
EUR/USD: "A FALL FROM GRACE" ?
Decline targets 1.3770/1.3410
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# EXECUTIVE SUMMARY



EUR/USD signals "a fall from grace" into 1.3770/1.3410 after failing beneath a critical technical level and multiple DeMark exhaustion signals, within striking distance of an anticipated June 13/14th cycle turning point. In Elliott Wave terms, the move is potentially part of a wave 3 impulsive structure. Expect a strong decline, punctured by weak "short covering" rallies, similar to this week.

Euribor's break at key trend-line resistance marks divergence and alerts to an important change in sentiment as investors potentially reduce expectations for higher interest rates, following the ECB's "v" code word [vigilance] on mounting inflationary pressures.

Focus shifts back to the EU peripheral debt crisis as CDS risk accelerates, with market's fearing the reality of a Greek default, after the S&P gave the country the world's worst credit rating. Meanwhile, Portugal may offer the next surprise as CDS risk increases by the most since the Euro's inception, while also surpassing Ireland.

All eyes remain poised on the US dollar's preparation for a bullish "KO" fight against the major currency blocks, as the greenback continues to unwind from extreme undervalued conditions. In a weak "relative" beauty contest (sharing major economic problems with EU & UK), technical performance on the DXY may still rise up to 30%.

Further US dollar tailwinds will likely be provided as the infamous "risk on" theme which has championed the first half of 2011, shows characteristics of finally abating from "irrational" comfort zones. Indeed, silver's 30% crash in April may have marked a peak in risk, spilling contagion onto related proxies, with stock markets set to follow.

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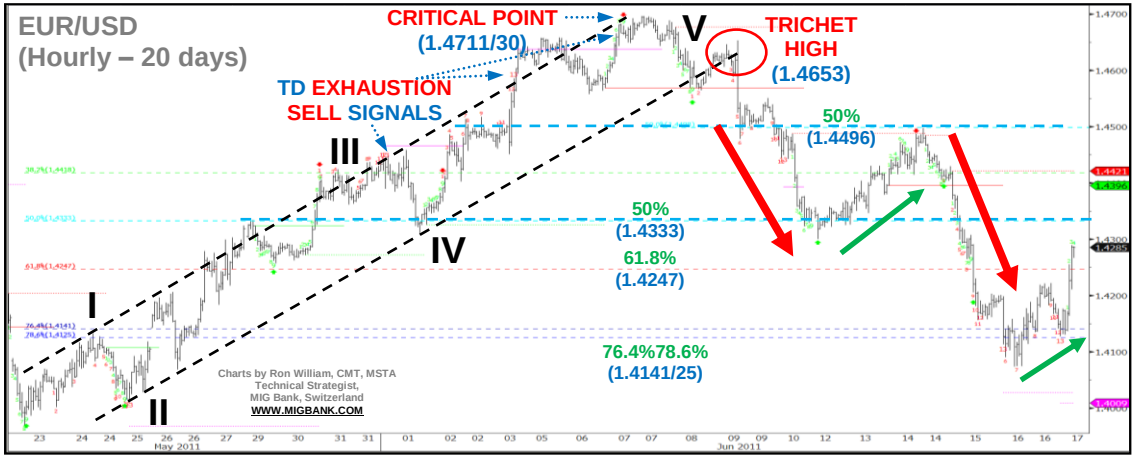


Figure 1. EUR/USD hourly chart with Elliott Wave structure & DeMark signals. Source: Bloomberg LP.

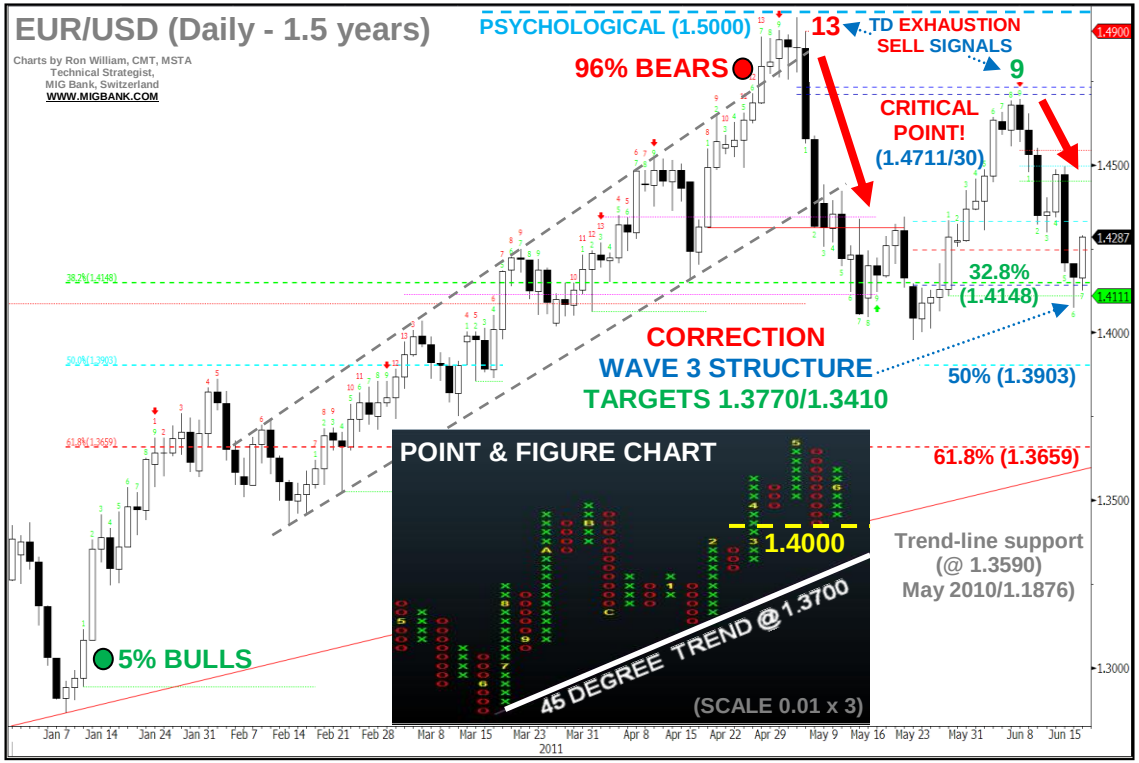


Figure 2. EUR/USD's big decline across daily and P&F charts. Source: Bloomberg LP.

## EUR/USD signals "a fall from grace" into 1.3770/1.3410.

- EUR/USD signals "a fall from grace" into 1.3770 (38.2% Fib-2010 uptrend) and 1.3410 (wave objective), after failing beneath critical technical levels and multiple DeMark exhaustion signals, within striking distance of an **anticipated June 13/14th cycle turning point.**
- **In Elliott Wave terms, the move is potentially part of a wave 3 impulsive structure.** Expect a strong decline, punctured by weak "short covering" rallies, similar to this week. (See page 5 COT chart).
- **On June 09th, the euro spiked beneath critical resistance at 1.4711/30** (76.4%/78.6% Fib-April decline), as ECB president Trichet used his signature "v" code word [vigilance]; only to see prices "sell on the fact" and reverse sharply by a -175 pips (in London trading).
- **Micro intraday price structure provides impulsive characteristics**, after collapsing from a five wave rise, anchored by renewed DeMark exhaustion and bearish momentum divergences.
- **We have opened a much awaited short position at our 1.4450 "low risk" trigger level**; achieving price target two (PT2). Stop-loss is now reduced to breakeven, ensuring a risk free trade.
- Watch for initial **support levels at 1.4148** (38.2% Fib), then **1.4000/1.3970** (P&F/May swing low). **Beyond here accelerates into 1.3770, then 1.3660 (61.8% Fib) and 1.3410 (Wave objective).**
- **Only a sustained close above the "Trichet high" at 1.4653 and most importantly 1.4711/30 will re-evaluate the status quo.**

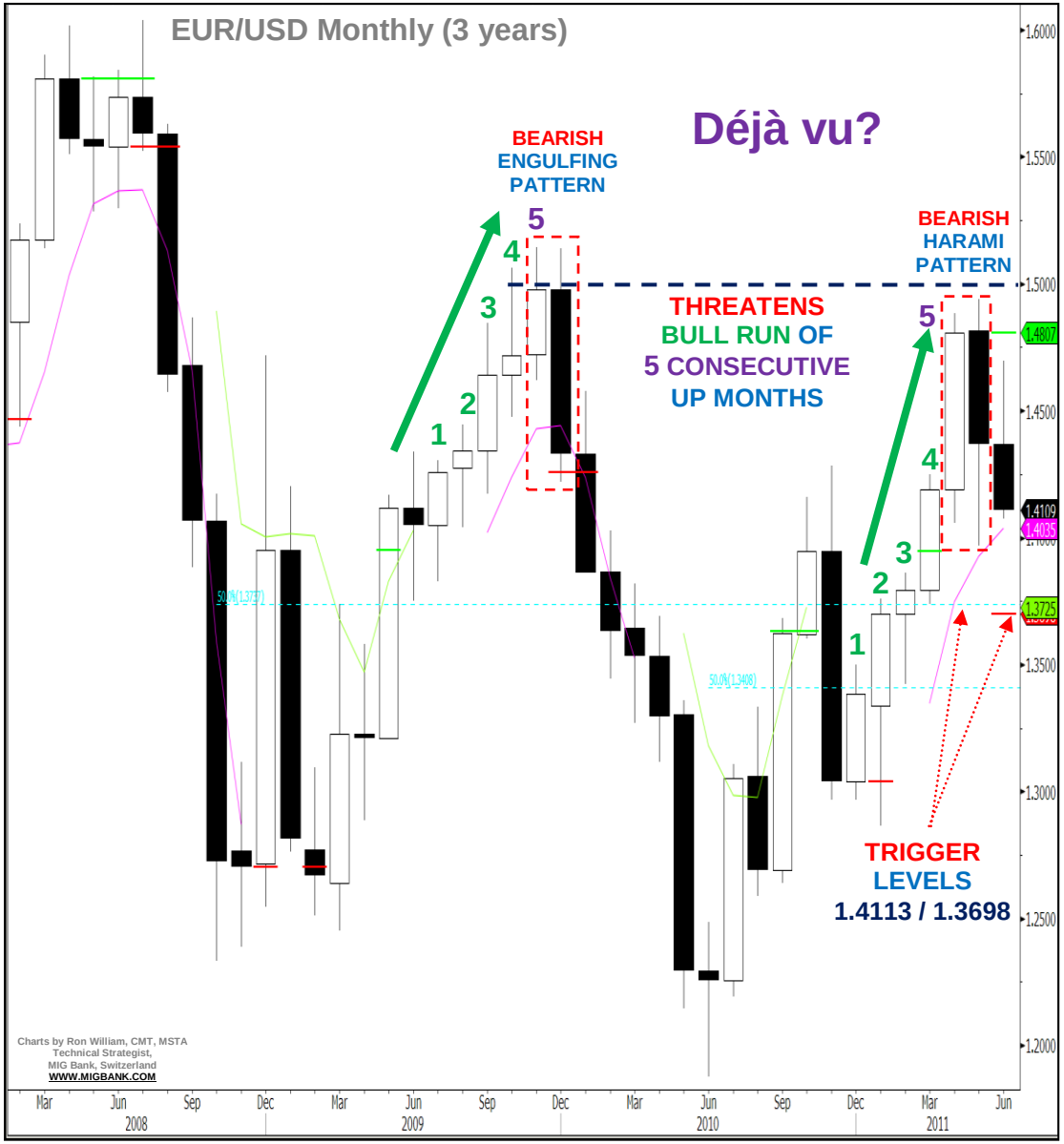


**Figure 3. EUR/USD's monthly bearish reversal triggers "fractal" risk. Source: Bloomberg LP.**

**Monthly Reversal Threatens Climatic Bull-run (Fractal).**

- Keep in mind that on a monthly basis, EUR/USD has developed a bearish candlestick pattern (harami) that threatens a bull run setup of five consecutive months, with higher reactive highs and lows. (Note, these particular "climatic" bull-run setups typically mature gains above the 50% half-way mark of an existing price swing).

- **The last time we experienced a similar monthly "climatic" bull-run setup** was between June - December 2010, failing beneath the psychological 1.5000 level and then ultimately **led to a collapse in price activity for seven consecutive down months.**

- In the popularized movie, "the Matrix", a "Deja vu" served as an important "glitch" or "signal" in the [market], to be respected. Even if price history may not repeat in exactly the same way, it is still worth to **keep this downside "fractal" risk on a cautionary watch.**

- According to Tom DeMark's proprietary indicators, **potential trigger levels for a significant price move lower exist at 1.4113 and 1.3698** (based on monthly TD MA1 and TD reference down close).


Figure 4. EUR/USD sentiment & liquidity proxies based on Risk/Reversal & COT. Source. Bloomberg LP.

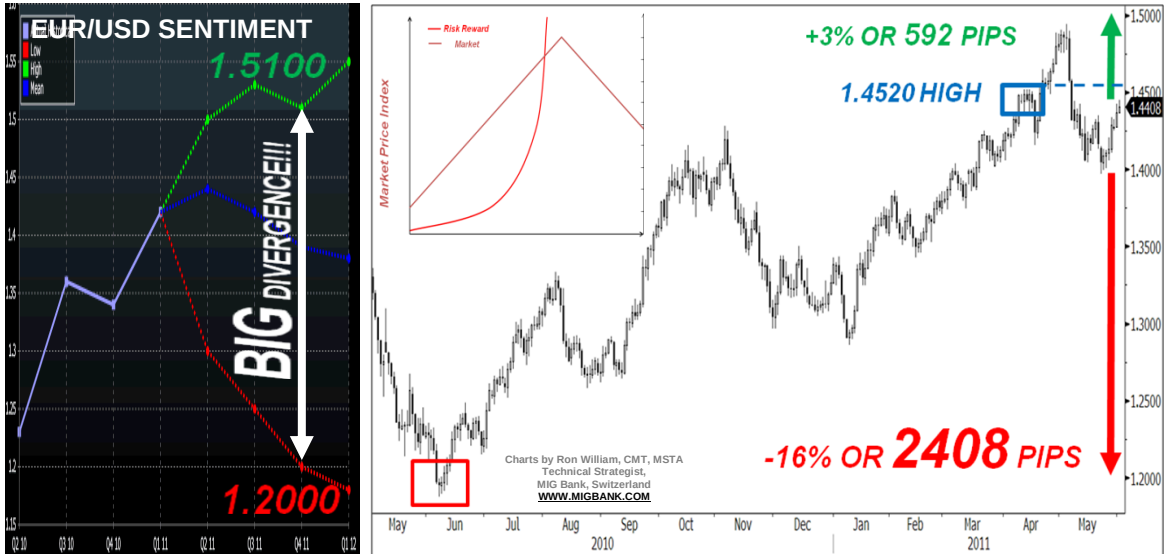


Figure 5. Bloomberg's market expert indicator marking BIG divergence. Source. Bloomberg LP.

**Sentiment & Liquidity Proxies warn of downside volatility.**

+ Sentiment and liquidity proxies, warn of further downside volatility on EUR/USD, with all our indicators either verging from extreme mean reversion stages, or actually breaking down.

+ Sentiment based on FX risk/reversals shows the **option market is undergoing a critical break down,** as volatility shifts into strong "put" or "sell" option territory, targeting 3.2000 (June extremes)

+ COT liquidity readings, based on net long orders are mean reverting from record highs. **The last spike characterizes a large "short covering" rally on EUR/USD,** which is likely to push to lower levels.

+ **Big divergence in sentiment can also be seen on Bloomberg's market expert indicator,** which surveys over 50 professional institutions around the world on their quarterly EUR/USD forecasts.

+ Results are wildly skewed, with the most optimistic (green) target at 1.5100 (near the old April 2011 highs/1.4940) and worst case scenario (red) priced in at 1.2000 (June 2010 trend lows/1.1877).

+ **The risk/reward ratio is very poor with optimists only pricing in a +3%/590 pip gain vs. -16%/2400 pip loss** (from recent levels). This is a strong contrarian bear signal, telling us the long-term uptrend has been increasingly overcrowded and unsustainable.

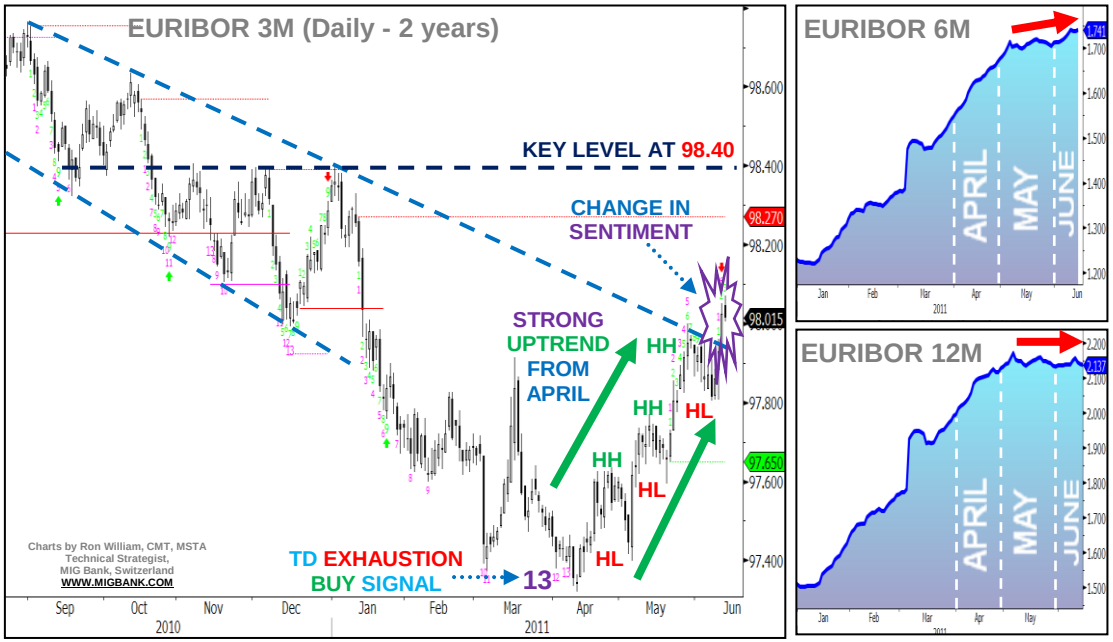


**Figure 6. Euribor 3M trend break marks divergence vs. long-term maturities. Source. Bloomberg LP.**

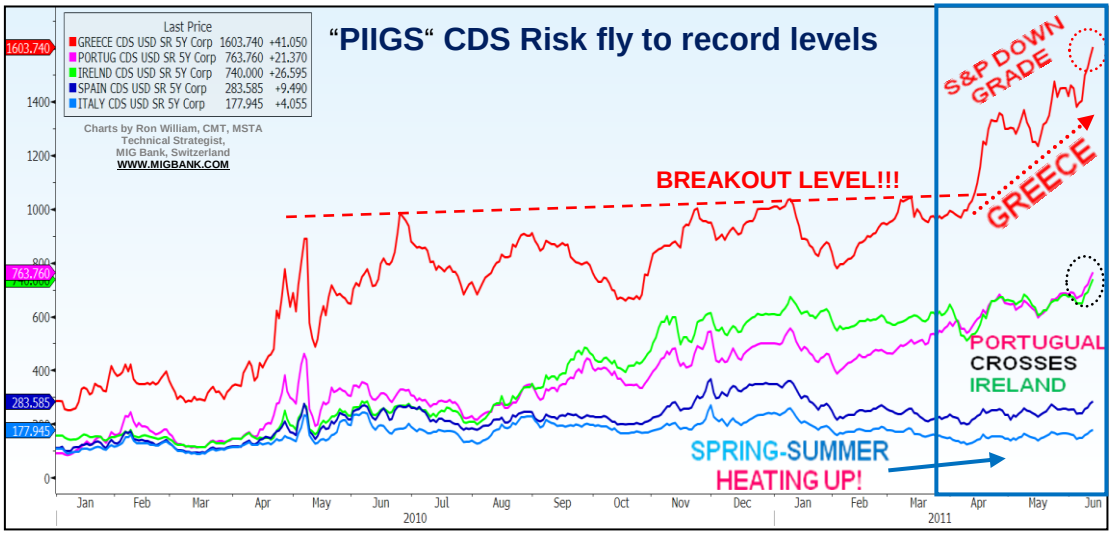


**Figure 7. EU peripheral "PIIGS" CDS risk proxies flying to record levels. Source: Bloomberg LP.**

## Euribor 3M break at key trend-line marks divergence and a change in market sentiment on interest rate expectations

- The three-month Euribor rate, a gauge of unsecured interbank euro lending, which is traditionally used to measure interest rate expectations, broke above key trend-line resistance last week, while marking divergence (across 6 and 12 month maturities).
- The divergence was triggered as investors potentially reduced expectations for higher interest rates, following the ECB's signature "v" code word [vigilance], on controlling inflationary pressures and ultimately signalling to the market they would raise interest rates by July, with the next hike potentially on hold until as late as December.
- **A change in monetary policy weakens the euro's interest differential** over its trading partners (notably US & UK) and is likely to magnify key macro drivers (relatively weak) or technical (now overvalued).

## Focus Shifts to EU Peripheral Debt Crisis as CDS Risk Fly High

- Focus shifts back to the EU peripheral debt crisis as CDS risk increases, with market's fearing the reality of a Greek default after the S&P gave the country the world's lowest credit rating, while the ECB and Germany continue their standoff on debt restructuring.
- Meanwhile, Portugal may offer the next surprise as CDS risk increases by the most since the inception of the Euro, while surpassing Ireland and triggering further psychological contagion.


**Figure 8. US Dollar Index developing a W-shaped base. Source: Bloomberg LP.**

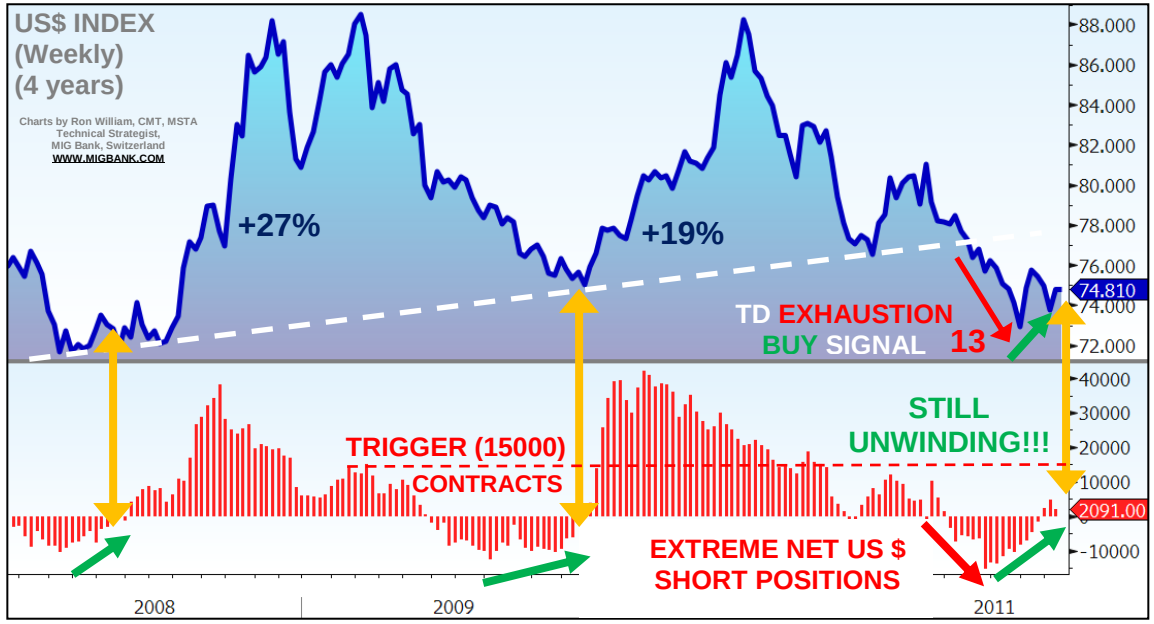


**Figure 9. US Dollar Index COT Liquidity unwinding from extreme net short positions. Source: Bloomberg LP.**

## USD prepares for a bullish "KO" fight against the majors

- All eyes remain poised on the US dollar's preparation for a bullish "KO" fight against the major currency blocks, as the greenback continues to unwind from extreme undervalued conditions.
- The broad US dollar trade weighted index, which has a 57% weighting toward the Euro, is rallying strong from an extreme technical retracement level (76.4% Fib-April rally), while also triggering a confluence of DeMark exhaustion buy signals across daily, weekly and monthly timeframes (Fig 6, 7, 8).
- A sustained close above 76.36 (23rd May high) would help establish a multi-month w-shaped base formation and unlock accelerated gains into price targets at 77 and 78 (50% and 61.8% Fib-Jan 2010 high).
- Furthermore, our COT liquidity readings are still unwinding from extreme net US dollar short positions and finally switched over into positive long territory over the last three weeks.
- **The last two examples of positive mean reversion back from extreme net short positions actually translated up to 19-27% price gains on the US dollar index.** Although note, these liquidity indicators do not offer useful market timing and often lag considerably. **An increase above the historical trigger of 15000 net long contracts would add significant upside scope into the old extreme highs at 40,000.**


Figure 1: US Dollar Index long-term downturns and ranges price cycles. Source: Bloomberg.

**USD technical performance may still rise up to 30%**

- In a weak "relative" beauty contest (sharing major economic problems with EU & UK), technical performance on the DXY may still rise up to 30% as illustrated on the long-term chart.
- A historical snapshot of the US dollar index since 1980 helps put the reserve currency's massive depreciation in perspective, while also offering useful information on previous short to medium term cycles.
- Closer examination highlights two similar volatile ranges, both lasting for over a decade. The accumulation period stimulated market recovery after structural downturns ranging from 96% and 50% peak gains (as marked by the long-term downward trend-line).
- The most recent multi-year volatile range signalled an **important low for the US dollar in 2008 and the completion of a primary Elliott Wave five wave impulsive structure.** This also supports the case for further upside scope on the USD dollar over the coming weeks and months.
- In terms of probable price targets, a **basic average of each of the price swings within the two volatile ranges equates to a minimum of 25% and a maximum of up to 30% gains** if we calculate the distance to the upper boundary of the greenback's long-term trend-line. Important Fibonacci targets are also nearby at 89.75, 99.04, with overshoot risk into 101.48.
- **RSI Momentum studies also provides a bullish range above 40% (which helped in prior bull markets). See Bull ranges A and B.**

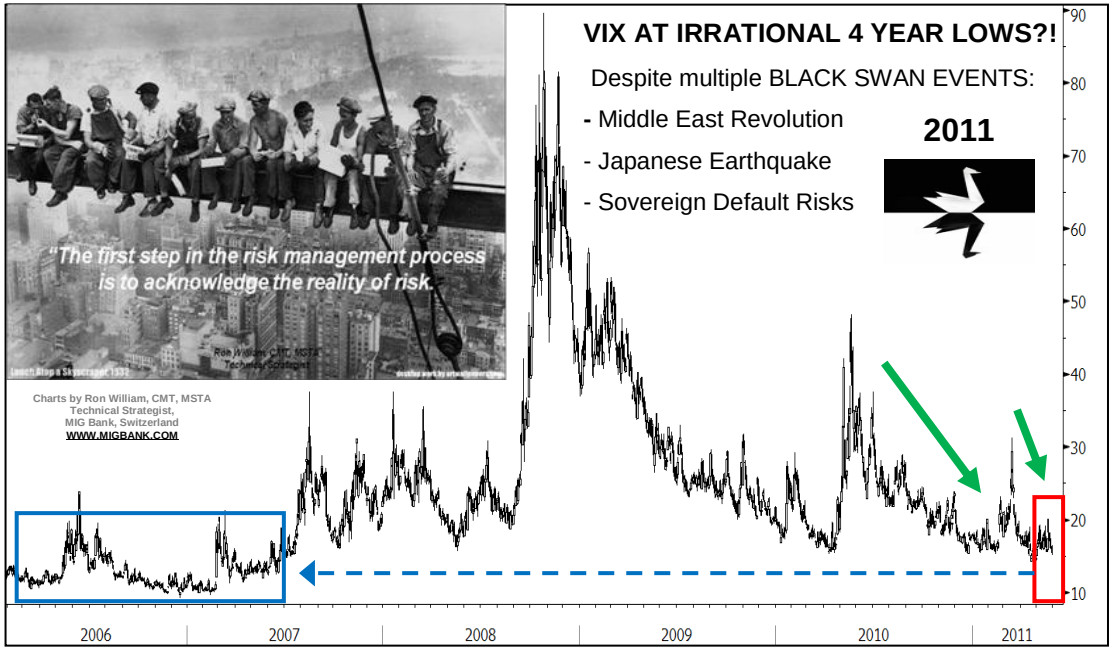


**Figure 11. VIX Volatility Index at irrational 4 year lows. Source: Bloomberg LP.**

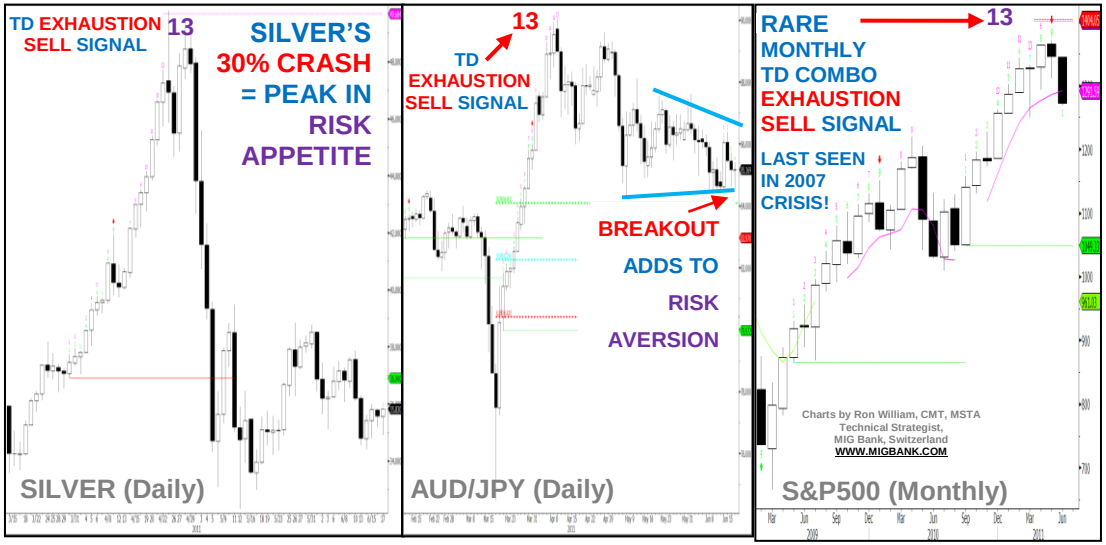


**Figure 12. Silver's crash signals peak in risk, AUD/JPY breakout, S&P500 rare signal Source: Bloomberg LP.**

**Risk Appetite set to unwind from "irrational" comfort zones.**

Further US dollar tailwinds will likely be provided as the infamous "risk on" theme which has championed the first half of 2011, shows characteristics of finally abating from "irrational" comfort zones.

+ The VIX volatility index, which is often used to gauge risk within the investment community, had recently dropped to 4 year lows, thereby suggesting a state of extreme "comfort" and optimism.

+ Such positive readings had only been seen pre 2007 financial crisis and seems very "irrational" given the number of "black swan" events that had taken place within the first half of 2011 (see chart timeline).

+ A potential explanation for this "irrational" comfort zone, despite the number of elephants stomping in the room, is best illustrated by the famous picture of a group of construction builders in the 1930s, miles up in the sky, having lunch on the top of the Rockefeller skyscraper!

+ Indeed, silver's 30% crash in April may have sobered even the strongest high-leverage players and marked a peak in risk, spilling contagion onto related proxies, with the stock market set to follow.

+ With that in mind, we continue to monitor these markets closely and EUR/USD's potential "fall from grace", which is likely to be fuelled by a synergy of the technical and macro drivers outlined in this report.

HAPPY Trading!

"Enlightenment Through Realised Knowledge".

Ron William, CMT, MSTA

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