



CitiFX[®] Technicals – Weekly Roundup

Technical Developments in the Foreign Exchange and Asset Markets

20 November 2008

[CitiFX Technicals Portfolio](#)

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Chart of the week

This week's weekly will focus on the markets we think are most compelling at this point starting with our chart of the week

Chart of the week:

U.S. Equity markets remain on a knife-edge

We have been of the view for a number of weeks that the DJIA is trying to form a base off its 10 October low. It is time to revisit the picture and articulate how things look today. **The reality is that on one side there are still some “glimmers of hope” while on the other side there are obvious reasons for concern.**

Foreign Exchange

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- Some support just below on G10 JPY chart and 76.4% hold so far on EURJPY
- EURUSD still trying to form a short-term base with GBPUSD also near support
- GBP weakness may be a little overdone short-term

Fixed Income

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- U.S. 2 year yield has traded below 1%, which confirms to us that another cut from the FED is imminent.
- German 2 year yields tell us that the ECB is going to have to slash rates and quickly.
- The BUND looks set to fly.
- European Sovereign spreads suggest stress remains in the system

Equities

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- FTSE approaches major supports
- Nikkei is pushing pivotal support

Techamentals

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- 8.5% unemployment remain on the cards

Commodities

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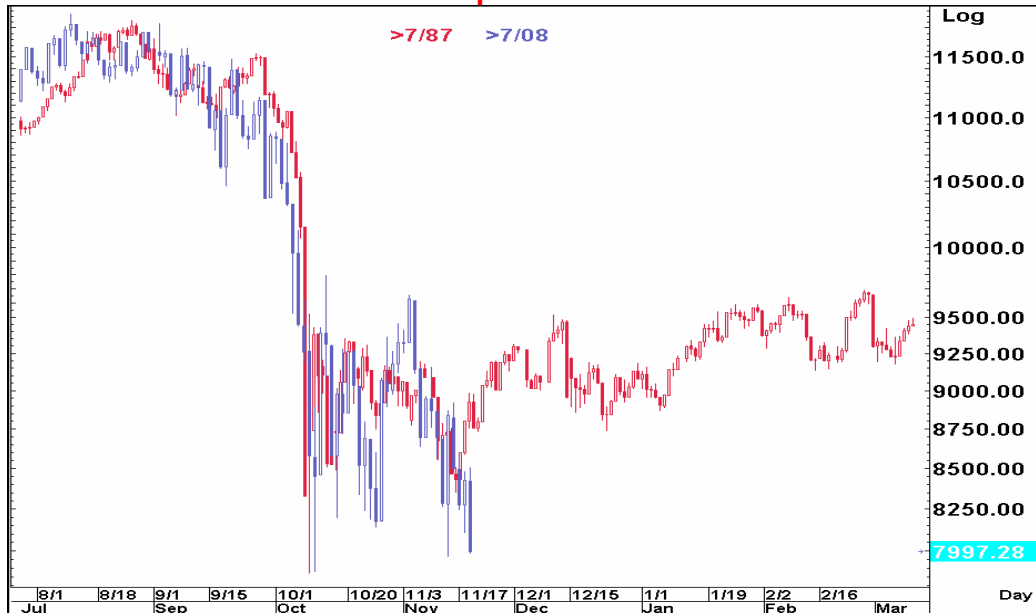
- Crude move towards \$40 remains likely
- Gold Crude ratio looks set to roar

Chart of the week:

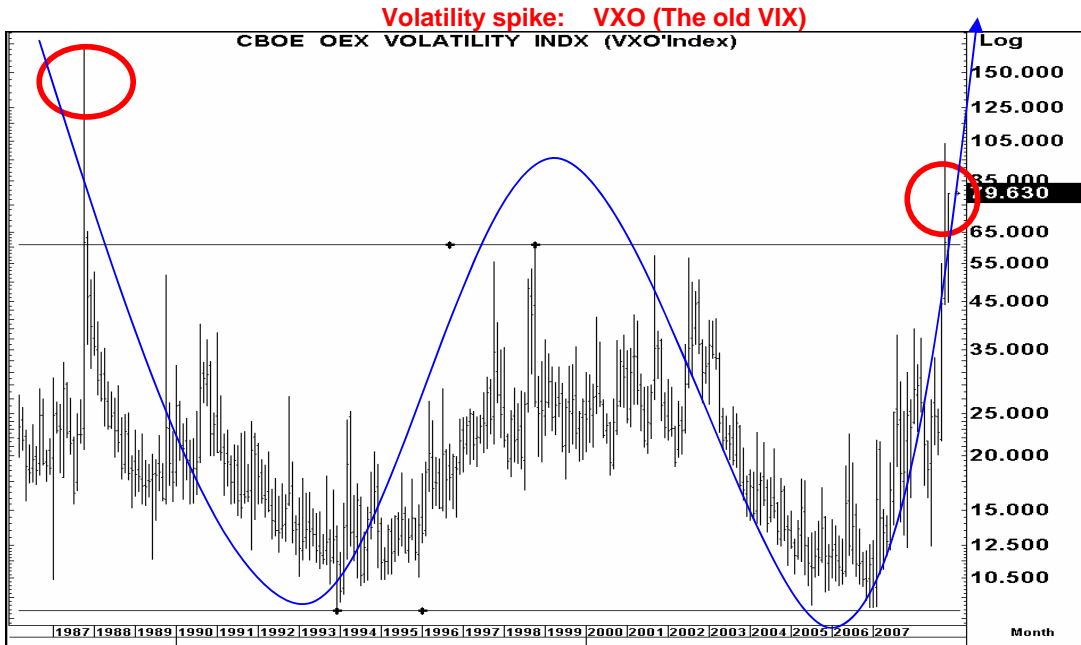
U.S. Equity markets remain on a knife-edge

We have been of the view for a number of weeks that the DJIA is trying to form a base off its 10 October low. It is time to revisit the picture and articulate how things look today. **The reality is that on one side there are still some “glimmers of hope” while on the other side there are obvious reasons for concern.**

The panic move



- Fear is without doubt one of the strongest emotions in financial markets. That was particularly evident in the sharp fall seen between August and October 2008. The chart above shows that fall overlaid on the sharp fall seen between August and October 1987.
- A move of this magnitude over such a short period of time provides the elevated levels of volatility and fear that ensure (as we saw in both instances) that whatever happens thereafter price action is likely to be very volatile. Fear does not disappear easily once it takes hold and apart from price action time is an important component in alleviating fear.
- Despite the huge volatility we have seen there may be a glimmer of light in the fact that the present levels of the DJIA remain relatively unchanged from 6 weeks ago.
- In 1987 it was not until 45 days after the 19th/20th October collapse low (4th December) that we started to see a gradual climb into year-end resulting in an 18% rally over 1 month. This is the type of thing we need to see here. Sharp 2 and 3-day rallies of double digit percentages followed by sharp falls only serve to exacerbate the fear. A gradual climb would have the effect of
 - Reducing fear
 - Reducing volatility
 - Allowing prices moving higher at a steady pace to encourage the “cash on the sidelines” to get involved
- We still hold out some hope that this could happen (We are 41 days since that low was put in on 10th October in the DJIA) but we are right on a knife-edge here. While fear rules the ability of this scenario to play out gets increasingly difficult. **As FDR so eloquently put it “The only thing we have to fear is fear itself”.** A weekly close below the 10 October 7,882 level would be of concern here and suggest lower levels still
- **What about volatility?**



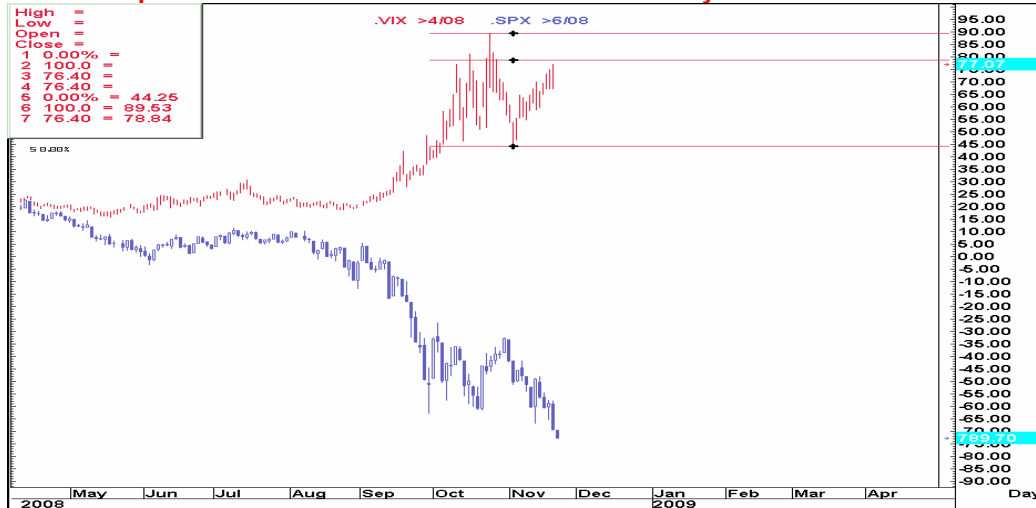
- This chart particularly concerned us when it closed above the 60.63% resistance (Peak in October 1998) level on 06 October this year.
- This close completed a double bottom formation that had a target of above 100%.
- On 10th October 2008 it traded to 103.40% putting it over 100% for only the 2nd time in its history. The other time had been 19th October 1987.
- Of concern at the moment is the failure in this index to re-establish itself decisively back below 60%. Elevated levels above that point will continue to make the possibility of getting a rally increasingly difficult. We need a decisive hold below 60% to provide at least some sense of stability albeit at still high volatility levels. **In 1987 when the steady rally began on 4th December the VXO was sitting in the 45 to 50% range. We will likely need to see something in that order before the chances of a more sustained bounce can really materialize.**

How does VIX look compared to 2002 when the DJIA hit its low on 10th October?



- We remember that day like it was yesterday. The S&P had gone on to set a lower low than that posted in July and the VIX stopped exactly at the 76.4% pullback level of the prior fall. It was the catalyst for what turned out to be the trend low.

This is the performance of the VIX relative to the S&P today



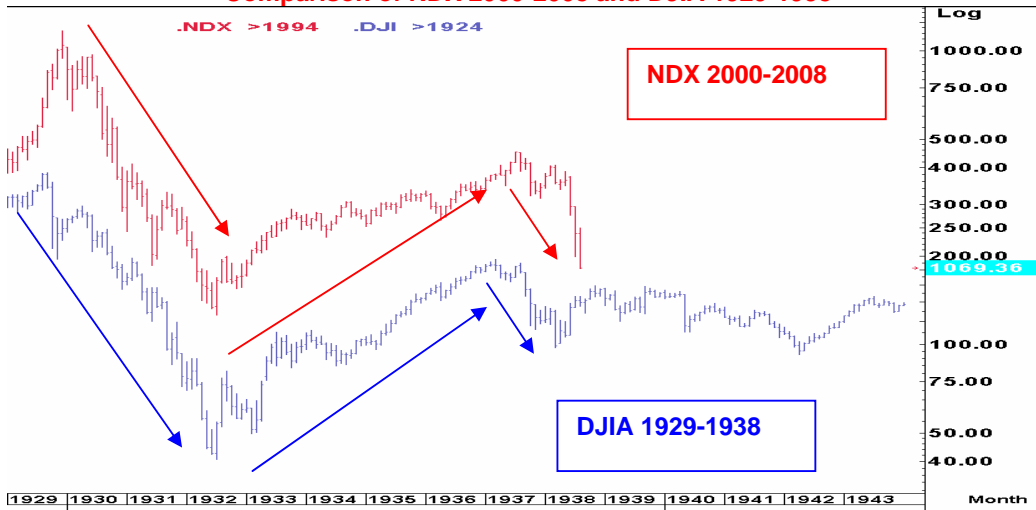
- While the S&P has moved on to set a new low the VIX as yet has not posted a new high and has a 76.4% pullback level at 78.84%. **This level may be worth watching in the days ahead on a closing basis to see if it can possibly hold here.**

How does this equity fall compare to history?????

We have looked back over the bear markets of the last 100+ years and have reached a few conclusions.

As yet this does not look like 1929-1932 to us. In fact we already saw a move that we believe replicated 1929-1932.

Comparison of NDX 2000-2008 and DJIA 1929-1938



- After the NDX fell precipitously in 2000-2002 we looked back to see if we could find a move of similar magnitude in history. There was only 1 instance we could find and that was the fall of the DJIA in 1929-1932.

1929-1932

DJIA falls 89.5% over 34 months
 Posts bullish monthly reversal off March 1932 trend low
 Rallies for 56 months
 Falls for 56 weeks losing 50.15%

2000-2002

NDX falls 83.5% over 31 months
 Posts bullish monthly reversal off October 2002 low
 Rallies for 60 months

This is week 55 in the down move of the NDX and it has so far fallen 52.4%

This is a chart that we have been watching for nearly 6 years

- After the 1938 low we did see a decent relief rally in Equities (8 months) but that gave way to a further 42% peak to trough fall from the 1938-1939 peaks (double top) to the eventual low posted in 1942.

As a consequence of looking back at all the major bear markets for over a century there are also a number of things worth noting

- As we said we believe that the 2000-2002 dynamic fits with 1929-1932 so (rightly or wrongly) we put that aside for the moment
- Also logically enough we put aside all those 20 something % bear markets.
- That leaves us with all the major bear markets of the last 100+ years
- These have ranged from 39% to 50% (Mid point of about 45%) the high to low move as we write this piece is 45.25% so far.
- At this point there are 2 bear markets that most closely resemble this move in terms of depth and time.

1916-1917 compared to today



1937-1938 compared to today



- Interestingly the average of these 2 falls is 45.14%- Almost identical to the fall so far.
- As mentioned above this is the scenario that fits most closely with the overlay that we have been watching for nearly 6 years.
- A move of the same percentage as 1937-1938 equates to a level of 7,077

What if we cannot bounce soon ?????

In that case the most concerning chart has to be the one overleaf.

Long-term chart of S&P 500



- While this is not our preferred chart (maybe we are just hoping) it would be remiss of us not to continue to draw it to your attention.
- This is over 80 years of the S&P (re-constituted back to 1927), which shows a danger of a major long-term double top forming with a neckline at 768.
- A decisive close below here (At least weekly) would complete this pattern and suggest a move to **AT LEAST 385**.
- If we get this close that is the danger that we have to protect against. We are not saying that will be easy. We already know that after we got a weekly close last year above the 2000 high it was sustained for 2 weeks, got no follow through and ended up being a false break. It could well be that a break of this low would do something similar. However the seriousness of a break below here is not linear. Protecting against further losses would mitigate **REAL** losses and risk a loss of **OPPORTUNITY** gains. In this environment return **OF** capital trumps return **ON** capital as a policy. If we get this break we will be cognizant of looking for something to suggest it could be a false break, but our starting point would have to be to presume it is real.

To sum up, we are at a critical juncture here and we have to very soon see some suggestion of price stability and an easing of volatility and thereby fear. In the absence of this further losses would likely be inevitable

Given that U.S. 2 years yields have now broken 1% it looks to be a foregone conclusion that another FED rate cut is coming shortly (Next 24 hours would be nice) and the inversion of German 2 year yields aggressively to ECB rates suggests that a good size cut there can only be around the corner (Next 24 hours would be nice here also)

As we have already seen these moves in themselves will not sort our problems but as we continue to say they cannot do any harm. Policy makers really have no option but to continue to “throw the kitchen sink at this” until something sticks because the alternative does not bear thinking about

This is the most onerous test of Global leadership in our lifetime and we can only hope that that leadership will materialize as it did with FDR who we quoted at the start of this note

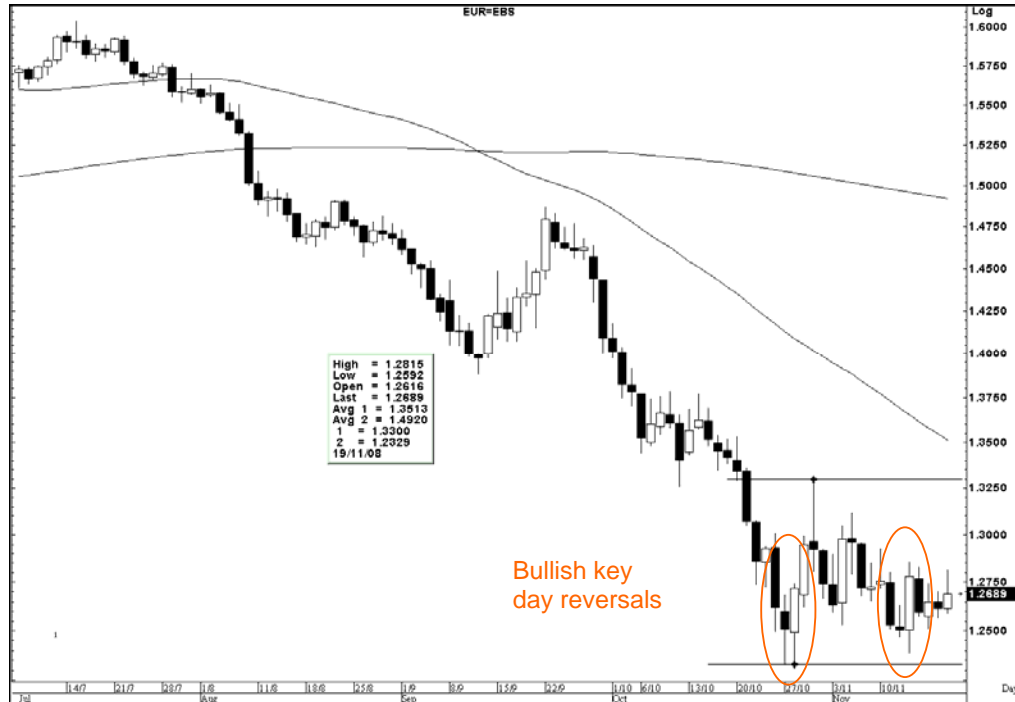
Foreign Exchange

G10JPY Index



The G10JPY Index collapsed (JPY strength) to the trend support by the same amount as it did from August 1998 to November 2000. It has therefore stabilised around support levels and a ST bounce in cross / JPY markets would not be surprising.

EURUSD



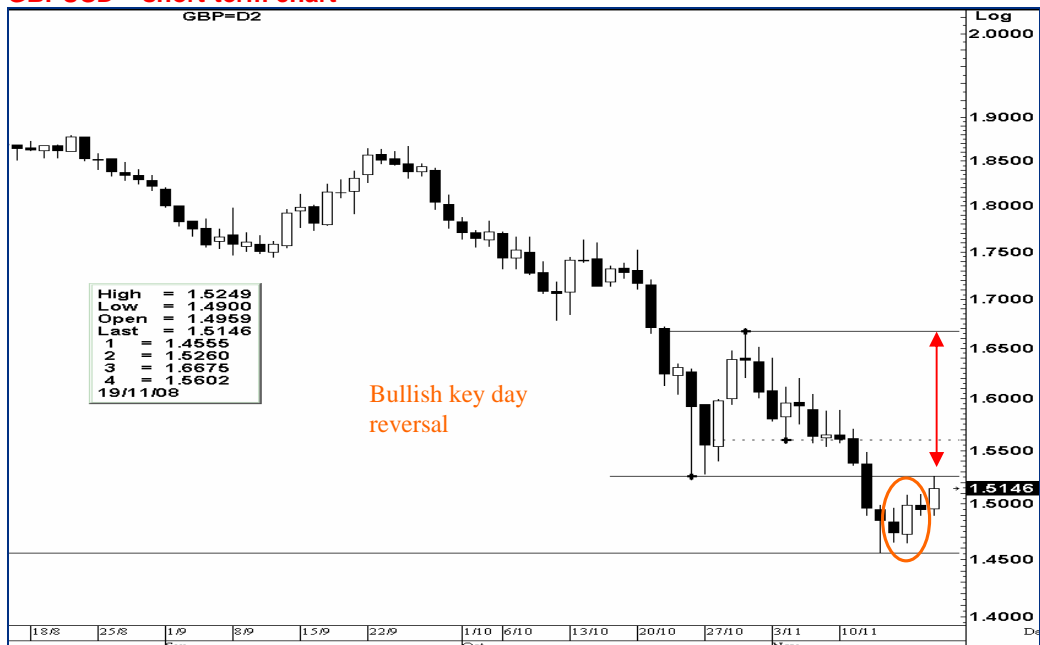
Rally towards the resistance level at 1.33 still remains a possibility within this long-term downtrend

GBPUSD – long-term chart

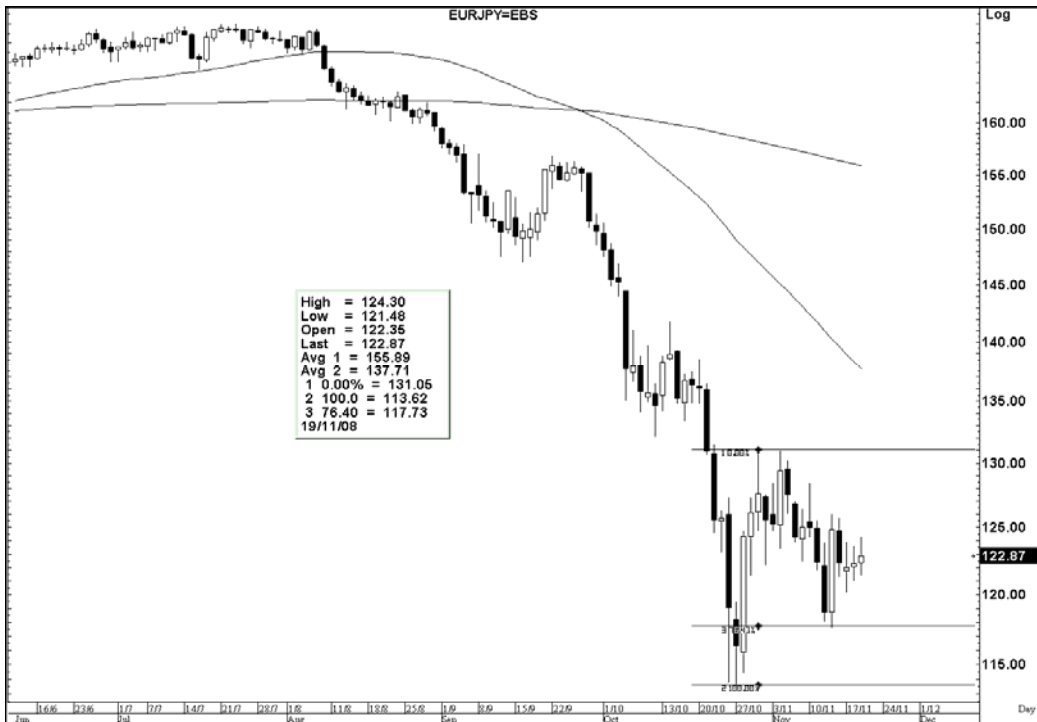


Has effectively tested the low from February 1994 at 1.455 and held up above there. The ST chart suggests that a rally to 1.5260 is possible with a break suggesting extended gains.

GBPUSD – short-term chart

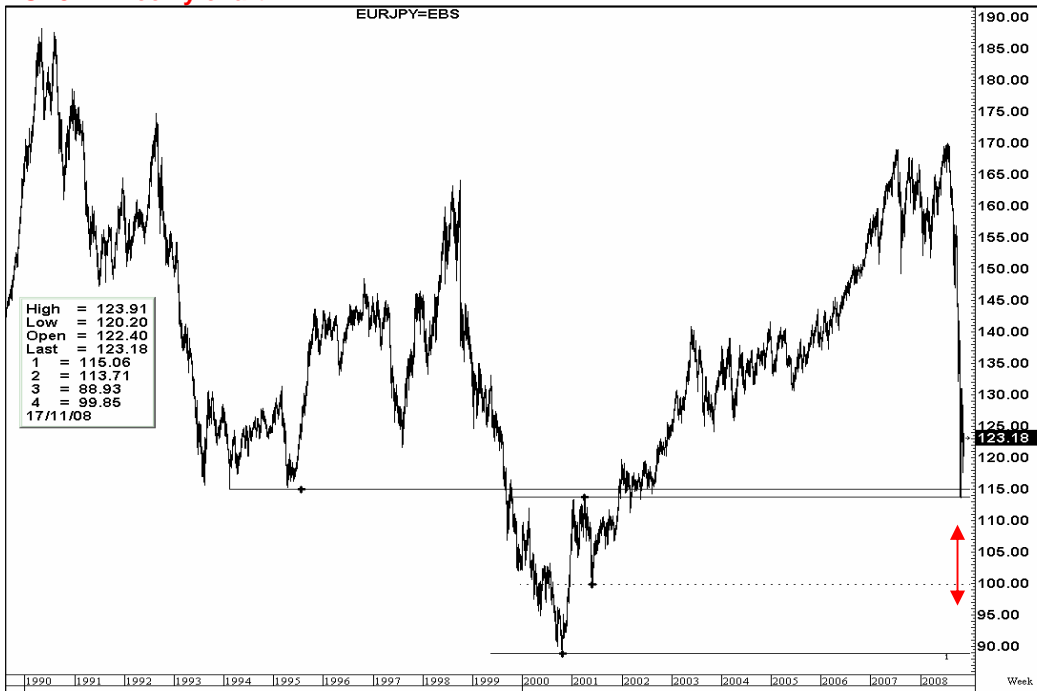


EURJPY Daily Chart



EURJPY has retraced 76.4% of the initial rally from the low at 113.62, which comes in at 117.73 and has posted a bullish key day up. This setup is still in place and suggests a rally back up to 131 is possible. A close through there would suggest a test of the 55-day moving average at 137. Below the 117.73 level would question this potential.

EURJPY-weekly chart



Long-term risks are for the pair to breach the 113- 115 area and trend down towards 100.

EURGBP – Monthly chart



We remained concerned on a LT basis that this uptrend is not sustainable. The negative monthly divergence suggests that the trend is tired and that the pair should trade lower towards support levels. Good LT support comes in at 0.7250. In the ST the pair is heavy and a test of 0.8187 is expected.

Headlines on nominal exchange rates (GBPUSD, USDCAD and EURGBP)



We find last week's headline interesting

Weak pound luring euro shoppers

BBC, Tuesday, 11 November 2008

The GBP weakness, and EUR strength as far as European consumers are concerned, is so well known that it is now being taken advantage of by the general public to the extent that it makes the 10PM news in the UK. That alone does not provide a good enough reason to sell EURGBP, but it does deserve attention from a long term perspective as previous examples of this have shown that over an extended period, this converges with major market turning points.

GBPJPY



We are still watching the momentum indicator on GBPJPY, which is forming positive triple momentum divergence. The momentum indicator is beginning to cross up and a ST rally will confirm it. Such a pattern would then suggest a test of resistance levels at 157.51 and above here possibly 165 again.

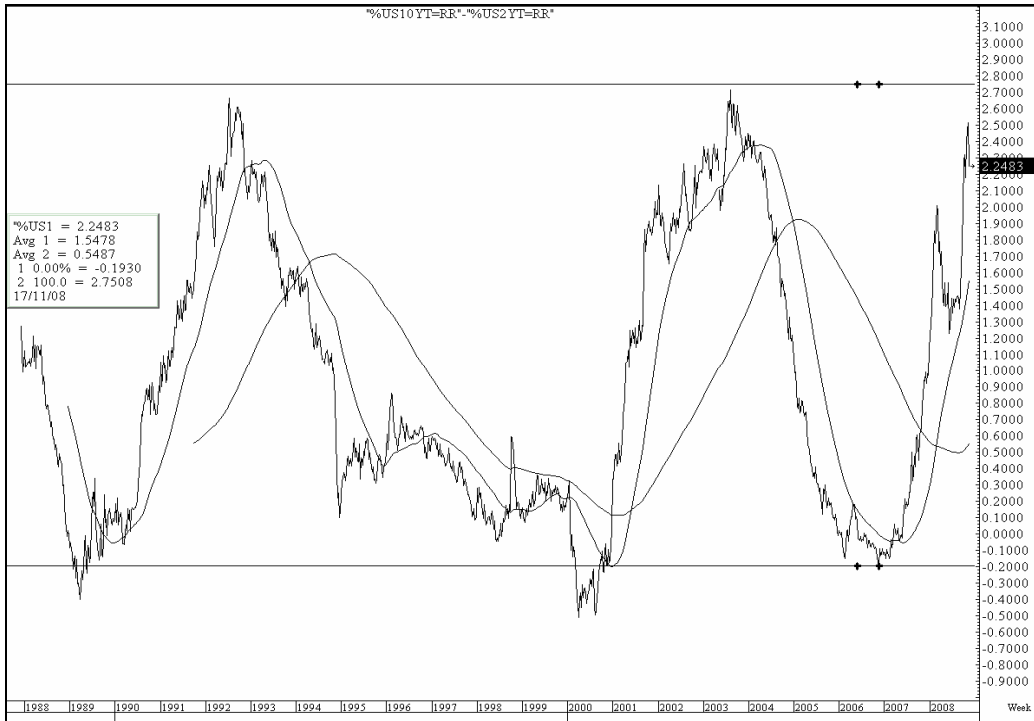
Fixed Income

U.S. 2 year yields



The trend is down and the support level at 1.02%.(2003 long-term trend low) gave way today. This confirms for us the further easing by the Fed is inevitable.

U.S 10 year yields – U.S. 2 year yields



Should test 275 bps.....but big caution would be signs of long-term quantitative easing which could flatten this curve as prior medicine fails to work.

German – U.S. 2 year yields spread

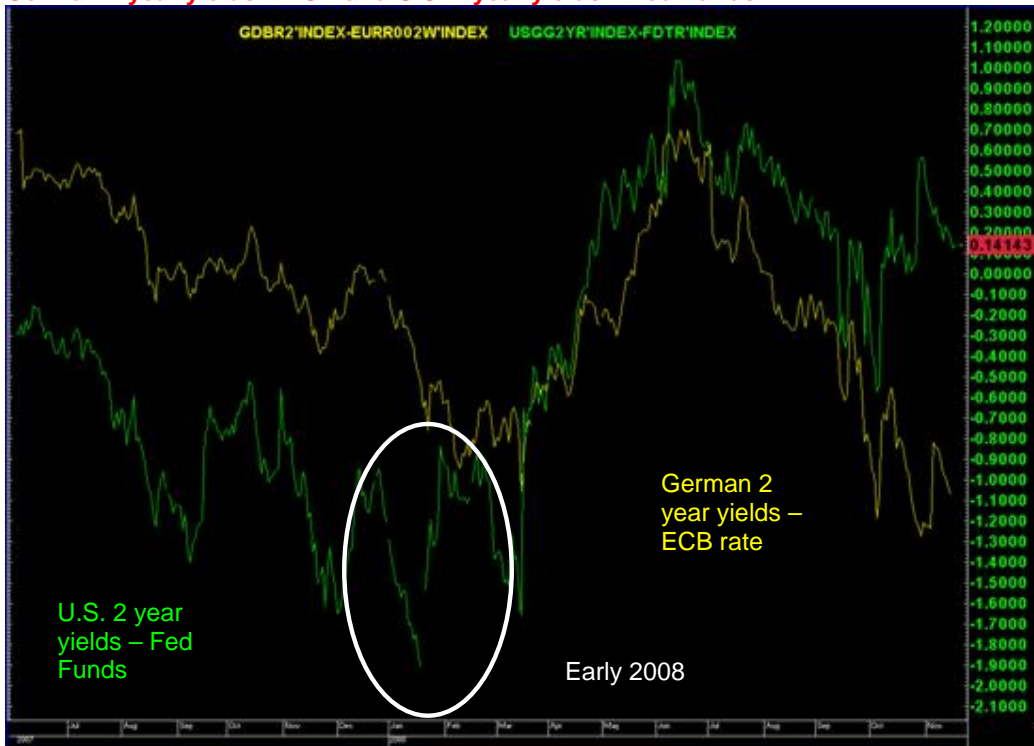


The long-term trend has turned here and we target the 200-week moving average, which currently stands at -44 bps. Maintaining that U.S. 2 year yields are still in a downtrend and are unlikely to rise anytime soon then German 2 year yields are expected to converge with U.S. yields by falling towards 1%. The trend in German 2 year yields is down...

German 2 year yields



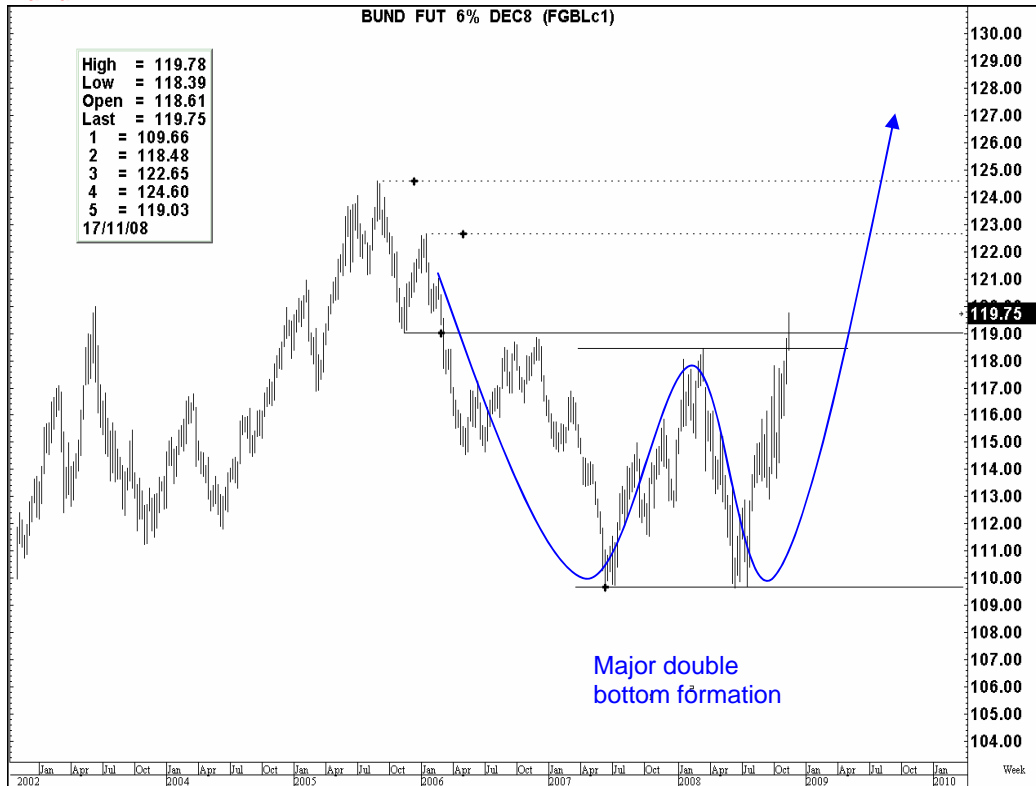
Support levels on German 2 year yields are at 1.96, 1.92 and then the low at 1.84
 Beyond that, a fall down to 1% (as per the explanation above) would not be surprising
German 2 year yields – ECB and U.S. 2 year yields – Fed Funds



Have we seen this movie before? One chart that we have been very focused on for the past 15 months has been U.S. 2 year yields and Fed Funds. When they were significantly inverted to the Fed Funds rate at the end of 2007 and going in to 2008, it was an indication that the Fed Funds rate was too high and more cuts were necessary. The pressures in the market place were at an extreme. Having already been 100 bps off the cycle high the Federal Reserve delivered an emergency 75 bps inter meeting emergency rate cut in Jan 2008. That is when U.S. 2 year yields were extremely inverted to Fed funds as highlighted in the chart above. The question now is whether the last remaining major central bank (ECB), which has not been aggressive in easing rates, faces the same issue? A quick move towards 1% in German 2 year yield could lead to such a scenario and corner the ECB into cutting rates dramatically.

Yields are falling for a reason. The economy is in recession and there is no inflation threat.

Bund



The market has closed above the major long-term double bottom neckline that was at 118.48. The pattern targets 127+ with interim resistance at 122.65 and 124.60. The trend is up and the outlook is bullish.

German – U.S. 10 year yield spread



The trend has turned and lower levels look likely.

Greece minus Ireland



The sovereign spreads in Europe began to get better briefly and now this week it is getting worse again

Italy minus Ireland



It is clear that a stealth ERM type disconnect is developing here which cannot be seen in the currency (In ERM days you had currency pairs- now there is just one EURO)

The core (Germany) is outperforming the periphery with stresses amongst the other in order of magnitude being

1. Greece
2. Italy
3. Ireland

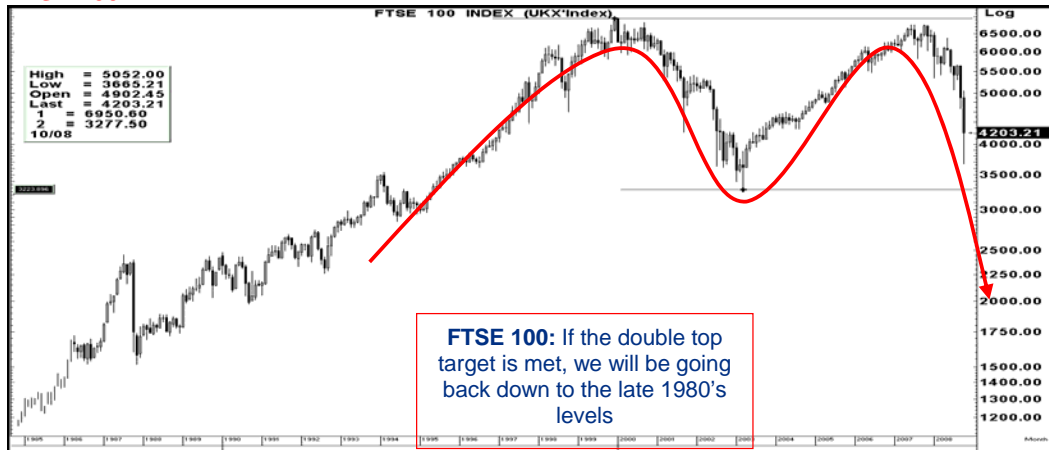
The true test of the EURO may come when one of these countries looks to the block as a whole for assistance.

A centralised approach (less likely) would likely help stabilise both spreads and the EURO (Showing a U.S. like co-ordinated response)

A fragmented/National approach (more likely) would suggest more spread pressure and also possibly concerns for the EURO. As a consequence we do believe that a move higher in the EURO is the near term will likely be short lived and more medium term weakness is a danger.

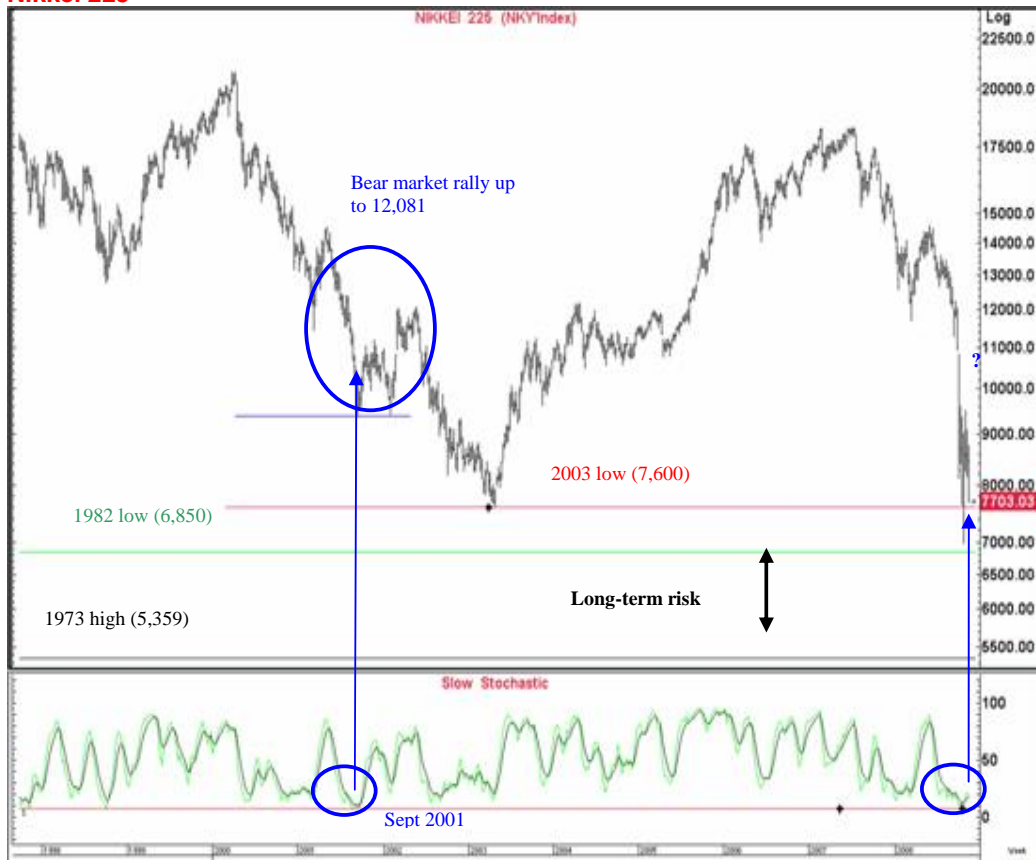
Equities

FTSE 100



From a long term (multi-year) perspective we are concerned that there may be a double top forming on the FTSE 100 Index, which would target 1,572...levels not seen since the late 1980's.

Nikkei 225



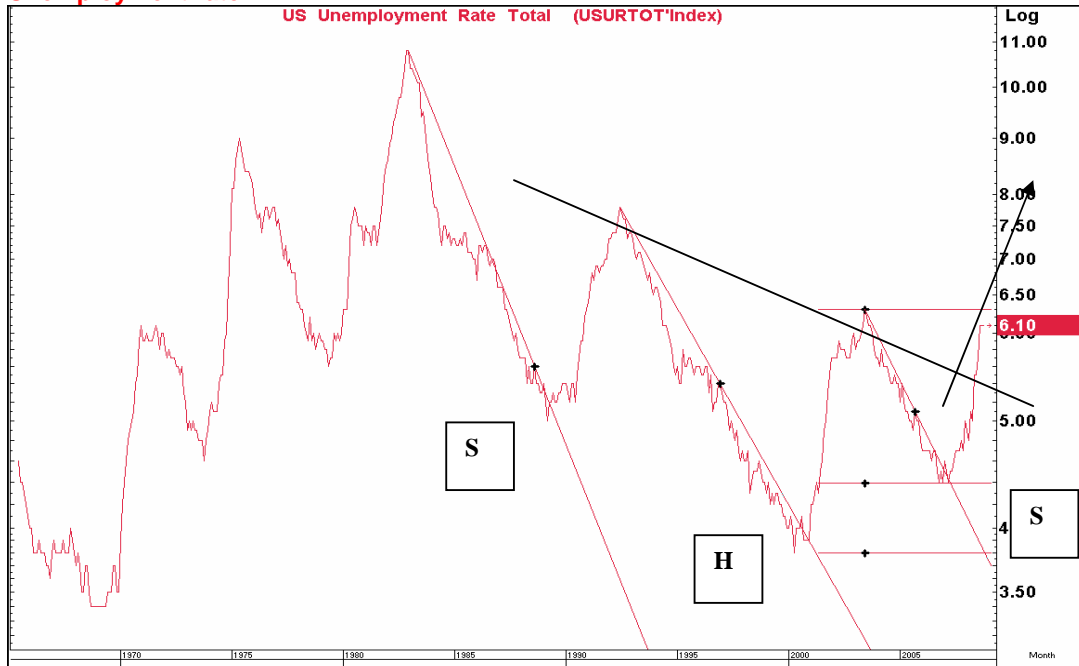
While there are longer-term concerns for the Nikkei 225, for now the index has not posted a weekly close below the 2003 low, which was at 7,600. Instead the market has turned from marginally above the October 1982 low at 6,850. Momentum on the weekly chart has not given an oversold indication like this since September 2001 where a trough was set and the market eventually set an interim high of 12,081 in May 2002...a rally of 28%.

Overall we would not be surprised to see further gains in the ST. A close this week above 9,358 (last week's high) would mean a bullish weekly reversal will be posted indicating serious gains in the ST.

A weekly close below the 2003 low and a breach of 6,850 (if and when that happens) would be very bearish and would open up the way for a test of the Jan 1973 high at 5,359....that is the longer-term risk.

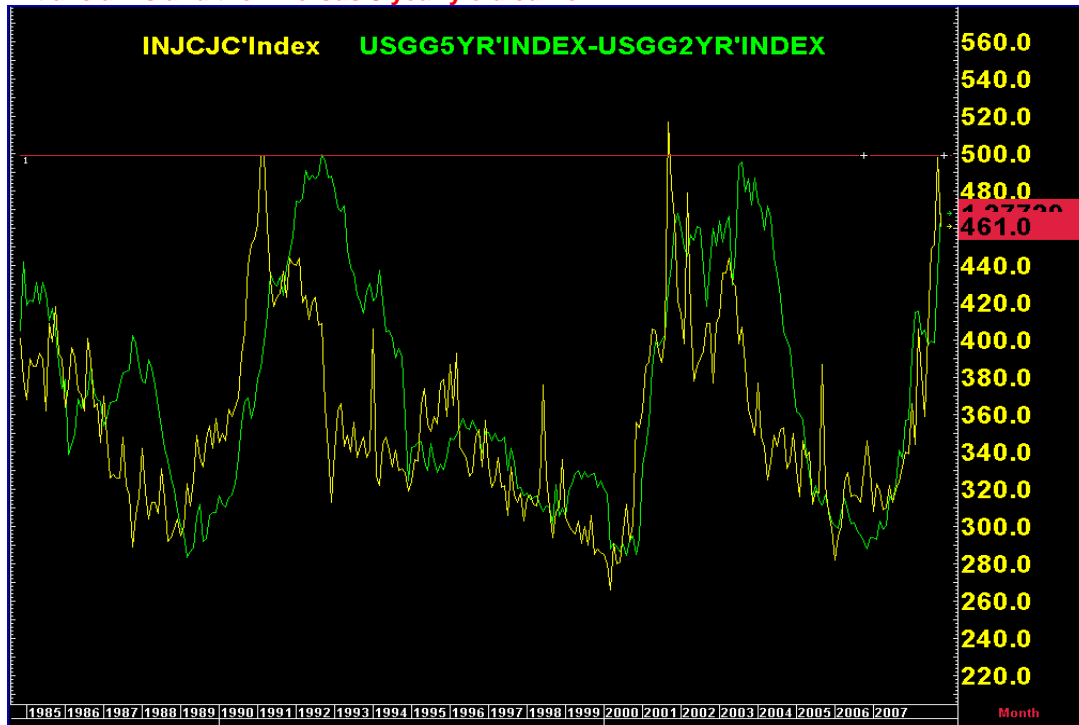
Techmentals

Unemployment rate



Suggests 8.5% by early 2010.

Initial claims and the 2 versus 5 year yield curve



At least the 1982 high at 671k if not as high as 750k-775k looks a danger on initial claims.

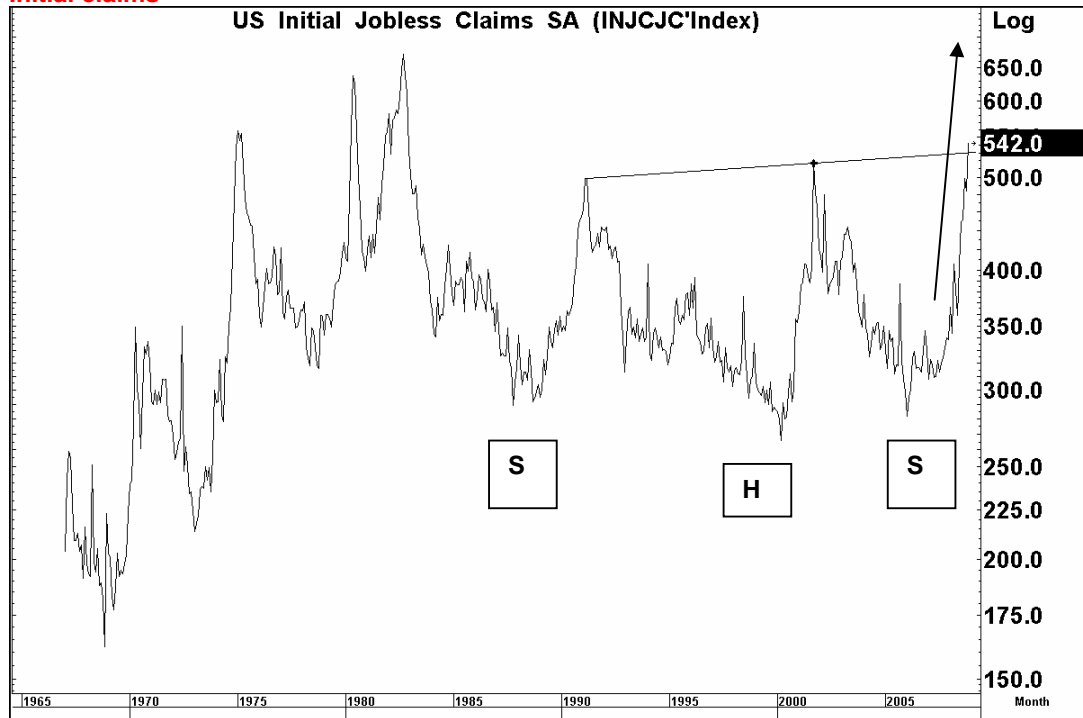
This is an overlay of the U.S. yield curve going back nearly a quarter of a century and initial claims. As we can see they are pretty much the same chart. Our bias for further weakness in Jobless claims is still in place.

This curve only inverted more than 20 basis points on 3 occasions in this period (1989, 2000 and 2006). After prior inversions it steepened to +150 to +160 basis points in 1992 and 2003. We are finally catching up this week as we have surged to +128 basis points

It is quite obvious that there is little belief that recovery is on the horizon and this level of “steepness” is not going to help financial institutions enough. So it is simple. The FED needs to cut more. With the transmission mechanism now still dysfunctional this will not easily feed to the consumer but it could help financial markets. It will certainly not do any damage and could eventually help the recovery process.

Initial claims remain dangerously close to the peaks of 1991 and 2001 at 499k and 517k respectively. It is very hard to believe that we are close to the peak of this move. For some time we have said that the present backdrop looks way worse than either of those periods and could easily be as bad as 1980-1982. The peak in initial claims in that cycle was 671k in Sept.1992 (In nominal terms- think what that equates to on a population adjusted basis)

Initial claims



At least 670k and possibly as high as 750-775 k is a danger

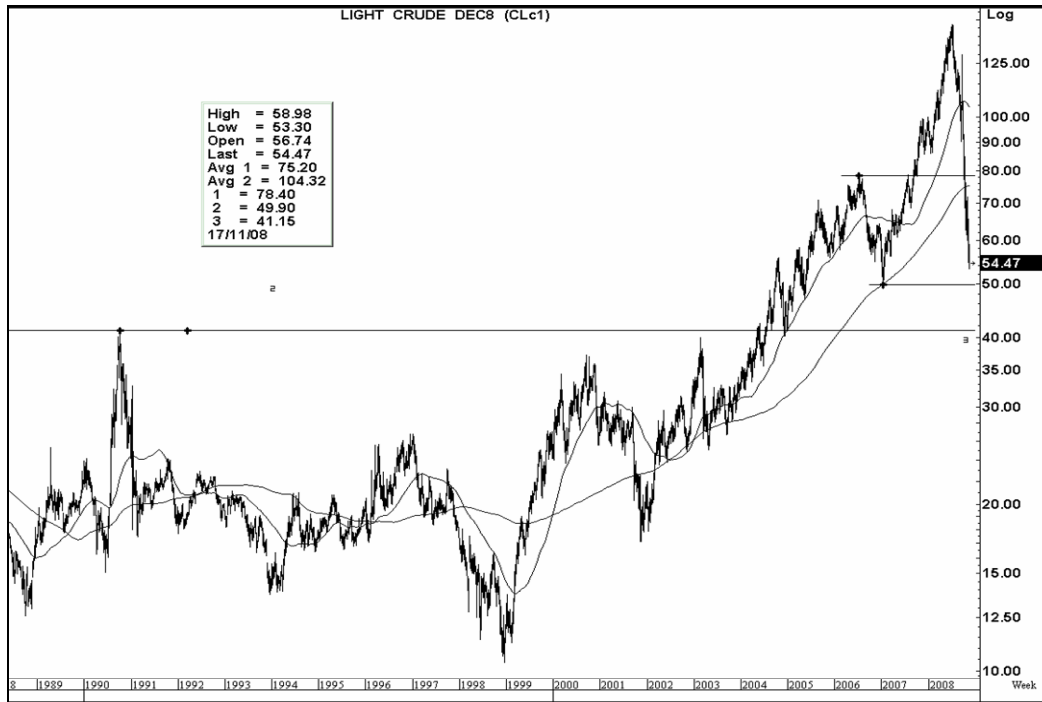
Our bias here is that even if the financial picture were to stabilise tomorrow it will not get fixed overnight. This will likely lead to considerable economic stress for some time to come. We believe at best this suggests a difficult economic backdrop into late 2009 into early 2010.

In its simplest form this likely means the FED easing cycle will have to continue at best stay in place as long as that seen in on average in the 1989-1992 and 2001-2003 periods.

That would suggest at least until the summer of 2010.

Commodities

Crude



The trend is down and we have now tested \$50. A close below there adds to the bearish outlook and opens the way for the next major support level at \$39-40.

Gold / Crude



An up move shows gold out-performance. The relative chart here shows that the double bottom has been completed and Gold should continue to outperform. The target on the linear chart is 18 while on the log chart it is 23.

Copper



The double top targets 140. But on the linear chart it targets 60 which were the lows in 1999 and 2001.

Portfolio:

	Position	Date established	Comment	Entry	Stop (If breached unless specified otherwise)	Target	Present level
EURGBP	Long 6 month (11 May 2009) 0.72 one touch	11 November '08	Major Long term levels and indications warn of a turn in the trend.	17%	Premium paid	0.72	0.8470

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