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The FTSE 100 and USD/JPY Bullish Yen warning for UK stocks

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LOOKING TO USD/JPY

Max Knudsen discusses the connection between the outlook for FTSE 100 and the USD/JPY rate.

USD/JPY and equities signals

At the end of August 2007 it became obvious that a major new bear market in USD/JPY was beginning. Due to the equity markets' dependence on a cheap yen, this meant only one thing for FTSE and the other major world indices - the end of the bull market.

Our call to sell USD/JPY, and by default equities, was based on the observation that for two decades since 1985 there have been 8 major bull and bear swings in long-term USD/JPY sentiment (see Figure 1). Each of these swings has coincided with the currency pair closing above or below the 20-month moving average. In August 2007, USD/JPY closed at 115.77 – the

first time prices had closed below the average since 2005.

With the knowledge that in two decades there has been a very strong correlation between the 20-month moving average and every bull and bear market in USD/JPY, and the average duration of trends following the break has been 35 months, we went short USD/JPY and looked for the reversal in equity market sentiment. This came in November in FTSE with the double top (see Figure 2).

USD/JPY and FTSE sentiment

With both USD/JPY and the FTSE off 17% since their sell signals, trend following indicators show no sign of

change yet. FTSE statistical comparisons show that the percentage of lows versus highs traded (-32% versus +13%) is not yet at the extremes seen at the last bear market low in 2003. This means that while investor sentiment is bearish, it has been worse. In USD/JPY however, the same comparison of lows versus highs shows that sentiment is almost at the most bearish level reached since the all time low in 1995. In that year the currency reached a low of 79.92 yen to the dollar after a five year bear market. The percentage of lower lows compared to highs traded reached 41%. As of March 2008 that figure is 37%. →



Figure 1.

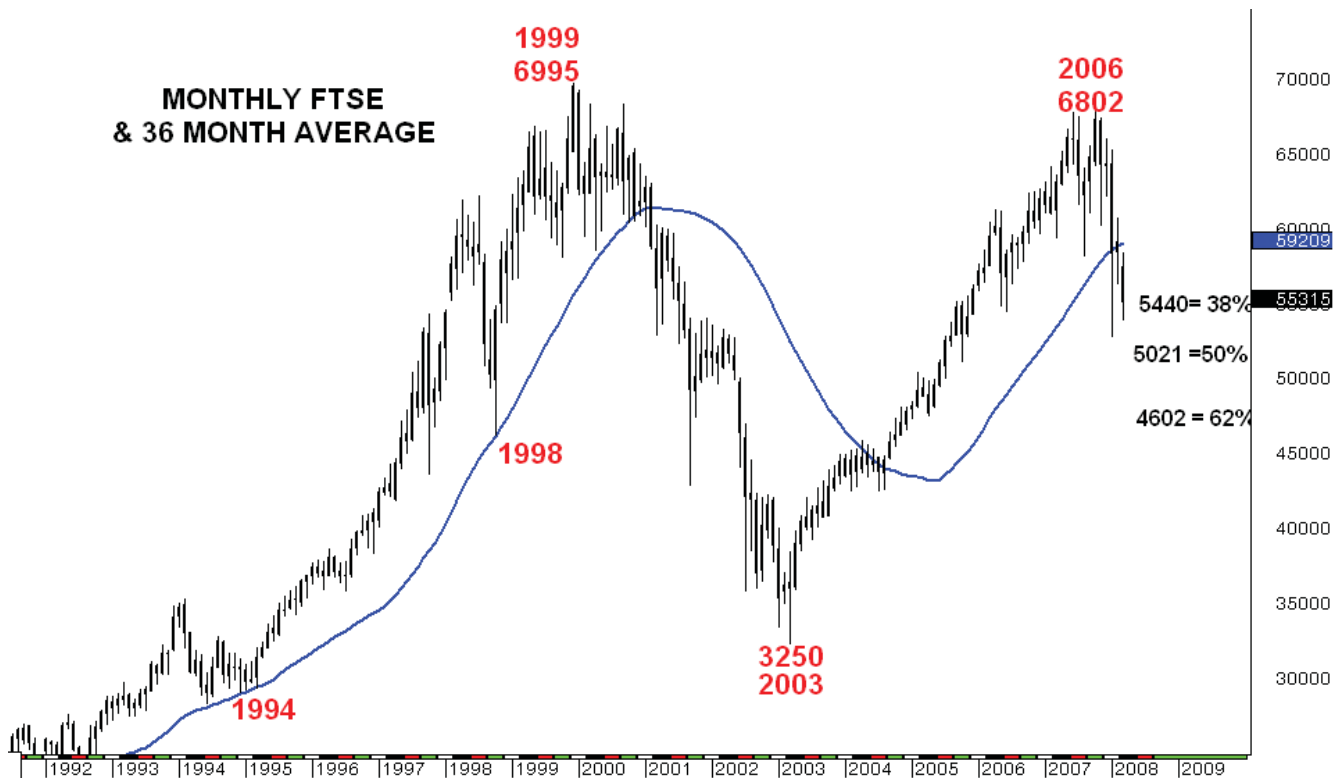


Figure 2.

“IN USD/JPY SENTIMENT IS ALMOST AT THE MOST BEARISH LEVEL REACHED SINCE THE ALL TIME LOW IN 1995”

Determining FTSE targets

So with USD/JPY nearing historic lows at 79.92 and bearish momentum near extremes, traders and investors will soon be making key decisions on their opinion of fair value. We believe these could dictate the next levels and direction for the FTSE. So far, the FTSE has corrected 38% of the 2003-2007 bull market (3250-6802) and attracted some buying interest. However if USD/JPY continues deteriorating to test the all time lows at 79.92, then this could see the FTSE move lower towards a 50% correction at 5035 over the next 2 months. After that the target is 4878, derived from the

June/October double top price projection.

Evening Star on yearly FTSE charts?

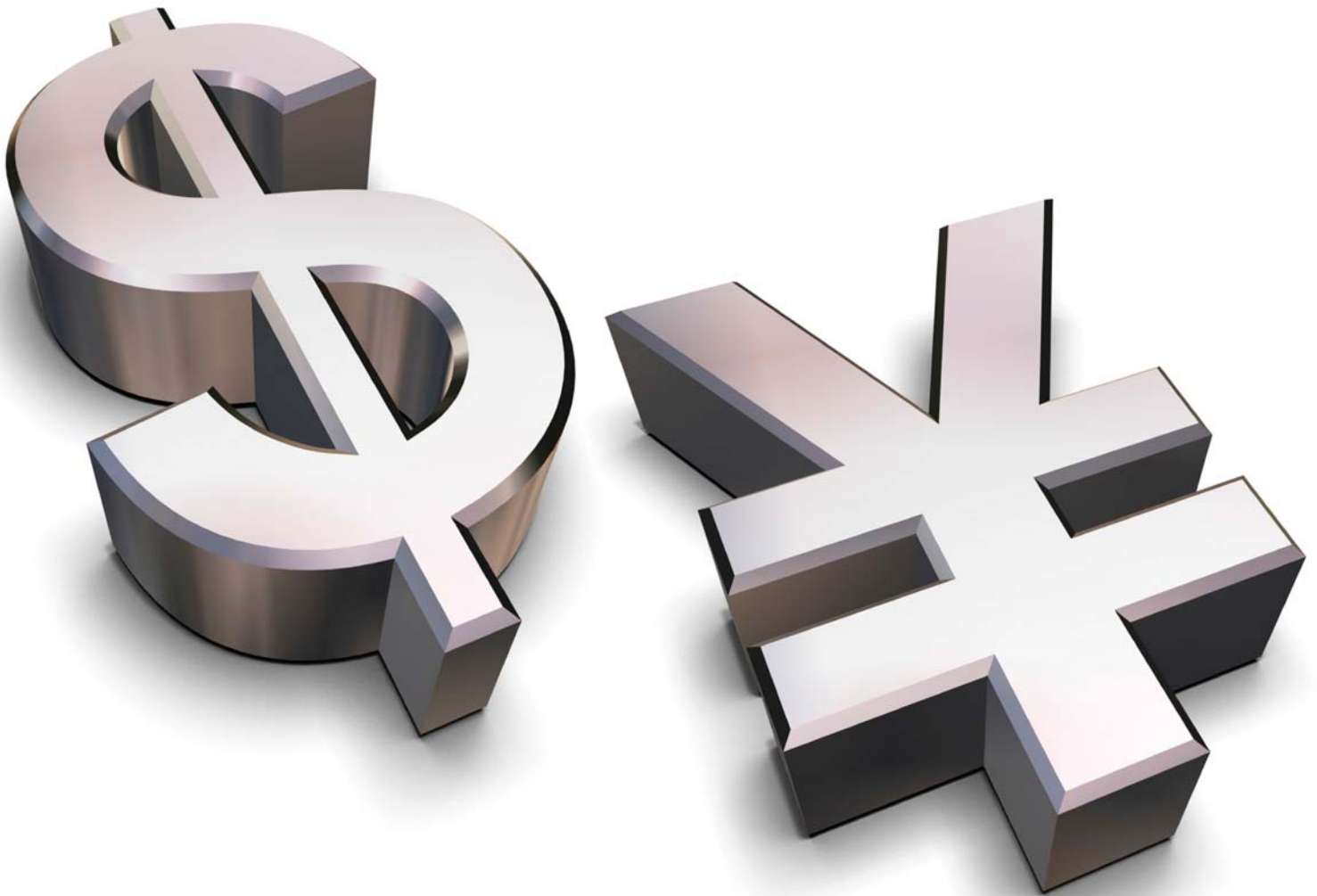
Continued selling beyond is dependant on whether investors sell USD/JPY below 79.92. At this stage our analysis indicates this will happen as the intensity of the bearish trend is showing no signs of slowing. Over the 8 months since August, negative momentum has increased by an average of 27% a month. However, targets for losses in USD/JPY below 79.92 are difficult to identify. FTSE targets are more obvious and would be 4610 - a deeper 62% correction to 2003-2007 bull market. This would also increase the likelihood of FTSE recording an Evening Star on annual charts - a signal for a declining stock market for some years to come.

The yen and possible FTSE recovery

To come back to the central question of whether the FTSE and indeed all major indices are showing any signs of recovery yet, our analysis is that one of the

indicators for this could be a bullish signal in USD/JPY to indicate the bear trend is exhausted. Monitoring what the market does as we get close to 79.92 is key; a bullish monthly candle signal such as a Hammer, Engulfing, or Morning star pattern in USD/JPY could be the first indication that negative sentiment is changing. Alternatively, a slowdown in the percentage of lows to highs traded would signal a change in the negative bias.

The follow through signal in FTSE could then be a similar candle pattern, or a close back above the 36-month moving average. This is not so highly correlated with the bull and bear swings as the 20-month average with USD/JPY, but has been a good indicator of FTSE sentiment during the last 25 years trading. Also worth watching is GBP/JPY as this has been closely correlated with the FTSE rally since 2003. GBP/JPY formed a bearish head-and-shoulders reversal over 2007. In addition, January’s trading closed below the 40-month average for the first time in 7 years, an indicator closely correlated with all the bull and bear



“...THE 36-MONTH MOVING AVERAGE HAS BEEN A GOOD INDICATOR OF FTSE SENTIMENT DURING THE LAST 25 YEARS TRADING”

swings in sentiment since the 1970's.

In summary, the trigger for a recovery in FTSE could be from a range of sources. However, bearish signals in USD/JPY seven months ago gave us a valuable edge in identifying the turn around in stock market sentiment. We think it's worth monitoring USD/JPY for the recovery signal. ■

Max Knudsen is managing director of PIA-FIRST. Previously head of Fixed Income Technical Analysis at UBS and Head of cross market Technical Analysis at Dresdner Kleinwort, Max and his partners now provide independent trading strategies in FX, Equities, and Interest Rates on daily, weekly, and quarterly time horizons. www.pia-first.com



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