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SPECIAL:

SHOCK AND AWE 2011

2011:

Which are the Best and Worst Performing Currencies?

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PLUS: FOREX 2011 – THE TECHNICIANS DREAM, A SUMMARY OF ECONOMIC INDICATORS, COMMODITY CURRENCIES UNDERPERFORM IN 2011, TAKING THE LONG WAY AROUND – WHY TRADE LONGER TIMEFRAMES...

USD/JPY – Verging on a Major 40-Year Cycle Reversal

The Japanese Ministry of Finance is known to aggressively intervene in the currency markets. Evidence suggests that the initial reaction after the third intervention was stronger than after previous attempts; each one has actually had a decreased price effect as the credibility of the Bank of Japan's ability to influence the yen diminishes for traders. Ron William analyzes the Japanese yen.

After yet another Japanese yen intervention by the Ministry of Finance, investors and traders around the world are questioning the "real" impact on the currency's eternal price appreciation. Technical evidence suggests that although the initial reaction on the Japanese yen, post intervention, was stronger than after previous attempts; each one is actually having a decreased price effect as the credibility of the Bank of Japan's ability to influence the yen diminishes for traders.

USD/JPY remains bullish over the medium to longer-term, but in the short-term expect another post intervention retracement (PIR), which may carve out a fresh new record low.

Sentiment proxies within the option market suggest that buying pressure is still overcrowded as everyone continues to try to be the first to successfully call the market bottom.

This may trigger a temporary, but dramatic, price spike that would help flush out a number of large downside barriers and stop loss-orders.

Keep alert for a 40-year long-term cycle on USD/JPY verging on a major reversal into November/December 2011. This is further supported by monthly bullish DeMark™ exhaustion signals. A confirmation above $80.60 is required to launch a powerful recovery toward $83.30 and $85.50 with upside scope into $94.00.

Global market attention and the potential major trend reversal will keep volatility high for a while. However, the major cycle reversal in the Japanese yen will be driven by broad weakness across a variety of other currencies.

In relative terms, high-yielding currencies such as Turkish lira (TRY), Brazilian real (BRL), South African rand (ZAR) are setup to gain most from yen weakness.

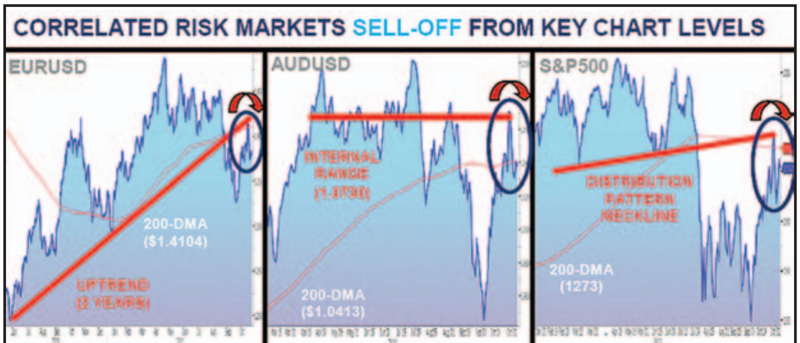

FIGURE 2: Daily Chart of EURUSD, AUD and S&P500 Index. (Bloomberg Finance LP)

JPY Intervention – How credible is the 3rd STRIKE?

- *After yet another Japanese yen intervention by the Ministry of Finance, investors and traders around the world are questioning the "real" impact on the currency's eternal price appreciation.*

- *The estimated ¥7 trillion injection used to counter the yen's record overvalued levels, which continues to hurt the nation's competitive export-led economy, was the largest on record, overshadowing previous efforts last*

- *Indeed, the vast amount of government liquidity marked a large carbon footprint that saw USD/JPY rocket by over 400 pips in just a few minutes from new post-World War II record lows at $75.35. The net effect was largely positive for the U.S. dollar, boosting the DXY (which allocates its second largest weighting of 13.6% to JPY).*

- *This also helped trigger a loud firing shot across popular risk proxies such as EUR/USD, AUD/USD and developed equity markets including the S&P500, which all reversed sharply from key chart levels, back under their long-term 200-day moving averages.*

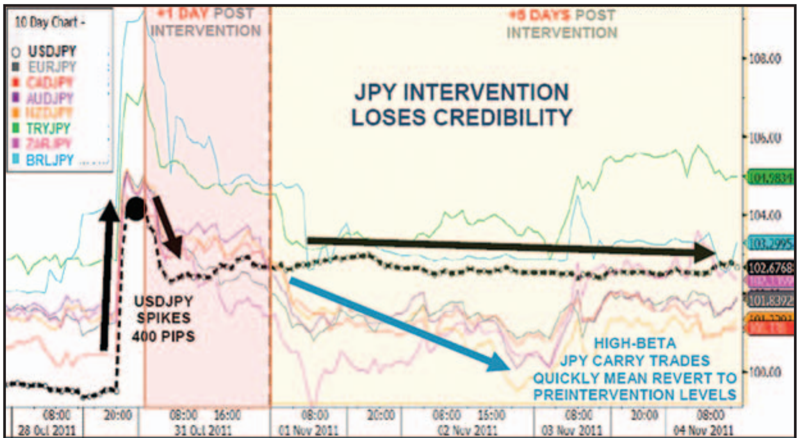

FIGURE 1: Intraday 60-minute chart of multiple JPY FX rates. (Bloomberg Finance LP)

FIGURE 3: USDJPY daily chart illustrating historical price reaction to Forex interventions in 2010 and 2011. (Bloomberg Finance LP)

ences on the yen. (Note; external event shocks such as natural disasters or political wars, have tended to historically induce major price reversals in markets).

• However, a review of Japan's most recent unilateral interventions in August this year and September 2010 shows it took only 4 and 15 days respectively for USD/JPY to trigger a post intervention retracement (PIR) and new low (PINL).

• The fact that each intervention is having a decreased effect over time suggests the credibility of the Bank of Japan's ability to influence the yen has likely diminished for traders. History also teaches us that virtually all JPY interventions over the last ten years exhibit comparable short-term reversion and timing characteristics.

FIGURE 4: USDJPY weekly chart with Sentiment and Liquidity proxies.

• But will the third intervention strike by the Japanese authorities this year be enough to hold back the Japanese yen's painful appreciation? In the end, the price chart – "Mr. Market" – dictates the future, where "in the short-run, the market is a voting machine, but in the long-run it is a weighing machine" and market sentiment will ultimately decide.

• Technical evidence suggests that although the initial reaction on the JPY, post intervention, was stronger than after previous attempts; the price reversals are becoming less sustainable each time. Without the compounding backdrop of a key change in the market cycle (mass psychology) and perhaps additional monetary-political support from G-7 governments, any benefits may only prove temporary.

• The only lasting currency devaluation this year followed the earthquake in March and consequential multilateral intervention, which served as a double-positive of external influ-

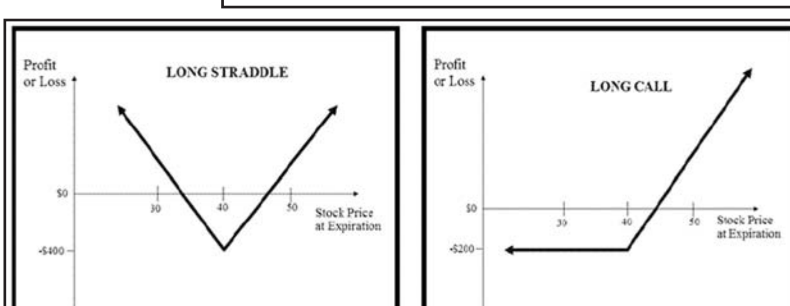

FIGURE 5: Option strategies - LONG STRADDLE & LONG CALL

USD/JPY Sentiment and Strategic Price Levels

• USD/JPY remains bullish over the medium to longer-term, but in the short-term expect another post intervention retracement, which may carve out a fresh new record low. This is also favoured by current sentiment measures, which remain heavily skewed in the option market (based on 1 month 25-delta Risk/Reversals), which shows long call options at multi-year highs. Put simply, USD/JPY buying pressure is still very overcrowded as everyone continues to try and be the first to successfully call the market bottom.

• This may trigger a temporary, but dramatic, price spike (that would help flush out a number of large downside barriers and stop loss-orders), into psychological levels at $75.00 and perhaps even sub-$74.00. Keep in mind that such a scenario would also inspire another round of even stronger yen intervention that would likely benefit from the price vacuum and assist their mandate of sustainably reversing the yen's trend.

• Watch strategic upside price levels on USD/JPY ahead of important cycle inflection points into November/December 2011 – $80.00-60 (Psychological -TD level), then $82.00 (post-G7 intervention high) and $83.30 (28th March earthquake high). All levels serve as important bullish psychological triggers in the market.

• Astute investors and traders can use diversified methods to manage risk/return exposure within option strategies, during what may continue to be a two-way, volatile market over the next 1 to 3 month horizon. High-probability option strategies include a "long straddle," favouring increased volatility (regardless of price direction) or a "long call" that would hedge for the likely upside breakout from USDJPY multi-year wedge pattern.

Major Cycle Reversal

• Macro chart dynamics confirm that a major turning point is developing on USD/JPY. Long-term charts exhibit a confluence of bullish evidence with our primary focus on the related 40-year Elliott Wave cycle and monthly bullish DeMark™ exhaustion signals.

FIGURE 6: Long-term 40 year Elliott Wave cycle on USDJPY, signaling a major upside reversal. (Bloomberg Finance LP)

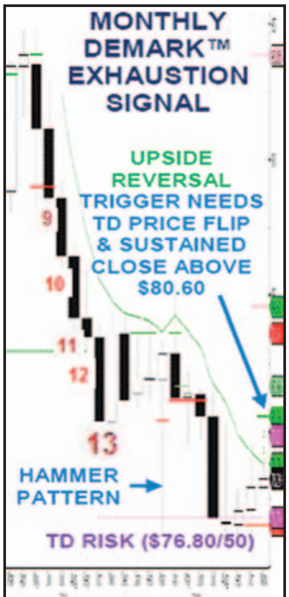

FIGURE 7: Monthly DeMark buy signals cap USDJPY decline. (Bloomberg Finance LP)

• The 40-year long-term impulsive Elliott Wave cycle on USD/JPY is on the edge of a major upside reversal. Closer examination also illustrates a symmetrical time fractal of 16.5 years (198 months), which is scheduled to end into this November/December 2011. This also follows a 9-month cycle, which bottomed in October 2011.

• The expanded chart (top, right-hand side) illustrates DeMark's bullish monthly reversal signal (Sequential & Combo), which was developed in late 2010. Although this long-term signal has not yet triggered the expected price upside reversal, we must respect that it has, thus far, managed to cap USD/JPY's powerful decline.

• A TD Price Flip and close above $78.80-80.60 (TD MA1-TD Ref Close), is required to launch a powerful recovery toward $83.30 and $85.50, with upside scope into $94.00. Only a sustained close beneath $76.80-76.50 (TD Risk Line-TD Ref Close) would negate the bullish macro setup.

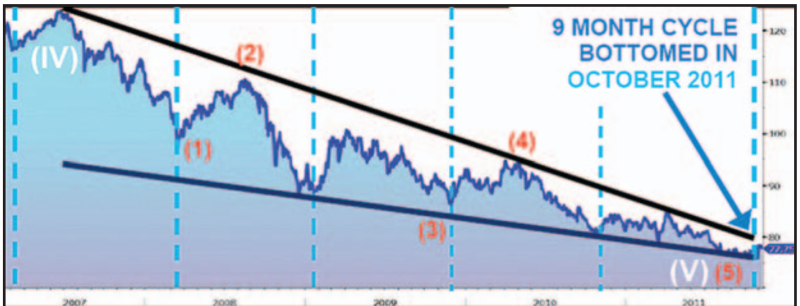

FIGURE 8: USD/JPY 9-month cycle bottomed in October 2011. (Bloomberg Finance LP)

• *The results derived from this unique visualization of market relative performance over time tells us that high-yielding currencies such as Turkish lira (TRY), Brazilian real (BRL) and South African rand (ZAR) are set to gain most from yen weakness (positioned within the upper right "leading" quadrant).*

• *All three markets exhibit strong bullish mean reversion characteristics from extremely undervalued levels against the yen. Such a scenario would unlock a massive unwind in the popular carry trade (where investors borrow from a low yielding currency such as JPY and fund higher return markets).*

What are the best FX Trades to profit from JPY weakness?

• *The global market attention and potential major trend reversal will keep volatility high for a while. However, the major cycle reversal in the Japanese yen will be driven by broad weakness across a variety of other currencies. It would also be valuable to look at other relative currency opportunities against the JPY, rather than only USD/JPY and EUR/JPY.*

FIGURE 10: Daily Chart of TRY/JPY, BRL/TRY and ZAR/JPY. (Bloomberg Finance LP)

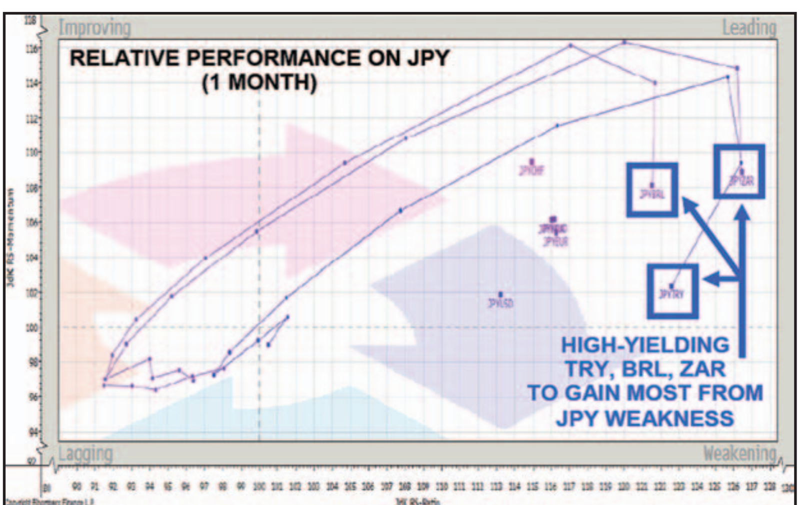

FIGURE 9: Relative performance on JPY, based on technical momentum filters. (Bloomberg LP. Developed by Julius de Kempaenar)

• *Figure 9 illustrates a technical model that measures relative performance (based on proprietary momentum filters), across a basket of Forex rates against the Japanese yen. Each quadrant represents a market's cycle, rotating clockwise, from "leading" to "weakening" and "lagging" to "improving" stages.*

Conclusion

• *USD/JPY remains bullish over the medium to long-term, but in the short-term expect another post intervention retracement (PIR) as the credibility of Bank of Japan's third strike attempt this year to reverse JPY diminishes with traders. Sentiment measures also suggest that USD/JPY buying pressure is still very overcrowded as everyone continues to try and be the first to successfully call the market bottom. This may lead to a temporary, but dramatic spike into the psychological levels at $75.00 and perhaps even sub-$74.00.*

• *"Mr. Market" will decide USD/JPY's fate as the rate edges closer to its 40-year long-term cyclical reversal (triggering a major change in mass psychology). Expect*

FIGURE 11: Daily Chart of Japanese yen Index. (Bloomberg Finance LP)

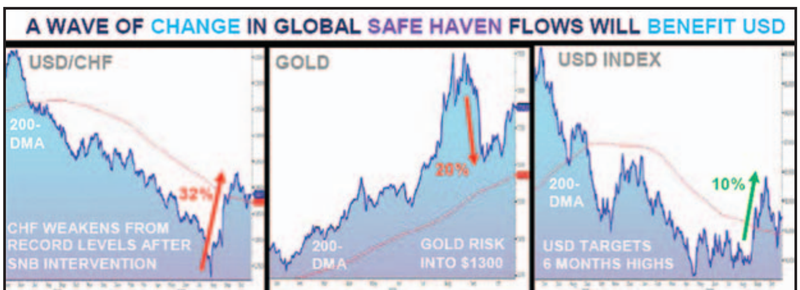

FIGURE 12: Daily Chart of USD/CHF, Gold and the USD Index. (Bloomberg Finance LP)

broad Japanese yen weakness to mark another wave of change in global safe-haven flows, which has traditionally been attracted to the yen and previously Swiss franc and gold. In a relatively weak beauty contest, the U.S. dollar, which is at a polar opposite technical set up (oversold levels), will gain from this domino effect, as capital searches for a new safe home.

• However, in the short-term, USD/JPY will remain a "house of pain" trade, marked by two-way volatility. Astute investors and traders can use additional methods to manage their risk/reward exposure through option strategies. Watch strategic upside price levels on USD/JPY ahead of an important cycle inflection points into November/December 2011 – $80.00-60, then $83.30 and $85.50 with upside scope into $94.00. In relative terms, high-yielding currencies such as TRY, BRL, ZAR, are set to gain most from a massive unwind of the popular carry trade. **FJ**

– Ron William, CMT, MSTA is the Technical Strategist in MIG Bank.

CONTINUED FROM PAGE 61

ent and unless one has opened a long position at 1.43 or a short at 1.30, one could not have gone wrong with any trade.

GRAPH 7 USD/CHF

Without exception, USD/CHF is, besides gold, the only instrument that has held a long-term trend in 2011. Down from January to mid-July, the trend suddenly reversed with the help of the Swiss National Bank intervention. It must be added that USD/CHF near 0.70 was indeed an exaggeration as an increasing number of investors joined the wave, buying CHF for an easy profit. Yes, the Swiss National Bank did massively intervene on two occasions, but as many traders and investors continue to hold long CHF positions, unwinding those positions has lead to a prolonged rise in USD/CHF. **FJ**

– Marc Spaelti, Risk Manager at Dukascopy (Suisse) SA has 18 years of experience in the Forex exchange market. Working for various banks and brokers in New York, Singapore and Switzerland, he has covered all aspects of the market: trading Interbank Forex spot, running proprietary option positions and covering institutional clients through advisory desks. Marc regularly contributes articles for various publications.