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The Charts That Matter Next Week

FX Sales Strats

Friday 13th August 2010

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Goldman Sachs International

From the trading desk

Have the G10 currencies peaked against the USD earlier than expected?..

Chart Source: Aspen Graphics   *Data: Reuters*

There are certainly a number of warning signs that the last stage of the USD-weakness trend we have been looking for (EURUSD to 1.35-1.37) is unlikely on a tradeable horizon

- The chart opposite is our Broad/USD Index which shows the performance of an equally weighted basket of the “Old World G10” currencies versus the USD, it’s USD-termed so lower is USD-strength. *Please note the Broad/USD Index is a product of the Securities Division of GS.*
- As discussed in the daily update on Tuesday it has turned lower from a near perfect hold of the 76.4 retrace of the drop from the cycle highs last November to the lows in June. As we often highlight 76.4 retrace holds against cycle extremes such as this are often seen at significant turning points.
- The subsequent drop in the index, particularly Wednesday’s sharp fall has taken the market below the uptrend which had been forming since the June lows.
- Overall, as an overview chart this warns of a material turn in the broader trend of the G10 currencies versus that USD.

Another notable development is the magnitude of Wednesday's EURUSD fall…

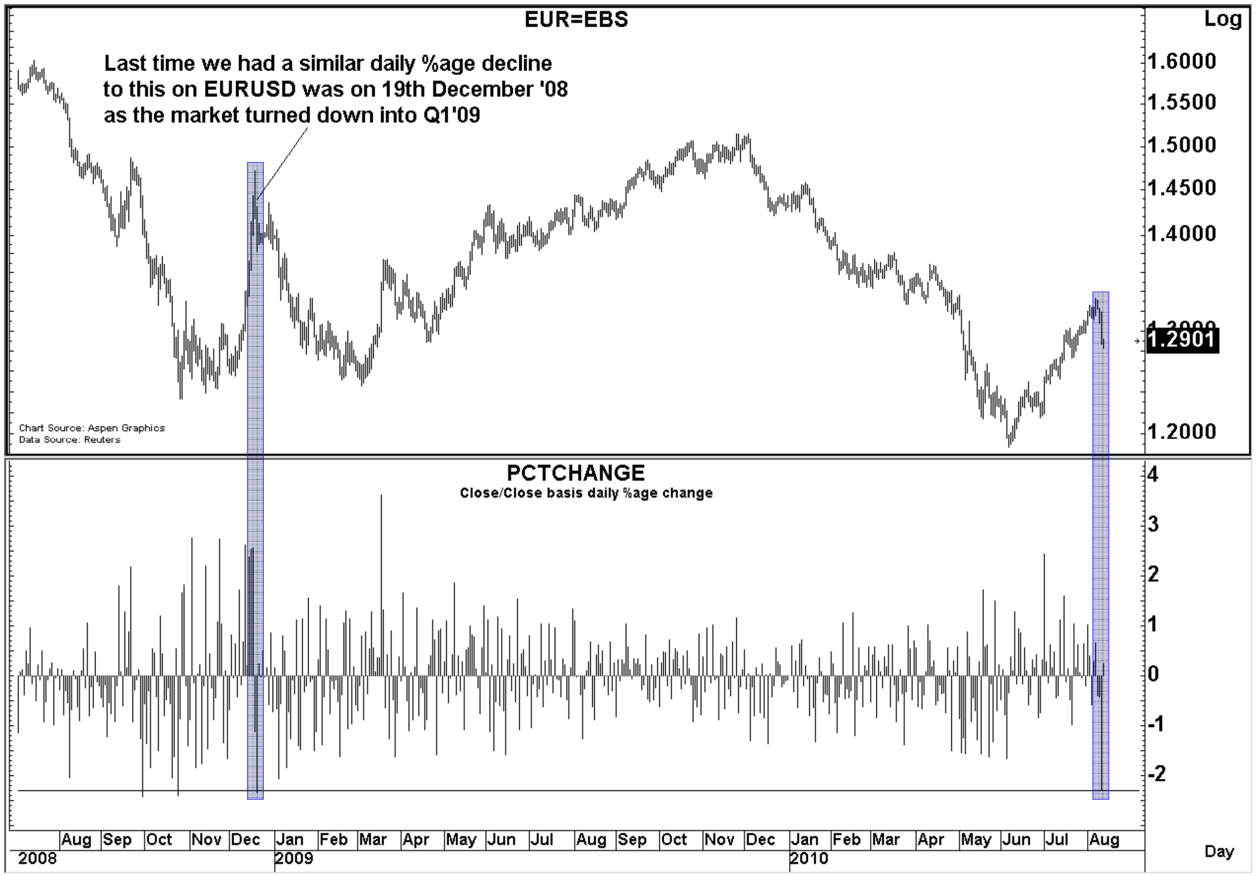

Chart Source: Aspen Graphics   Data: Reuters

On a daily close/close basis the market fell 2.29%. The last time a similar move took place was on 19th December '08 (-2.34%) – just as the market was peaking following the December '08 rally and beginning the fall into the March '09 lows (1.4720 to 1.2457)

- While we're only making a comparison with one other event in this case, over the last few years we've tended to find that "statistically significant" moves, such as Wednesday's, tend to be seen at trend turn or acceleration points. Looking at this particular case and put another way, violent pull backs such as Wednesday's are uncommon within healthy trends.
- Taking this and some of the more classic analysis discussed on the following slides into account, makes us very seriously consider the idea that EURUSD will not move to the 1.35-1.37 targets we've been discussing over recent weeks and that it's already peaked on a tradeable horizon.

Looking at the standard daily chart, the rally fell short of the 200-dma target…

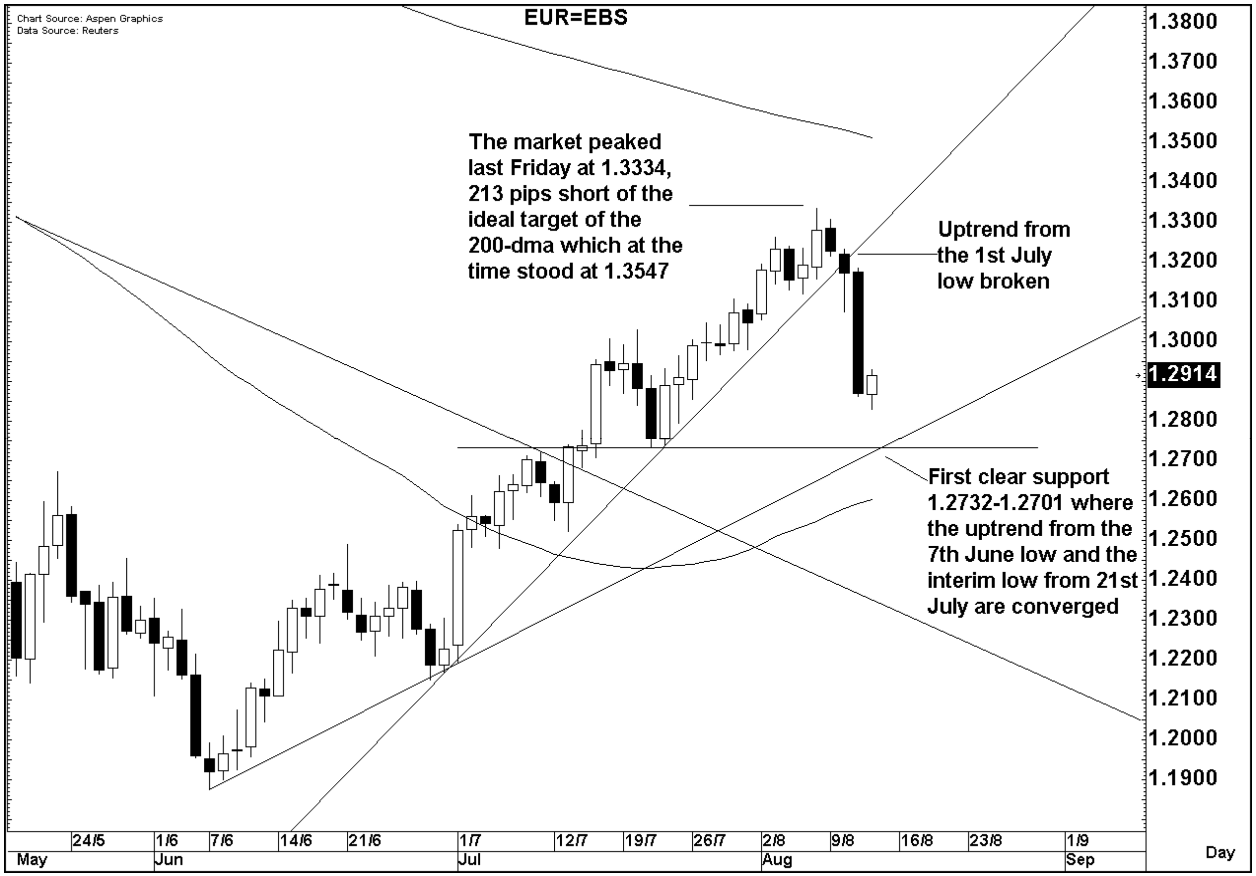

Chart Source: Aspen Graphics *Data: Reuters*

The market has also broken notable support with the move below the uptrend from the 1st July low

- Looking at the setup on the daily chart, on Tuesday the market closed marginally below the uptrend from the 1st July low. Wednesday's subsequent sharp fall argues a pretty clean break is in place.
- The next pivot/support region to watch is 1.2732-1.2701 where the interim low on 21st July and the uptrend from the 7th June low are converged.
- A break of this would act as further confirmation of a turn in place.

The weekly candle patterns could also be pretty significant…

A weekly close below 1.3069 will give a bearish engulfing on EURUSD

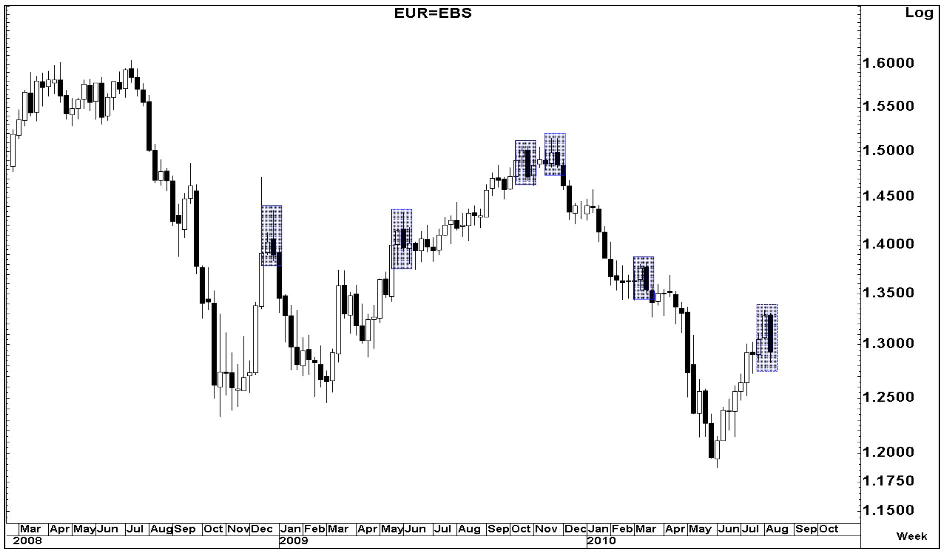

Chart Source: Aspen Graphics Data: Reuters

- The blue highlights indicate a selection of other bearish engulfing weeks which have been posted on EURUSD over the past 2-years. As can be seen they have been quite reliable/important patterns in indicating when the market was either turning lower or entering a significant period of consolidation. The most notable is probably the pattern from the last week of December '08 as it followed the sharp %age daily decline on 19th December '08 – i.e. the last time we had a similar %age daily decline to that seen on Wednesday this week. *For full disclosure it was also a bearish weekly reversal (the bar chart equivalent pattern) in December '08, that pattern isn't possible here as there was no new trend high this week.*

A weekly close above 81.51 will give a bullish engulfing on the DXY

Chart Source: Aspen Graphics Data: Reuters

- The blue highlights above show where *bullish* engulfing patterns have been posted on the USD Index over the past two years. They again have a reasonable track record. it's notable the same pattern was again posted at the December '08 lows. *Again for full disclosure there have been a couple of failures, particularly in the first week of August last year which is something we'll need to keep an eye on.*

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The historic comparison chart we've been following also remains important…

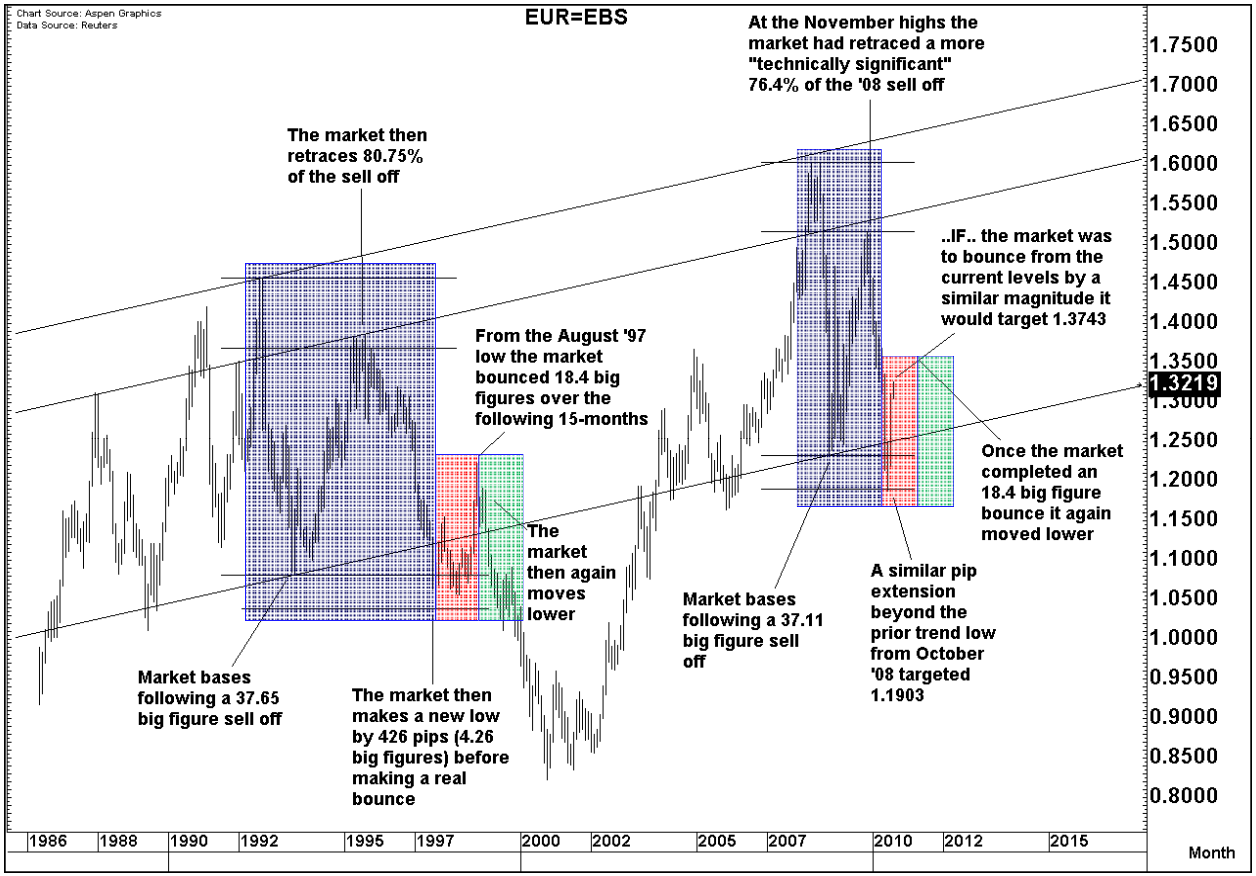


Chart Source: Aspen Graphics *Data: Reuters*

Again EURUSD has fallen short of the ideal target it implies of 1.3716, but the bigger picture warning that the market will likely find it difficult to, at least initially, rally beyond the mid- to high-1.30s remains

- As discussed on slide 3 the market has so far also fallen a little short of the 200-dma target. These developments could really therefore be viewed in two ways;
  1. We could still have a little more upside to come to fulfil the mid-/high-1.30s targets
  2. The fact the market has fallen short of targets derived from a number of different forms of analysis and subsequently posted quite negative price action could be a signal of underlying weakness
- When taking into account developments across the different asset markets it seems the real answer is closer to scenario 2. While we find it difficult to argue that EURUSD specifically has an underlying bearish setup given the problems for the USD, it does seem that EURUSD's inability to move to the mid-/high-1.30s target and so quickly develop quite a negative setup (extreme daily %age decline and bearish weekly patterns) shows the market's lack of comfort with being long EURUSD at higher levels.

Looking at other currencies, AUDUSD has a particularly concerning structure…

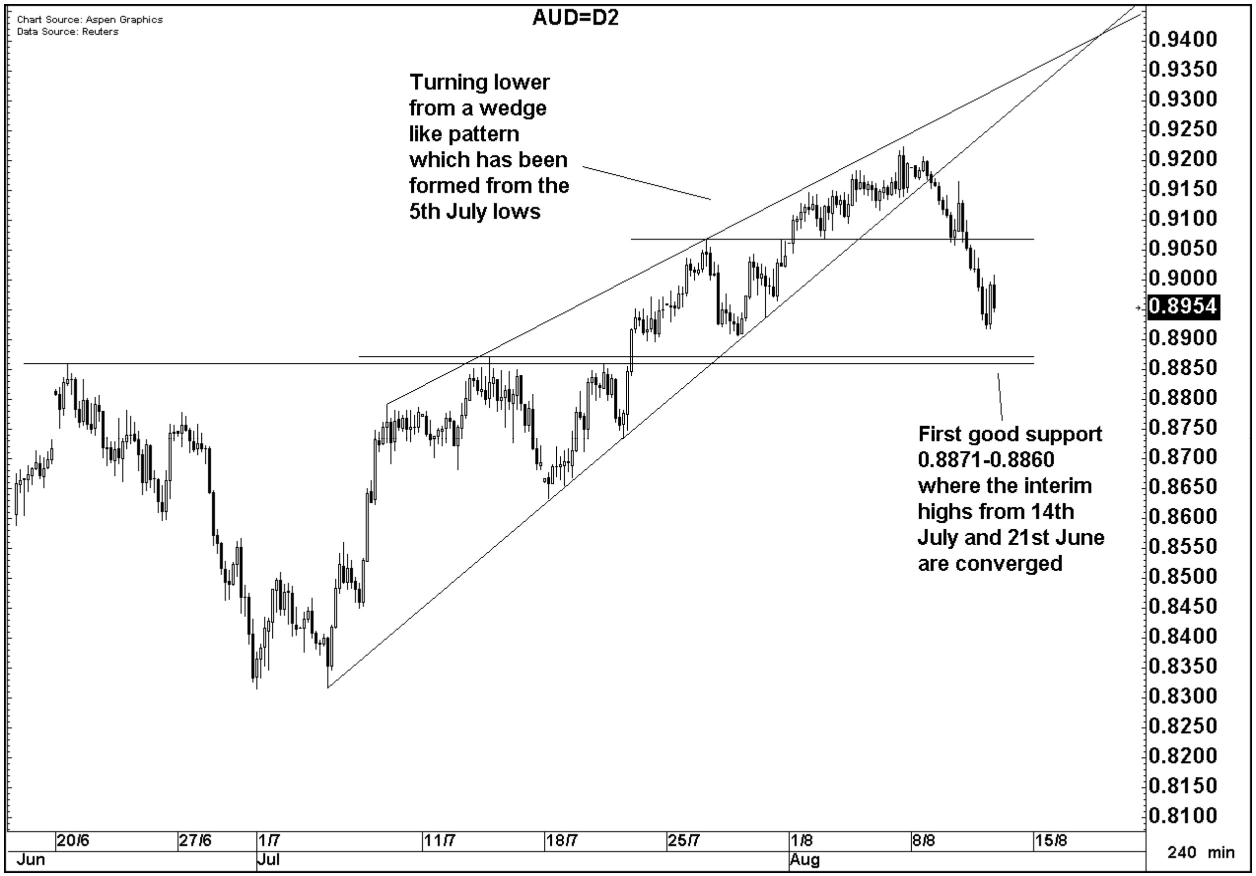


Chart Source: Aspen Graphics   Data: Reuters

The rally from the 5th July low took the form of a divergent wedge. It's a rare pattern which often culminates in relatively sharp downside corrections

- A full explanation of the theory behind the effectiveness of "Wedge" patterns is given on slide 8 (it's an extract from our *The Hows and Whys of Technical Analysis* presentation).
- In short they are often seen during the latter stages of carry trades, and in FX markets tend to form and subsequently work best when the market is near valuation/range extremes. Once the market breaks lower from the pattern sharp downside corrections and/or trend reversals often take place.
- In this case although not all of the characteristics of a classic carry trade have been present, AUDUSD is certainly near the extremes of it's range over the past two decades.
- The first support below current levels comes in AT 0.8871-0.8860 where the interim highs from 14th July and 21st June are converged.

Albeit on a larger scale, a similar pattern formed on AUDUSD into the July '08 highs…

Chart Source: Aspen Graphics *Data: Reuters*

Once the market eventually broke lower in late-July (a similar time of year to now) the market began the sharp drop into the October '08 lows

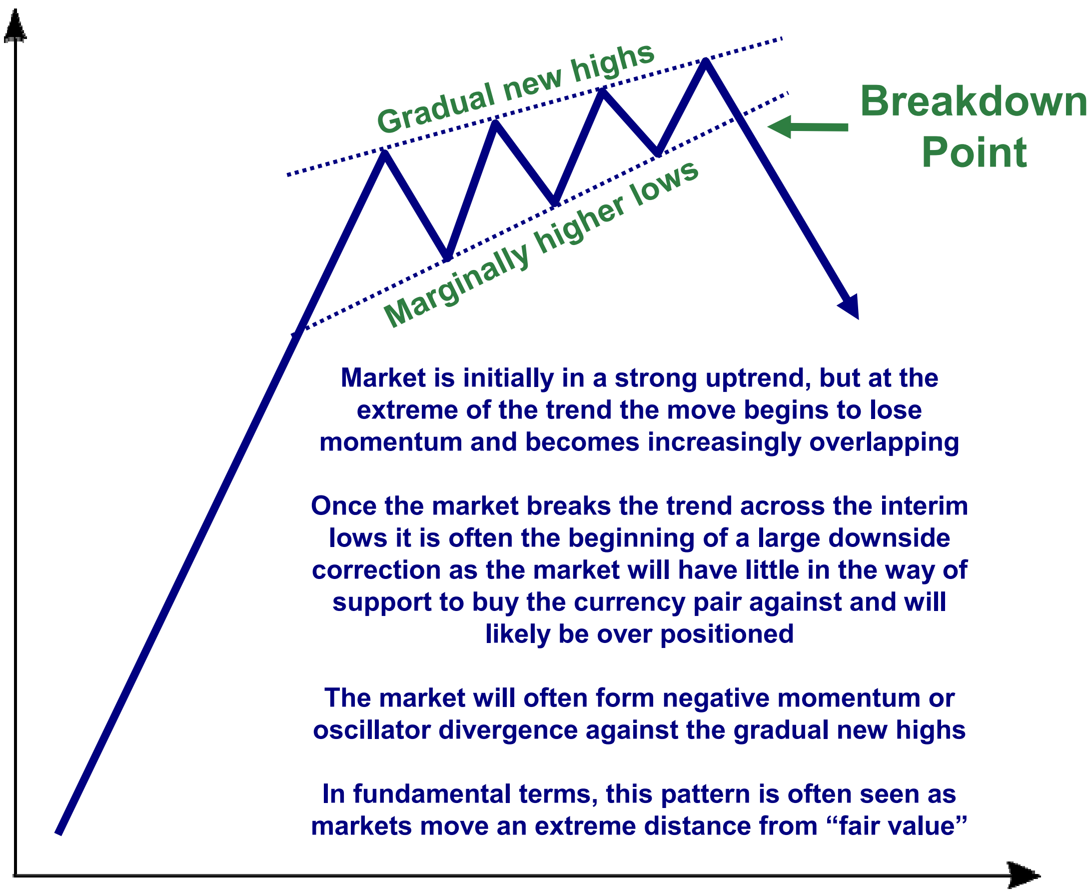
- A move of similar magnitude seems unlikely here as the pattern is only evident on the intraday as opposed to daily charts and also the backdrop for the USD remains very negative so it's difficult to argue a simultaneous AUD-negative/USD-positive story to get a "real" FX move to develop. However, some further downside correction does certainly look very possible/probable.

STRUCTURES AND THEIR TARGETS: Wedges…

An extract from GS Techs "The Hows and Whys of Technical Analysis", full slide pack available on request

- Trend extremes are often associated with loss of *underlying* momentum. This can manifest itself in one of two ways; (1) extreme volatility with the market making little real progress with the trend or (2) the trend continuing but in an increasingly slow and over-lapping manner
- Double Tops/Bottoms and Head and Shoulders patterns tend to be associated with (1)
- Wedge patterns are associated with (2), and are often seen at the extreme on carry trades – market participants being of the view that "they have to own the currency because of its yield" but the news flow to drive incremental gains (i.e. higher yields) is waning

- EXAMPLE: AUDUSD from the August '07 lows to the July '08 highs



Market is initially in a strong uptrend, but at the extreme of the trend the move begins to lose momentum and becomes increasingly overlapping

Once the market breaks the trend across the interim lows it is often the beginning of a large downside correction as the market will have little in the way of support to buy the currency pair against and will likely be over positioned

The market will often form negative momentum or oscillator divergence against the gradual new highs

In fundamental terms, this pattern is often seen as markets move an extreme distance from "fair value"

On the daily chart the first significant support/important pivot runs 0.8871-0.8860…

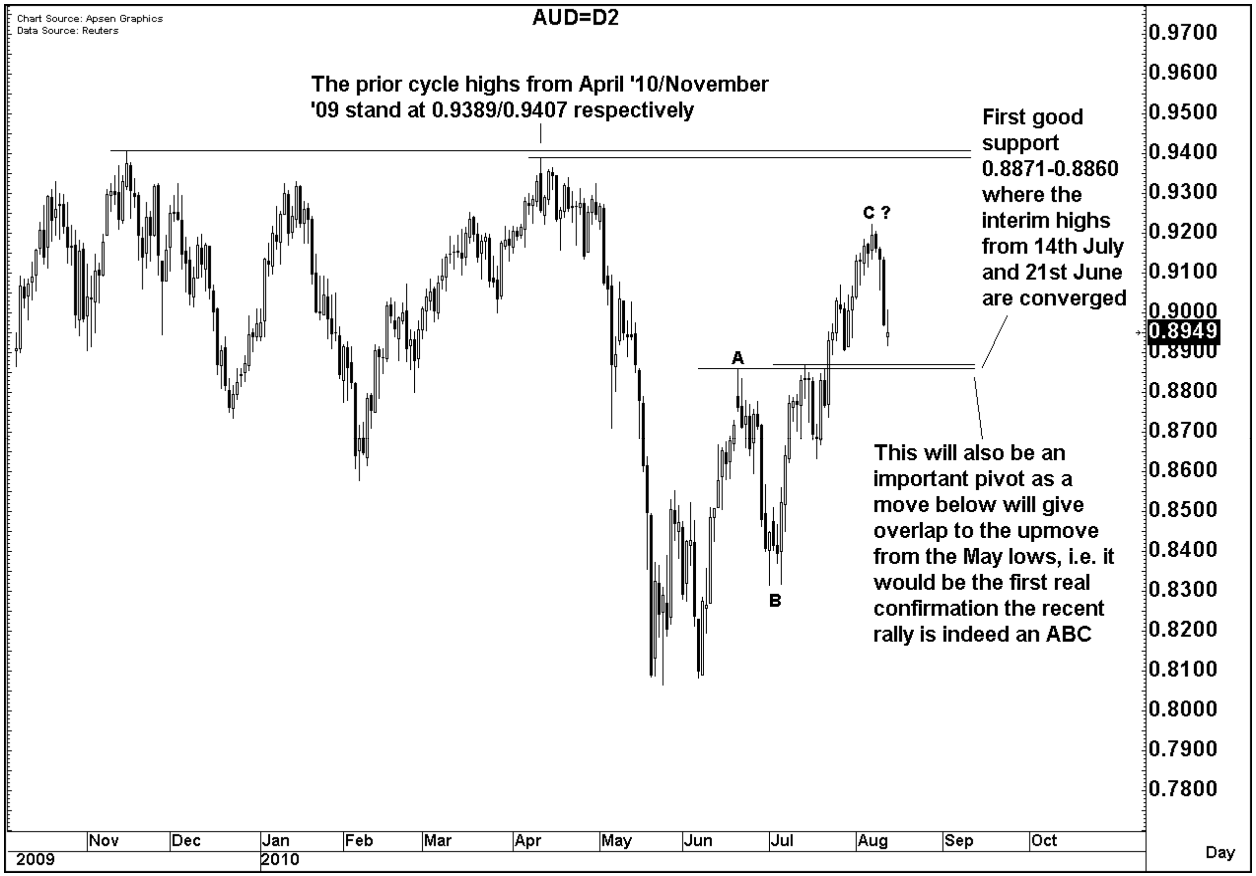


Chart Source: Aspen Graphics *Data: Reuters*

Below that point overlap would be created within the up move from the May lows. This would make it easier to argue that the rally from the May lows is corrective in nature prior to another decline

- Given the underlying cross asset picture for the USD we'd be tempted to lock in a positive return on our Bearish-AUDUSD *Favourite Tactical Theme* if and when the market does test the 0.8871-0.8860 support with a plan to re-establish on a bounce or once a close below that pivot has been achieved to give further confirmation of more downside to come – it's been very easy to get dragged into being too bearish on the AUD over reason months.

AUDUSD has remained very highly correlated to equity markets…

Although AUDUSD currently looks a little high versus the S&P

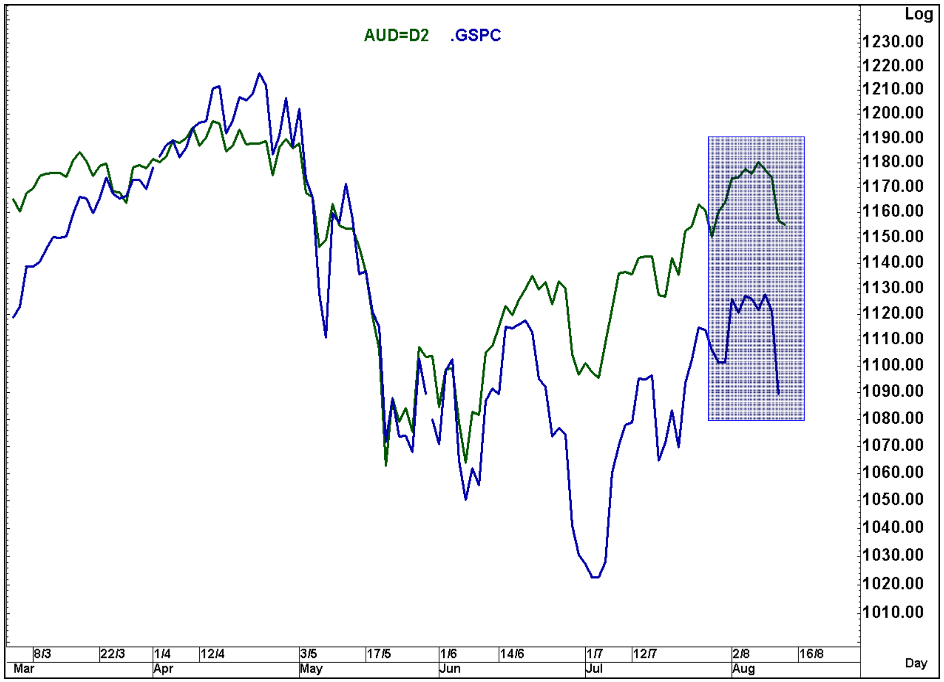


Chart Source: Aspen Graphics   Data: Reuters

- The positive correlation between AUDUSD and the S&P has been strong for a number of months/years and has been particularly tight directionally for the past few months. The one notable point at the moment is that AUDUSD looks a little too high versus the S&P, although this was also the case in late-June/early-July too.

The S&P's rally from the July lows can also be viewed as a wedge

Chart Source: Aspen Graphics   Data: Reuters

- Given the positive correlation between AUDUSD and the S&P it's interesting that the recent rally in the S&P also appears to have taken the form of a wedge.
- It highlights the market's inability to develop the necessary positive momentum to break above the prior corrective high from 21st June at 1,131.

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The daily chart of the S&P again looks heavy…

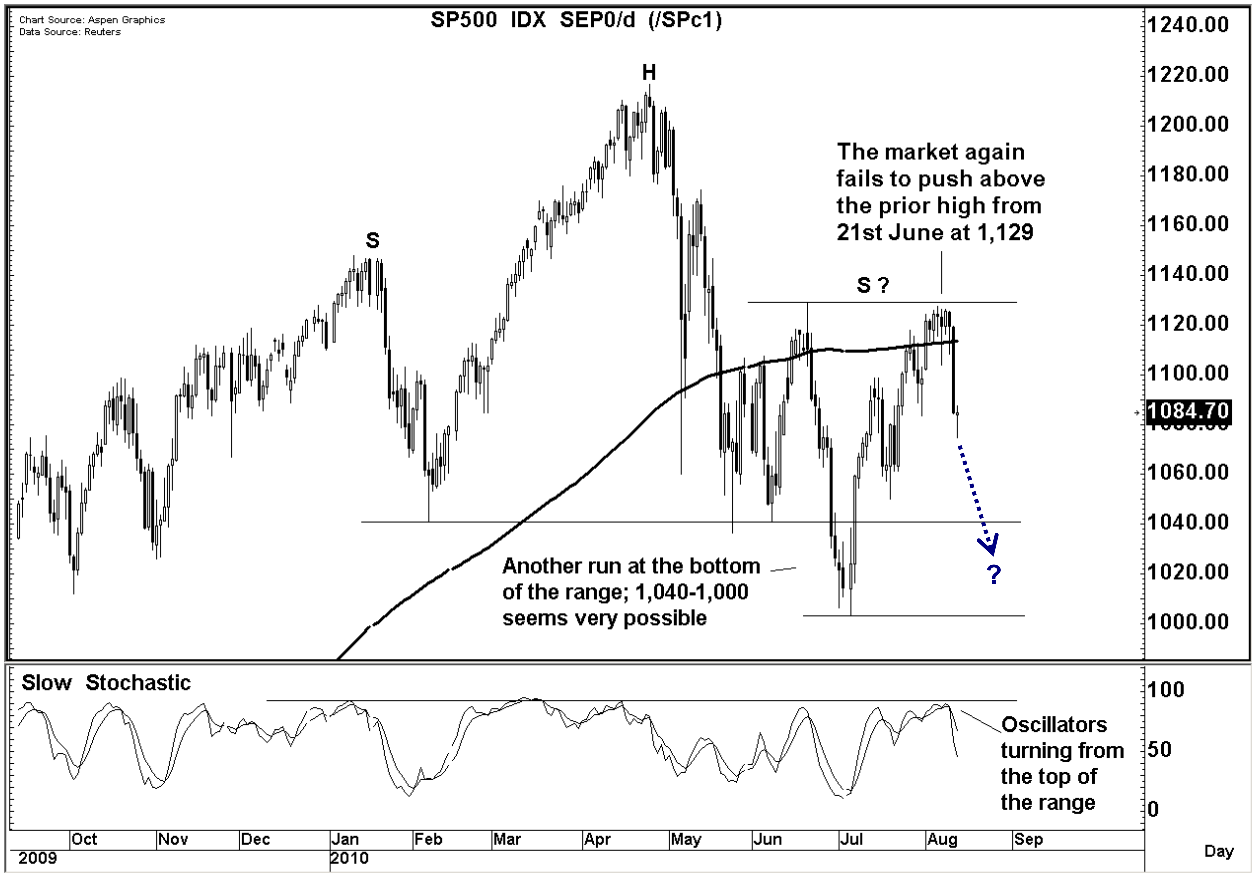

Chart Source: Aspen Graphics *Data: Reuters*

Arguably the market could still be forming a larger H&S top

- As detailed on the prior slide the market has failed to move beyond the prior high from June at 1,129 with the momentum of the bounce waning as this level was reached.
- Given the wedge like nature of the rally from the July lows a return to the base of the range from 1,040 to 1,000 looks very possible.
- This would fit well with some further downside correction in risk correlated FX currency pairs.

The weekly close on the S&P will also be very important…

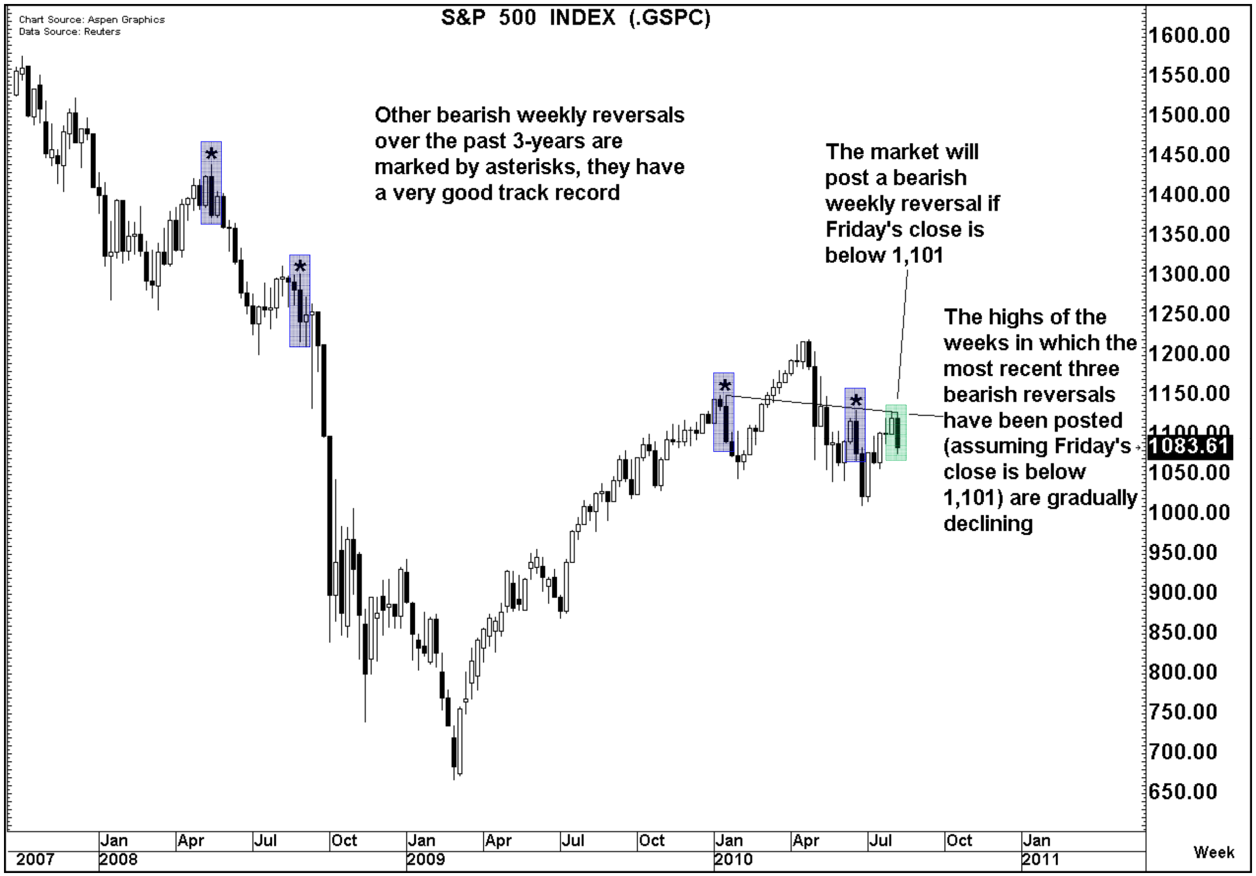

Chart Source: Aspen Graphics   Data: Reuters

If Friday's close is below 1,101 the market will post a bearish weekly reversal from the high of the recent recovery

- Looking back over the past 3-years four other such patterns have been posted. All have given at least some downside follow through.
- Most notable were the two posted in May and September '08. Following both the market declined very sharply.
- The most recent two, posted in mid-June and mid-January this year, have only given minor pull backs, particularly the one posted in January. But the market did still correct lower following both.
- One other notable point, assuming the pattern is achieved this time around with a close below 1,101 on Friday, is that the last three patterns will all have been posted from similar, but very gradually declining, highs; January 1,150.50, June 1,131.08 and August 1,129.23. Taken at face value this seems to indicate that the rallies are becoming weaker as time goes on.
- **In conclusion, as discussed in recent client meetings, while the timing is difficult, we remain concerned that a larger topping structure is still being formed on the S&P – which will eventually lead to another meaningful decline.**

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Finally we should watch the weekly close on the VIX closely too…

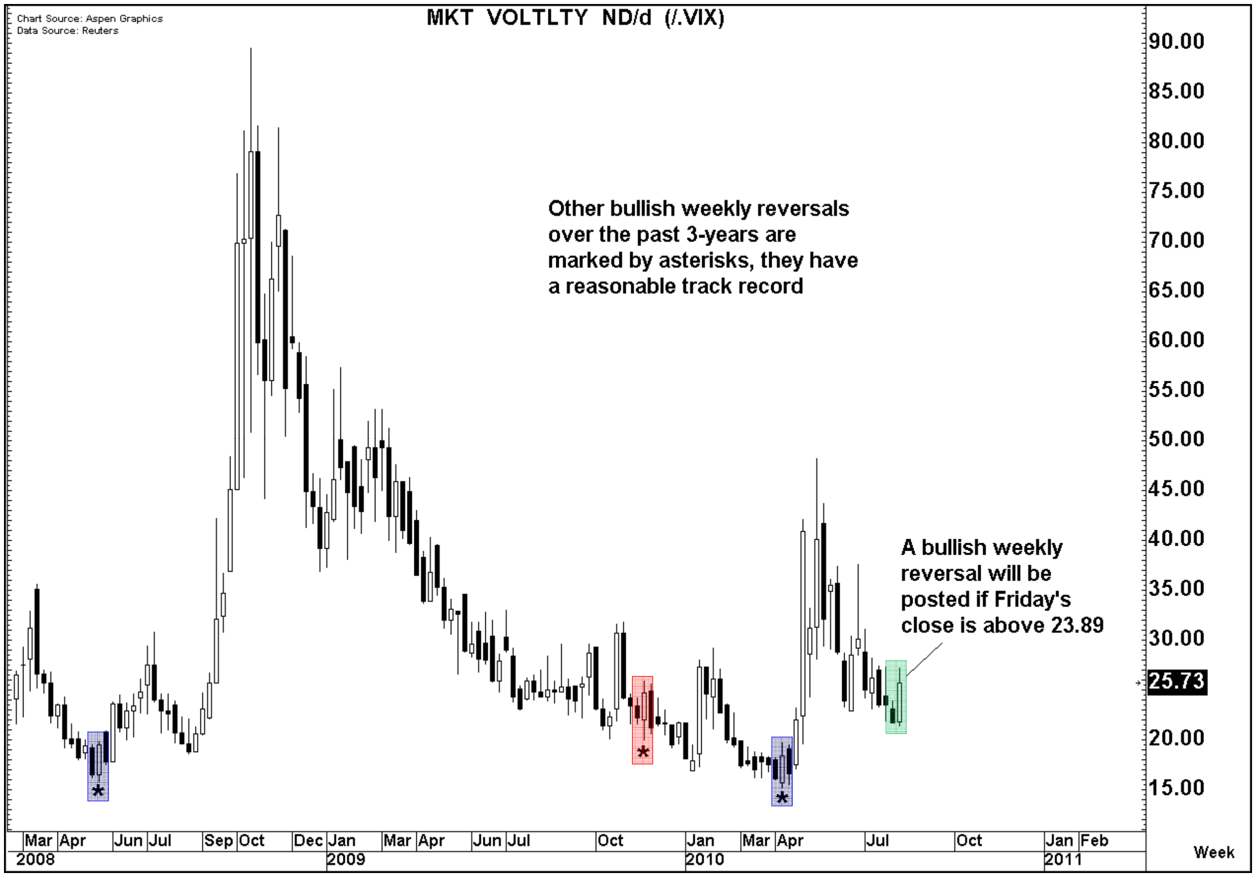

Chart Source: Aspen Graphics   *Data: Reuters*

If Friday's close is above 23.89 the market will post a bullish weekly reversal from the base of the recent down move

- Three other bullish weekly reversals have been posted over the past 3-years. Their track record isn't perfect, two have worked very well and one didn't work at all.
- The conclusion seems to be that given how well two of the patterns worked…
  - May '08, low to high on the VIX; 15.82-89.53
  - April '10, low to high on the VIX; 15.23-48.2
- …it's probably best to go with this week's pattern if it's achieve.
- Beyond the significance of VIX patterns for the S&P they're also important for broader markets as in the vast majority of cases a broader swing in risk appetite will take place across asset classes.

U.S. 10-year yields continue to decline…

Following last Friday's poor data yields broke from their July range

Chart Source: Aspen Graphics Data: Reuters

- While it's difficult to calculate ST targets from the consolidation, the base of the old pattern from 2.85 to 2.88% should now act as good resistance (price support) if we do see a material bounce in yields.

The multi-week chart still looks like a big double top targeting 2.2%

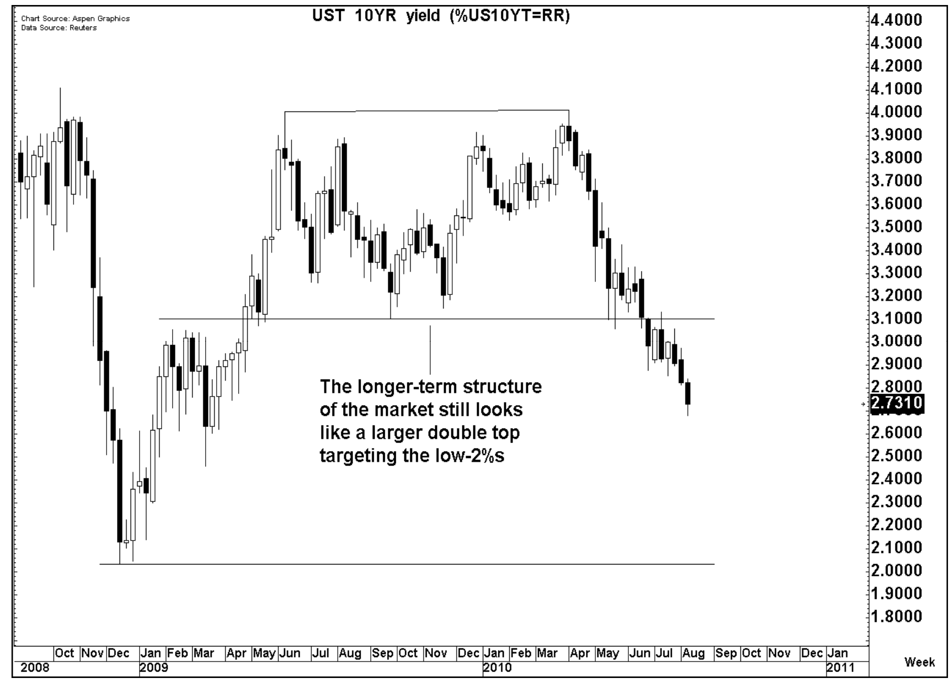

Chart Source: Aspen Graphics Data: Reuters

- The break lower from the daily chart consolidation as discussed opposite adds weight to the idea that from May '09 to June this year the market formed a larger double top which targets approximately 2.2%.

As a result the 10-year/2-year curve is continuing to flatten…

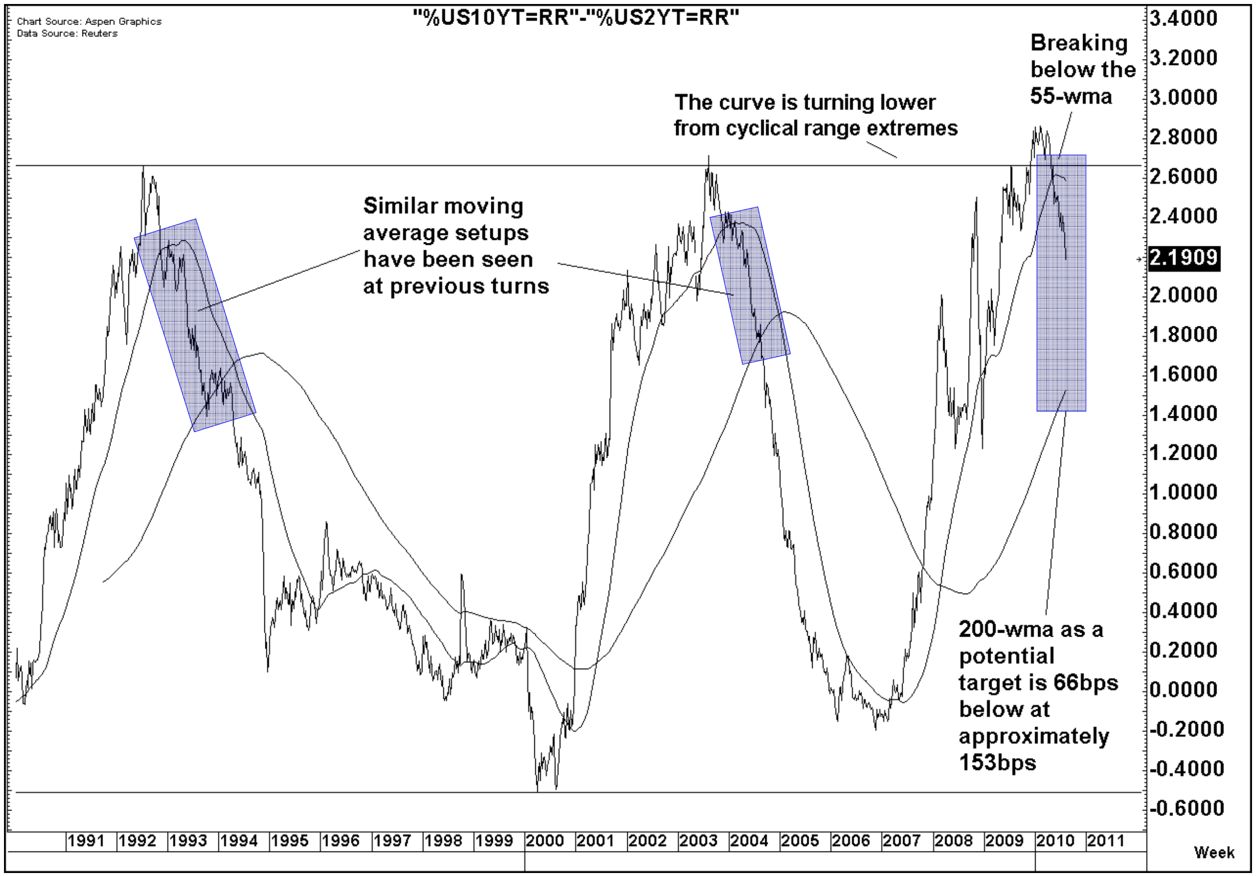

Chart Source: Aspen Graphics *Data: Reuters*

The ultimate target of the 200-week moving average now stands approximately 66bps below current levels

- While the curve is now bull flattening which is different to the prior trend flattening from ‘04/’05 this chart alone makes a clear argument for the trend to extend significantly further.

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With this in mind our U.S./Japan spread basket continues to move gradually lower…

The target of the double top is still 30bps below current levels

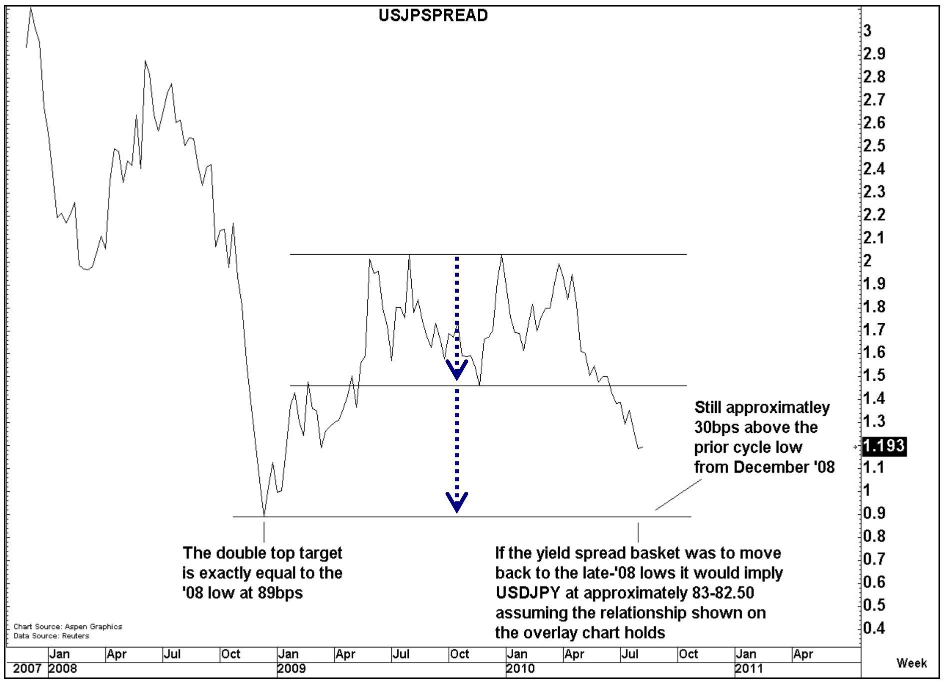

Chart Source: Aspen Graphics   Data: Reuters

- This chart shows the performance of the equally weighted basket of U.S./Japan 10-, 5- and 2-year yield spreads which we've been watching for the last few weeks. Although it has declined significantly over recent weeks it still stands approximately 30bps from the target of the double top which has completed which targets 89bps – interestingly that is exactly on the prior low from December '08.

The spread basket overlaid with USDJPY

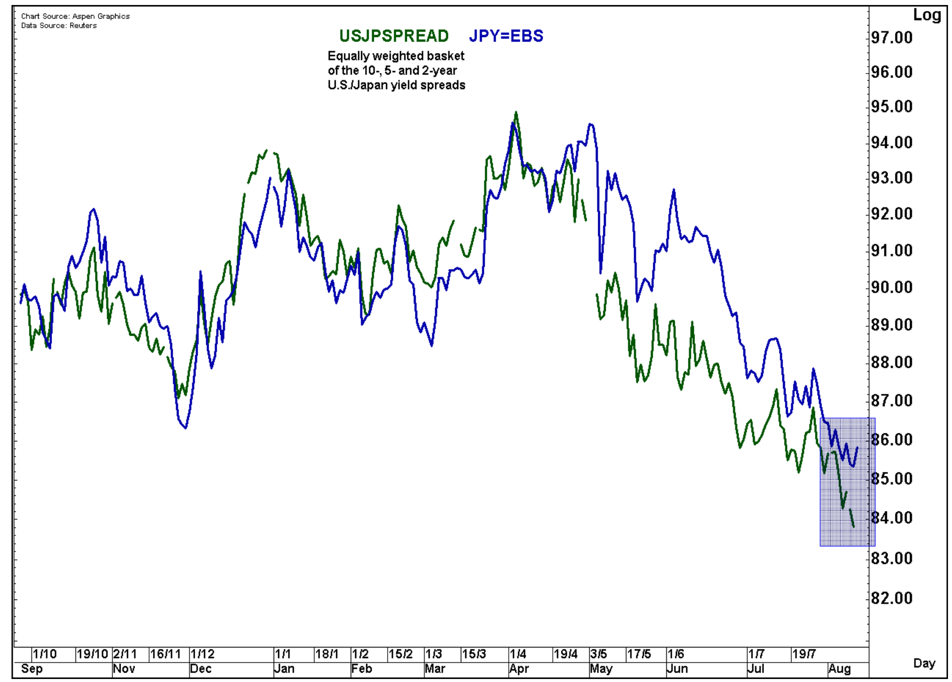

Chart Source: Aspen Graphics   Data: Reuters

- This chart shows the spread basket in green overlaid with USDJPY spot in blue.
- The correlation has been quite tight over the last year. Currently USDJPY looks a little over-valued relative to the basket. If the current correlation holds a move to the double top target on the index at 89bps would imply USDJPY nearer to 82.

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With the prior slide in mind, what does USDJPY look like?..

There are some signs of at ST base on the daily charts

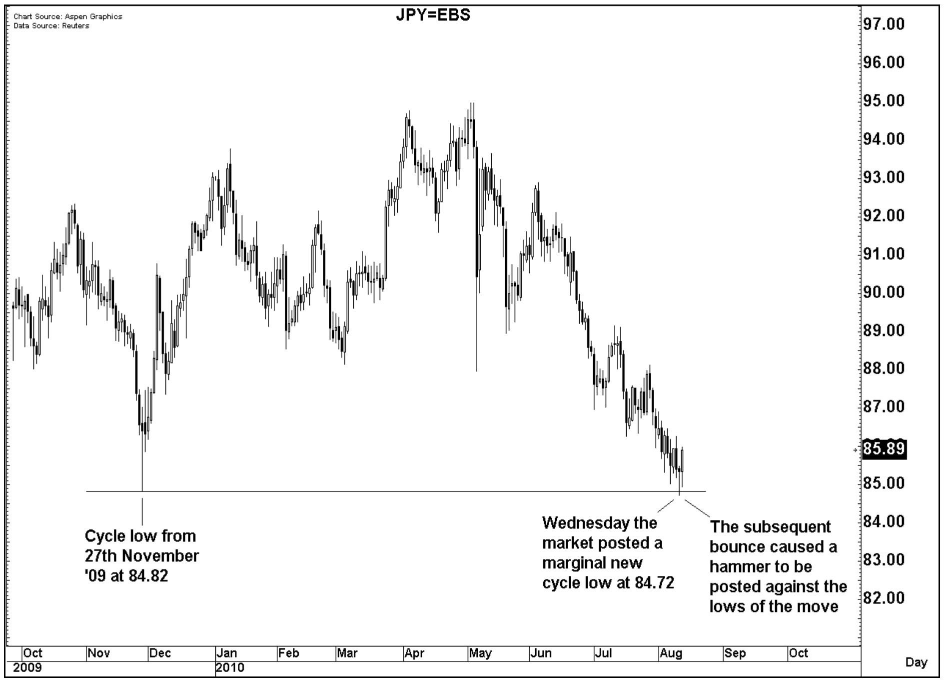

Chart Source: Aspen Graphics Data: Reuters

- Wednesday's low at 84.72 was very marginally below the prior cycle low from 27th November '09 at 84.82. From that point the market recovered relatively sharply and in the process posted a hammer like patter against the base of the move. This does argue the market can enter a period of consolidation.

Given the setup on the yield spread basket it's difficult to get excited

Chart Source: Aspen Graphics Data: Reuters

- Although the daily chart setup does argue for at least ST consolidation, given USDJPY's strong correlation to yield differentials, the setup on the yield spread basket makes it very difficult to actively look for more than a bounce within the recent downtrend. Interestingly as discussed on the prior slide if the yield spread basket moves to its potential target it would imply a move near to 82 for USDJPY. This would be very close to the base of a possible parallel channel formed off the August '98 high.

While on the subject of Asia, USDSGD is at a very important pivot…

This week's low at 1.3453 was against the prior low from July '08

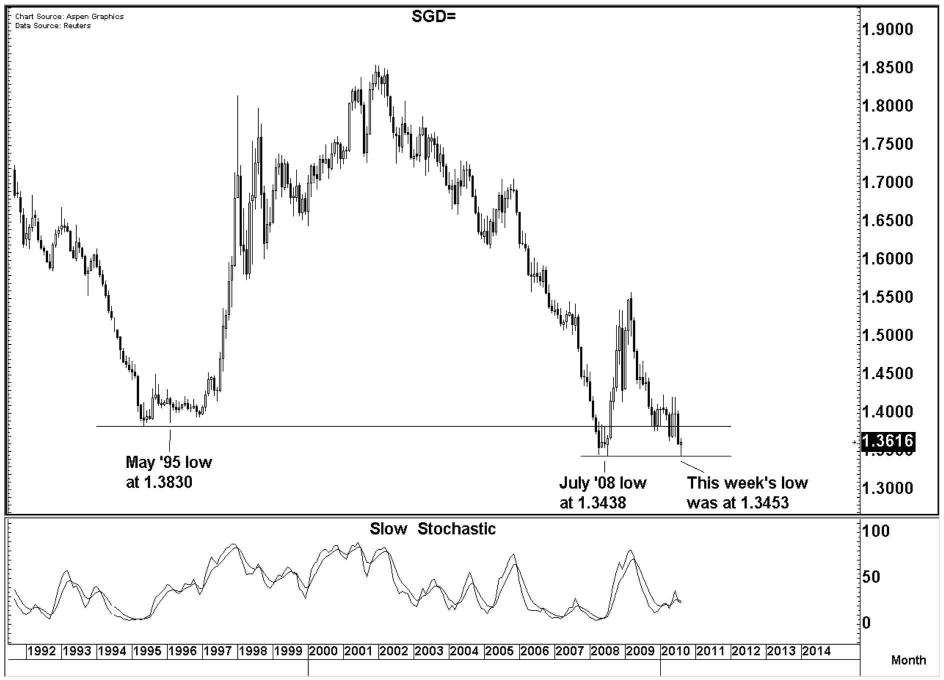

Chart Source: Aspen Graphics   Data: Reuters

- This week's low at 1.3453 was only very marginally above the all time low from July '08 at 1.3438. This gives the potential for a double bottom to form.

If Friday's NY close is over 1.3603 a weekly reversal will be posted

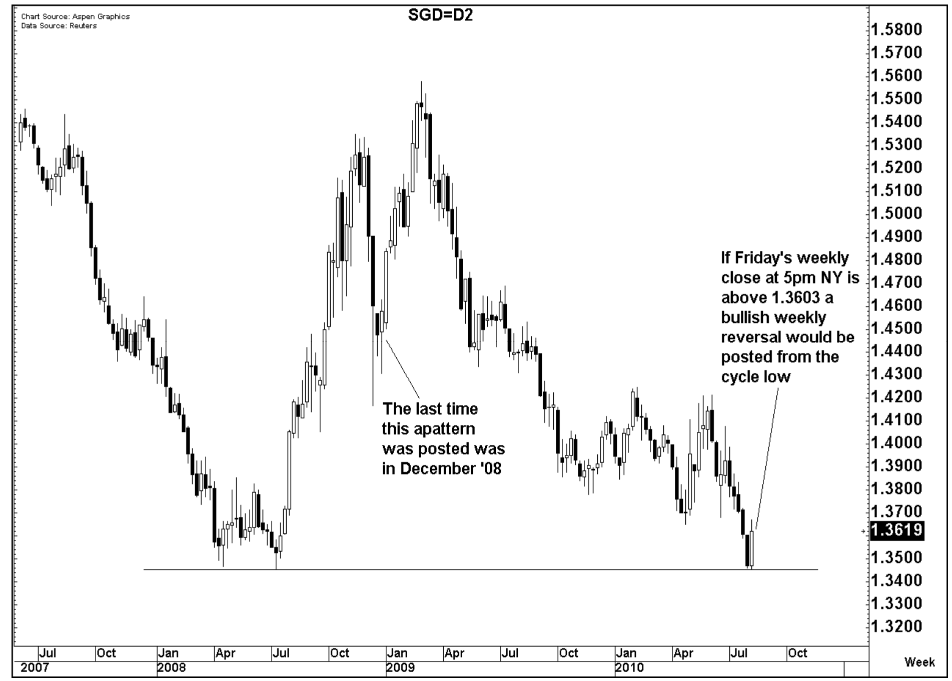

Chart Source: Aspen Graphics   Data: Reuters

- While it's difficult to calculate targets this would certainly warn of further upside correction for USDSGD.
- The last such pattern was posted in December '08 with the market spiking exactly 10 big figures over the following nine weeks. It's notable that it was posted from a far less significant pivot than is potentially the case here.

With U.S. data deteriorating and yields falling it's very difficult to buy the USD…

Chart Source: Aspen Graphics   Data: Reuters

But is USDSGD really an FX view or just an equity trade?

- This chart shows the Straits Times Index in green overlaid with SGDUSD in blue (i.e. inverse-USDSGD).
- It highlights that while short-USDSGD can be thought of as a USD-trade, really, it's is play on the direction of the Straits Times Index.
- The positive AUDUSD/S&P correlation makes the same point. While EURUSD has to a certain extent de-coupled from equity markets, broader "risk/growth correlated" markets such as AUD and SGD really haven't.
- So it seems that when you sell-AUDUSD or buy-USDSGD you are really still just selling equities as opposed to really buying the USD.

Looking specifically at The Straits Times, the market is heavy against resistance…

The recent highs being against the 76.4 retrace of the ‘07/’09 fall

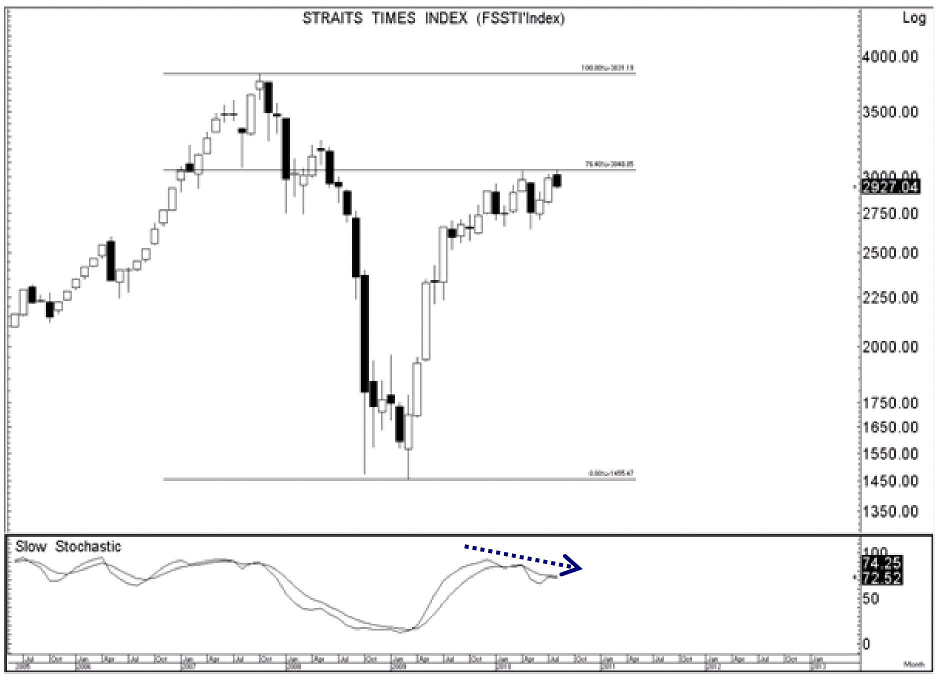

Chart Source: Aspen Graphics   Data: Reuters

- On a log scale basis this month’s high at 3,043 was right on the 76.4 retrace of the drop from the October ‘07 high to the March ’09 low at 3,048.
- Negative monthly Stochastic divergence is also attempting to develop against the recent series of marginal new highs.

How does this fit with the constructive look to the Shanghai Comp?

Chart Source: Aspen Graphics   Data: Reuters

- Over the past year the Shanghai Composite has significantly under-performed the Straits Times. The ratio falling from a high of 1.45 in March ‘09 to the low in mid-July this year at 0.82 – i.e. the Shanghai Composite fell 43% relative to the Straits Times. The ratio now however sits just above an historically important pivot centred on 0.826-0.809. Fitting with the setup on the components this is where you would look for the Shanghai Composite to begin to recover in at least relative terms.

Finally in EM space USDZAR is worth watching closely…

The market is now against an important multi-year pivot support

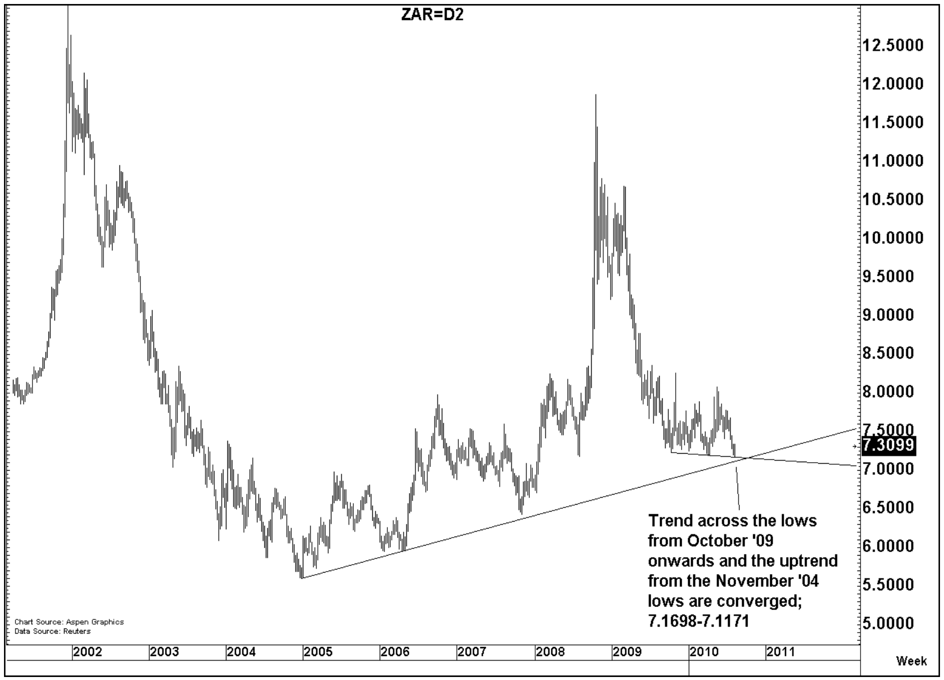

Chart Source: Aspen Graphics Data: Reuters

- The trend across the interim lows from October '09 onwards and the major uptrend from the November '04 lows are converged just below current levels; 7.1698-7.1171.
- Signs of a reversal higher from here (see opposite chart), or a break lower, would both likely have significant implications.

A bullish weekly reversal will be posted with a close above 7.34

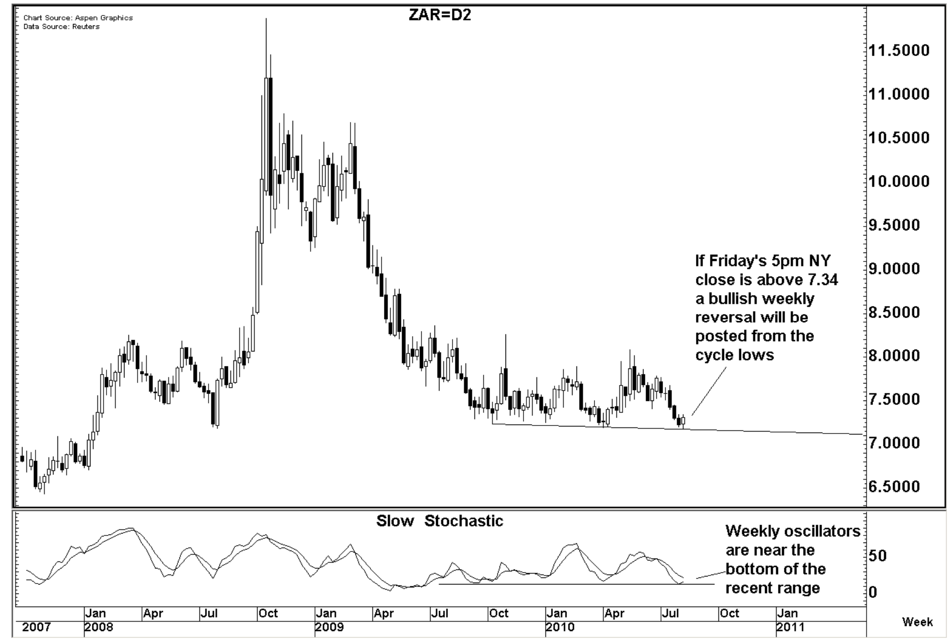

Chart Source: Aspen Graphics Data: Reuters

- Looking at the weekly chart. A close above 7.34 at 5pm NY on Friday would give a bullish weekly reversal from the base of the recent downtrend.
- Coupled with weekly oscillators being against the base of the recent range this would be an important signal of further bounce to come. Particularly with other markets such as equities and the VIX potentially on track for corresponding patterns.

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