VOLUME 1

HARMONIC TRADING

PROFITING FROM THE NATURAL ORDER OF THE FINANCIAL MARKETS

SCOTT M. CARNEY

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Introduction

Harmonic Trading: Volume One represents an important advancement of the gamut of technical trading strategies that seek to define opportunities in the financial markets through the identification of price patterns and the analysis of market structure. This analysis employs a foundation of several existing price-based measurement approaches to the markets, while adding many unprecedented strategies that create a synergistic system of rules to optimize the decision-making process of trading. Price pattern analysis provides precise and effective information regarding potential future trends. Most important, Harmonic Trading possesses unique and effective technical measurement strategies that define critical new patterns and expound upon the existing knowledge base of general Fibonacci and price pattern theories to establish precise guidelines and extremely effective predictive tools to define and analyze market trends.

As in any literary work, it is important to cite all appropriate references and original ideas that are discussed. I have researched extensively most of the relevant reference material that applies to the ideas covered in this book. I believe it is necessary to emphasize the preparation required to outline the Harmonic Trading concepts and the lengths that I have pursued to distinguish the origins of these ideas. Technical methods from Elliott, Gann, Hurst, Gartley, and others have been thoroughly cited as the foundation for many of the advanced concepts within the Harmonic Trading approach. However, it is important to note that most of these measurement techniques and analytical assumptions have not been presented previously. Therefore, the Harmonic Trading methodology may challenge previous technical theories and prove to be controversial. The ends do justify the means, as the strategies that comprise Harmonic Trading represent time-proven ideas that have served as reliable analytical guidelines in even the most volatile of market climates.

The Evolution of *The Harmonic Trader*

I want to thank the thousands of people who have bought my first book, *The Harmonic Trader*. It has been a rewarding experience for me to share this information. The response has been overwhelmingly positive, and I never could have imagined that it would have been so well received. I hope you find the material in this book as enriching and educational.

My first book, *The Harmonic Trader* (HarmonicTrader.com, L.L.C. Nevada; 1999), was a compilation of ideas based on several general technical approaches that incorporated new applications of existing analytical tools. *The Harmonic Trader* and the Harmonic Trading techniques evolved from a collection of individual strategies into an entire methodology to analyze price action in the financial markets over the course of many years. These techniques coalesced to define a unique system of rules for every step of the trading process. From the identification of a potential opportunity to exiting a trade, these techniques were designed to guide every decision from start to finish.

The Harmonic Trading approach offers pertinent technical information regarding the state of potential future price and specific levels of support and resistance. In fact, *The Harmonic Trader* distinguished itself from the outset by offering strategies that identified areas of potential support and resistance in ways that no other technical method had previously measured. The eventual evolution of years of experience culminated in the categorization of an entire system of pattern recognition of specific price structures based upon prescribed alignments of Fibonacci ratios.

The writing of *The Harmonic Trader* was a gradual evolution of many years of work that essentially arose from a great deal of trial and error. The book came together smoothly, however, as most of the initial work focused on precisely defining each of the basic patterns. Although the actual writing was no small task, the real work was organizing the file cabinets of charts, notes, trade journals, and the like into an effective and comprehensive "how-to" manual. In fact, most of the unprecedented ideas outlined in the book were the result of lessons learned from actual trades. I refined the strategies to devise a system of the most effective techniques to identify harmonic patterns. In doing so, several new strategies were presented that identified and defined new price patterns unlike ever before.

The system utilized new technical measures that proved consistently reliable and effective in determining potential future price action. In the development stages of this approach, I never stopped to question why such Fibonacci phenomenon was occurring. Rather, I continually strived to find the methods that were reliable and perfect the rules to define these situations. As the best relationships were identified, I classified distinct areas of specific price behavior that commonly developed in these specific situations. Essentially, I went with the techniques that worked! After compiling hundreds of charts and notes, I started to write *The Harmonic Trader*.

Initially, I compiled a list of Fibonacci strategies that repeated and the technical events that were consistently occurring within the framework of price patterns. Focusing on the peculiarity of exact combinations of Fibonacci pattern alignments, much of my initial work attempted to define the best situations among multitudes of possibilities. I realized early in my research into the best harmonic patterns that each setup was not the same. Although many potential pattern structures appeared to be similar, I realized that the alignment of points was a critical factor in differentiating potential trading opportunities and in providing vital information regarding the potential state of future price action.

After this discovery regarding price structures, I succeeded in defining the best alignments of Fibonacci measurements that validated each pattern. In the process, several unique concepts were outlined in *The Harmonic Trader* that shed new light on the measurement of price movements with respect to Fibonacci analysis. It is important to emphasize that **Harmonic Trading is different** from all other Fibonacci-related market approaches. Harmonic Trading techniques define potential trading opportunities with extensive precision and detail. Every price movement must be analyzed for possible information regarding the state of future price action. In addition, this approach utilizes unique rules and measurement techniques to generate valid trading signals.

As I have mentioned previously, others long before me have utilized Fibonacci ratios with price patterns. Robert Prechter and A. J. Frost in their book *Elliott Wave Principle* advanced the original writings of R. N. Elliott and clearly outlined Fibonacci applications with respect to their measurements of price movements. In fact, Elliott Wave analysis was probably the first comprehensive application of Fibonacci measurements to price pattern movements in the financial markets. Although Charles Dow utilized standard retracements (1/3, 2/3) in his tenets of Dow Theory long before Elliott, the aspect of relating Fibonacci measurements differentiates these methods and possesses greater technical implications beyond simple estimation. Regardless of the differences, various predecessors have applied similar tools and measurement techniques in previous literary efforts.

I would like to take a moment to discuss the material presented in *The Harmonic Trader*. The following list represents a few of the unprecedented ideas outlined in *The Harmonic Trader* that must be distinguished:

- **Potential Reversal Zone (PRZ).** Although many have discussed the use of simple Fibonacci measurements, *The Harmonic Trader* was the first comprehensive work that specifically outlined the concept of three or more Fibonacci calculations of a specific price structure converging at a defined price level as a potential zone for a change in trend. Essentially, the Potential Reversal Zone (PRZ) calculates resistance and support targets based upon the Harmonic Trading measurement techniques. In the years since this concept was introduced, it has been referred to groupings, clusters, Target Reversal Zone, and so on. Whatever the term, the concept was initially presented in *The Harmonic Trader*.
- **Distinguishing *all* points within the pattern.** *The Harmonic Trader* specified and differentiated every aspect of 5-point reversal structures by examining each Fibonacci point within the pattern, proving that not all patterns are the same. One of the most notable developments from this differentiation was the creation of the ideal Gartley pattern—a setup that required a 0.618 B point and a 0.786 D point retracement as the only valid alignment for the structure. After *The Harmonic Trader* was released, this alignment has become the industry standard for the structure.
- **The Mid-Point (B) as the defining element of 5-point price structures.** Another unique concept outlined in *The Harmonic Trader* was the significance of the mid-point (B) in 5-point price structures as the critical determining element for all harmonic patterns. For example, the B point distinguishes Bat patterns from Gartley structures.

- **Alignment of Fibonacci numbers defines the pattern structure.** After differentiating each of the patterns, *The Harmonic Trader* and Harmonic Trading techniques emphasized the importance of the alignment of Fibonacci ratios to differentiate each price structure. This discovery proves that similar structures are not the same. Furthermore, each alignment requires specific strategies that are common to each structure.
- **Alternate AB=CD pattern.** Among many of the unique technical measurements discussed in *The Harmonic Trader*, the Alternate AB=CD pattern was a vital advancement of the basic AB=CD theory, and it is a critical element within the Potential Reversal Zone of many harmonic structures.

In this book, the material reviews each of these concepts extensively and offers many new strategies to expand the arsenal of tools within the Harmonic Trading approach. It is important to note that the new ideas presented in this material build upon several existing technical approaches, such as Elliot Wave. These established technical principles are cited thoroughly to serve as a foundation for the numerous unprecedented strategies that are outlined in the Harmonic Trading approach. From this foundation, the techniques discussed in this book incorporate the best synergies of several Fibonacci-related strategies to define specific situations for potential trading opportunities.

HarmonicTrader.com

After the release of *The Harmonic Trader*, I launched HarmonicTrader.com. As the Internet became mainstream in the 1990s, I saw a website as a phenomenal opportunity to display the Harmonic Trading concepts as applied to real-time situations. Because most of the price measurement strategies were entirely new to the field of Technical Analysis, it was essential to define current market opportunities and maintain a consistently accurate record of predictive analysis. Therefore, the website was a vital forum to substantiate the unprecedented ideas outlined in *The Harmonic Trader*, and it was critical for me to prove that these methods worked—in any market.

At that time, the predominant bull market of the 1990s was about to turn and the Harmonic Trading concepts were about to be thoroughly tested. The website became an established track record that solidly reflected the ability of Harmonic Trading techniques to decipher price action in any market. For example, the monthly market reports consistently outlined numerous harmonic patterns that identified critical turning points in the major market indices. Specifically, distinct Bearish Gartley and Bullish Bat patterns in September 2000 and March 2003, respectively, were the defining harmonic patterns that pinpointed the critical turning points of the markets consistently for many years.

In the years that followed, the rally from the 2003 bear market low eventually led to yet more distinct long-term harmonic patterns that pinpointed another devastating market top. As difficult as the bear market of 2000–2003 seemed, the events of 2007–2008 financial markets were some of the most challenging conditions of the past 100 years. Through it all, the new measurement strategies enabled the Harmonic Trading approach to consistently define the most important technical levels in an unprecedented fashion.

In the past few years, the emergence of long-term bull markets in commodities such as energy, precious metals, and agricultural products shifted the trading focus away from nearly two decades of predominantly stocks to a more diverse palette of vehicles to consider. Not to mention, burgeoning currency market traders have fueled a new generation of online traders on an unprecedented international scale to expand the overall appeal of trading. Such diverse cross-market appeal has furthered the need for trading strategies to maintain a stringent unbiased perspective and analyze price behavior without favor. For these reasons, the Harmonic Trading approach has emerged as a reliable and effective system of rules to navigate any market.

Harmonic Trading: Volume Two

Since this book is titled *Harmonic Trading:* ***Volume One***, the obvious question is "Will there be a ***Volume Two***?" Yes, and relatively soon. *Volume Two* will contain advanced concepts that refine Harmonic Trading techniques to an extremely specialized degree.

It is important to note that *Volume One* is not a rehash of *The Harmonic Trader*. This book addresses several new patterns and trade management techniques that have not been discussed previously. *The Harmonic Trader* covered an extensive gamut of trade identification techniques. Admittedly, the other two aspects of Harmonic Trading, trade execution and trade management, were not sufficiently addressed. This material will cover the other two aspects of Harmonic Trading more extensively.

This book updates the foundation established in *The Harmonic Trader* and dramatically advances the application of the entire methodology. Several concepts, such as the Bat pattern, the 0.886 retracement, and the trade management rules, that have not been discussed outside my work on HarmonicTrader.com and other financial-related websites and organizations. However, several strategies, such as trend channel Fibonacci retracement trading and the Three Drives pattern, are important within the realm of this methodology but discussed only in *The Harmonic Trader*. This book advances the initial collection of strategies proposed in *The Harmonic Trader* and defines the primary principles of the Harmonic Trading approach.

Fibonacci and Harmonic Trading

The measurement strategies within the Harmonic Trading approach employ the somewhat controversial use of Fibonacci ratios. The recent popularity of the mystique of ancient codes has led to an unfortunate distortion of the true value that these methods inherently possess. In fact, it is almost hilarious that there are now numerous financial websites and publications claiming to possess the "Fibonacci Secrets," the Gann version of the Harmonic Trader, the quick Harmonic Trader, or the proper Fibonacci node levels that attempt to mimic the Harmonic Trading methodology. I say almost hilarious because most of it is not. The blatant borrowing of these techniques without proper citation and credit has become the standard in this industry, I am sorry to say. In fact, most of the Fibonacci-related material on trading the markets is misleading and frequently cite only the well-chosen examples to demonstrate their techniques.

It is important to emphasize that Harmonic Trading is clearly different from other Fibonacci-related methods. Although others have utilized Fibonacci ratios to quantify various price patterns to identify potential trading opportunities, their application has been vague and not precise enough for actual trading situations. This was an initial frustration of mine when I first worked with these patterns, and it was a motivating factor to be as specific as possible in my analysis. Such specification led to the classification of *harmonic patterns* and even the defining of an entire analytical system that I coined as Harmonic Trading.

Essentially, I have been trading harmonic patterns longer than anyone. Period. End of story. How can I say this? Because there was not anything as specialized as the harmonic patterns until *The Harmonic Trader* was released. Furthermore, the other ideas presented on HarmonicTrader.com and other websites, such as StockCharts.com, eSignal, and others, furthered the basic concepts established in *The Harmonic Trader*. These unprecedented strategies have evolved into an entire methodology that I have termed *Harmonic Trading*.

Harmonic Trading is a sophisticated and comprehensive approach that utilizes specific and consecutive Fibonacci alignments unlike any other methodology. I am not trying to claim to invent the Fibonacci wheel. In addition, it is essential to me that all relevant original work be cited properly and thoroughly. From W. D. Gann to H. M. Gartley, I have credited all pertinent sources. However, Harmonic Trading utilizes many techniques and specific measurements that have not been presented previously in this manner. Furthermore, the strict approach of the interpretation of market price action from the perspective of harmonic price patterns is not the same as other Fibonacci-related Technical Analysis.

Although not exclusive in its analysis of price movements, these methods offer precise and accurate trading strategies that utilize unprecedented technical measures. From the 0.886 rertracement to the Bat and the Crab patterns, this approach is the most specialized and effective Fibonacci trading strategy. The Harmonic Trading methodology *is* a distinct perspective, and I assure you that "You will never look at the financial markets the same way again."

Chapter 1

Harmonic Trading

What Is Harmonic Trading?

Harmonic Trading is a methodology that utilizes the recognition of specific structures that possess distinct and consecutive Fibonacci ratio alignments that quantify and validate harmonic patterns. These patterns calculate the Fibonacci aspects of these price structures to identify highly probable reversal points in the financial markets. This methodology assumes that harmonic patterns or cycles, like many patterns and cycles in life, continually repeat. The key is to identify these patterns and to enter or to exit a position based upon a high degree of probability that the same historic price action will occur.

Harmonic Trading is based upon the principles that govern natural and universal growth cycles. In many of life's natural growth processes, Fibonacci numeric relationships govern the cyclical traits of development. This "natural progression" has been debated for centuries and has provided evidence that there is some order to life's processes. When applied to the financial markets, this relative analysis of Fibonacci measurements can define the extent of price action with respect to natural cyclical growth limits of trading behavior.

Trading behavior is defined by the extent of buying and selling and influenced by the fear or greed possessed by the market participants. Generally, price action moves in cycles that exhibit stages of growth and decline. From this perspective, the *collective entity* of all buyers and sellers in a particular market follow the same universal principles as other natural phenomena exhibiting cyclical growth behavior.

In an attempt to learn the origins of this analysis, many get lost in the need to understand why these relationships exist. The basic understanding required to grasp this theory should not move beyond the simple acceptance that natural growth phenomena can be quantified by relative Fibonacci ratio measurements. Applied to the financial markets, Fibonacci ratios can quantify specific situations where repeating growth cycles of buying and selling exist. It is the understanding of these types of growth cycle structures (patterns) that provides pertinent technical information regarding price action that no other approach offers.

The evidence of harmonic patterns in the financial markets can be found in price charts. A chart is nothing more than the collective record of buying and selling over time. Patterns that form over a particular period of time reflect a signal or technical "signpost" that can indicate the state of potential future price action. Furthermore, these situations have been historically proven to repeat and can identify significant potential trading opportunities with favorable risk-to-reward considerations.

After learning the basic requirements for each structure, it will take some time to develop the experience necessary to differentiate which price structures are valid trading opportunities. Although price structures can vary with respect to their Fibonacci alignments, Harmonic Trading techniques identify common elements of each situation that identify opportunities and maximize trading decisions.

Order within the Chaos

Many have argued that the financial markets are a random entity. According to the Random Walk Theory, popularized in the book *The Random Character of Stock Market Prices* by Paul H. Cootner (ed., MIT press, 1964), price action is "serially independent." This means that price history is not a reliable indicator of future price action. Although this theory does possess validity, since anything can happen in the financial markets, history has proven that within this randomness there is a degree of repetition.

Many events in the markets have repeated historically through the years. Significant corrections have occurred in October, which are usually preceded by a late summer peak. In addition, many common events such as defined levels of support and resistance or trend lines define repeating market action on a daily basis. Harmonic Trading techniques capitalize on such repeating market events by identifying specific price patterns within the randomness of the markets. Correctly identifying these situations is the key to profiting from these opportunities.

The identification of historically repetitive price patterns is the primary means that these techniques utilize to interpret the market's signals. It is in this effective price pattern identification ability that Harmonic Trading possesses its greatest advantages. The precision and accuracy of the specific pattern alignments define a consistent and effective approach that can be easily applied. Furthermore, each distinct pattern acts as a model for the basis of all trading decisions. Once a potential pattern is identified, the trading opportunity can be managed according to a defined set of rules that are particular for each situation. Although each pattern possesses different elements, Harmonic Trading identifies specific repetitive situations within the chaos of the financial markets.

Three Stages of Harmonic Trading

Harmonic Trading utilizes an enormous array of effective Fibonacci alignment combinations to define patterns. However, Harmonic Trading does not stop at the identification of valid patterns. Although it is the important first step in defining potential trading opportunities, specific rules and guidelines are required to maximize the management of a position. There is more to profiting from the patterns than just proper identification. The other aspects of trade execution and position management are equally as important to maximize profit potential and to reduce risk exposure:

1. **Trade Identification.** Regardless of what type of trading system is utilized, the initial step is identifying a potential opportunity. Harmonic Trading techniques utilize historically proven and repetitive price patterns that capitalize on overbought and oversold signals generated by the market's technical price action. A good portion of this material is dedicated to identifying and differentiating harmonic price patterns as quantified by Fibonacci ratio alignments. Understanding the differences among the various harmonic patterns is essential to capitalize on specific trading opportunities.
2. **Trade Execution.** After accurately identifying a potential trade opportunity, the actual trade must be determined. Several considerations must be assessed within a specific time period defined by the potential opportunity. The validity of the pattern must be determined, and the final action of executing of the trade or not must be considered.
3. **Trade Management.** After the execution action is decided, there are a variety of general considerations involved within the trading process. If the trade was executed, the position must be managed with specific rules to maximize the profit while minimizing the risk.

These three stages are important to consider as the general process of trading harmonic patterns. As I said earlier, any system utilized to trade the markets must identify a potential opportunity, execute the trade, and manage the position until it is closed.

If these concepts are new to you, I recommend that the identification of patterns be thoroughly understood before executing trades. The essence of Harmonic Trading is the ability to differentiate price structures based upon specific consecutive Fibonacci ratio alignments. Therefore, a thorough comprehension of the specific pattern price point alignments is an essential first step to successfully trade these situations. The other skills of effective trade execution and acute trade management are equally as important and represent the necessary elements to consistently profit from the Harmonic Trading approach.

Harmonic Trading utilizes the best strategies of Fibonacci and pattern recognition techniques to identify, execute, and manage trade opportunities. These techniques are extremely precise and comprise a system that requires specific conditions to be met before any trade is executed. The Harmonic Trading approach offers information regarding the potential state of future price action like no other technical methods. The unique measurements and price point alignment requirements are some of the unprecedented methods that differentiate this approach from other technical perspectives.

If you are new to Harmonic Trading, these techniques will open your eyes to many effective strategies that can indicate the potential future price action. If you have experience with these strategies, the material in this book will enhance your understanding of specific situations and offer many pattern-specific techniques that will improve your trading performance.

Index

C

D

E

F

G

J–K–L

M–N

O–P

Q–R

S

T

U–Z