technology, and it's the antithesis of Elliott Wave theory.

At the high in 2000 I realized we were starting a 20-year corrective market environment. Unfortunately, Wave theory would be less useful over the next 10 to 20 years as we moved toward the center of this 20-year consolidation. I realized that my ability to forecast markets would continuously decline during this time. If I was going to survive as a trader and as a trading service provider, I'd have to find a way to deal with markets when they're unpredictable. How would I manage trades if I didn't know what was going to happen? How could I advise others?

Over the course of the past 10 years, I've developed Neely River Technology – a way to enter markets, manage trades, move stocks, and exit positions that does not rely on forecasting, does not require any perspective of what the market is supposed to do into the future.

The concept of Neely River Technology is like being in a boat in a river – you know the river leads to the ocean, but you don't need to know exactly where the ocean is to get to there. Your primary focus is making sure you don't hit rocks or run into a sandbar, because the river will take you to the ocean eventually.

Interviewer: Glenn, would you say that Neely River Technology offers a specific focus on the trading moment – how to best understand that moment in time and act in the market, versus forecasting where we may be in the future?

Neely: Exactly. It's about how to manage what you're doing now. What should you do *right now* in the river to avoid the rocks, sandbars, and waterfalls? Your focus is making sure you stay in your boat until you get to the ocean. Neely River Technology is about how to manage trade, stay in control, and calmly wait to see where the market takes you. We'll talk about Neely River in the next interview, and that will be the first time I reveal a detailed explanation of Neely River Technology.