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# BLACK SWAN VOLATILITY:

## THE IMPACT ON OIL, JAPANESE YEN & GLOBAL RISK APPETITE

By Ron William

### REVOLUTIONARY TSUNAMI: What does it mean for oil?

A revolutionary tsunami has swept across the Arab world and given rise to a hopeful and yet uncertain path of “creative destruction”, a term coined by Marxist economic theory to describe a cycle of progressive change that is achieved through terminating the older models of economic, social or political order.

The mounting geopolitical risk, which saw the overthrow of both the Egyptian and Tunisian regimes in a matter of weeks, has now escalated to violent

unrest in Libya, a member of the OPEC cartel and a major supplier of light sweet crude oil to Europe. Of most concern is that this revolution may spread further into the region to other top oil producers such as the Kingdom of Saudi Arabia and Iran. This comes at a time when oil prices are already high and the global economic recovery is vulnerable.

All these sizeable headwinds have increased additional risk premium on the price of oil and related risk assets

and created further interest in traditional “safe haven” plays. While the immediate future will likely remain uncertain, it is important for investors to observe the chart dynamics and understand potential market risks. We have already seen oil prices rocket over 23% in just a week (with jet fuel, diesel and gasoline breaking above \$1000), equity markets pressured from their mountainous altitudes and the VIX volatility benchmark spike 53% higher from its historic lows (see Figure 1). →

**Oil chart dynamics**

A glance at both Brent and US WTI crude oil in Figure 2 shows they have rallied to their highest levels in more than two years, extending impressive gains of 250% respectively from their post 2008 crisis lows.

Brent crude, which is highly correlated to the Middle East and Africa region, continues to outperform its US WTI counterpart. The spread accelerated higher during the early stages of the revolutionary tsunami and consequent geopolitical risk.

Looking at WTI oil, we expect the current resumption above its \$100 glass ceiling to recapture the fresh 2011 high at \$113, unlocking gains towards our confluence zone at \$120 (200% channel resistance/76.4% Fib from oil's 2008 peak). The next upside target would be at \$130 (September 22nd 2008 spike), thereby completing a potential impulsive wave five, within an Elliott Wave structure.

Keep in mind that such a move would also equate to one-third of oil's price gain which was recorded during the Persian Gulf War between →



Figure 1. Oil prices rocket over 23% in one week. Chart insert (i) SPX500 under pressure from the mountainous peak and triggers a sell-off after developing a TD Sequential exhaustion signal. Chart insert (ii) The VIX equity volatility benchmark spikes 53% from historic lows.

Source: Bloomberg Finance LP



Figure 2. Brent and WTI Crude oil rallying to their highest levels in two years. A target of \$130 equates to one third of oil's price gain during the Persian Gulf War. Source: Bloomberg Finance LP.

**"THE HISTORICAL VOLATILITY CHART TELLS US THAT PRICE SPIKES IN OIL ARE NOT ONLY NORMAL, BUT ALSO CYCLICALLY OVERDUE."**



Figure 3. Oil's historical volatility signature deviates an average of 1 standard deviation every two years. *Source: Bloomberg Finance LP*

August 2nd, 1990 and February 28th 1991 (see lower chart insert). Watch for minor dips to tentatively hold around \$94.14-94.49 (price gap), then \$92.80/60 (old congestion range).

**Cyclical volatility signature**

Meanwhile, historic volatility offers compelling observations on the timing and likelihood of a spike in oil prices. 30-day historical volatility previously jumped higher from its multi year lows,

after breaking from a congestion range and is now reverting to the historical mean level around 37.89 (Figure 3).

Reviewing the past 10 years of history, we can also see that oil has experienced a cyclical volatility signature, with a tendency to generate an average of +1 standard deviation swings every two years (2001, 2003, 2005, 2007, 2009, 2011, with more potential upside to come). The most eye-catching "fat tail" move took place after the financial cri-

sis of 2008 and resulted in an extreme volatility reading of 120.25.

The historical volatility chart tells us that price spikes in oil are not only "normal", but also cyclically overdue. Keep an eye on the "leptokurtic" shaped probability distribution chart, which exhibits "fat tail" market risk and a tall peak. These statistical measures reveal that over the last ten years, oil volatility favoured an upside skew, deviating between 20 and 40 for 80% of the time.

Such a sharp move, would overshadow oil's recent 23% price rise in just one week, while pressuring other risk assets and mounting considerable headwind on the global economic recovery which is already vulnerable. Expect an increase in traditional "safe haven" plays.

**Longer term cycles**

In terms of the big picture, it is worth remembering that oil experiences alternating long-term bull and bear cycles which tend to last for an average of twenty years (see Figure 4). Oil has been rising for just over twelve years, which is only a little more than half the duration of previous cycles. The fact remains that global oil reserves are finite and with global demand unlikely to abate any time soon, oil will remain within the rising tide of a long term bull market cycle for the immediate future. →

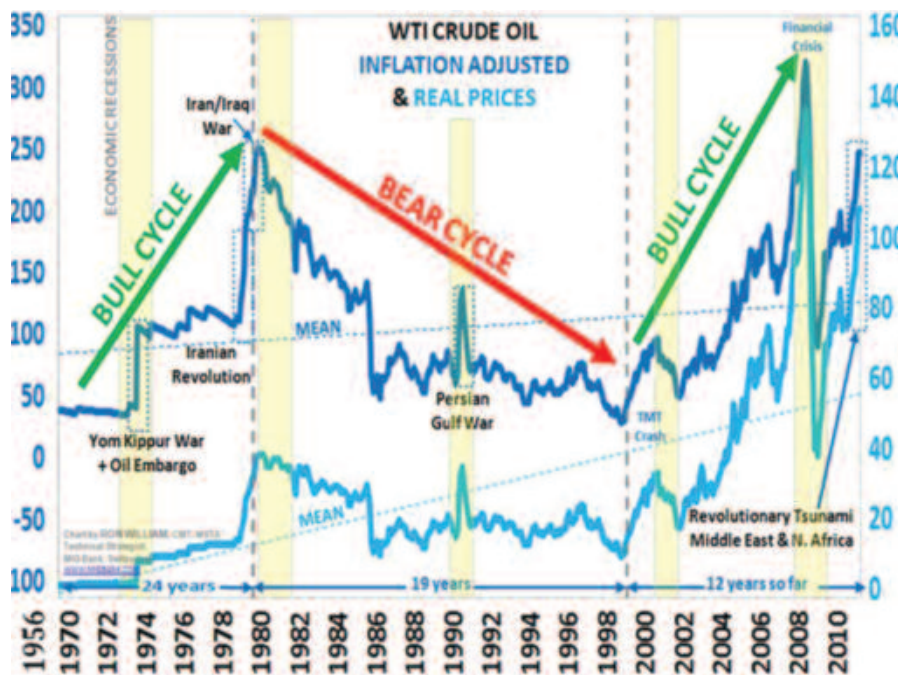


Figure 4. Inflation adjusted, historical chart of oil illustrating alternating bull & bear cycles. Note the periods of political wars (black), financial crisis events (blue) & Economic recessions (yellow highlight). *Source: Bloomberg Finance LP.*

# JAPANESE YEN: A major turning point

## How successful was the coordinated G-7 intervention on JPY?

While the coordinated G-7 intervention into the foreign exchange market on Friday 18th March was successful in helping reverse a historic price move on Japanese yen, it may have arrived a little late for investors and traders with large exposure to the yen and related high risk/return carry trades.

A plethora of high-yielding currencies, notably across the emerging market region, fell sharply against the Japanese yen, under the weight of potentially large stop-loss orders. The move followed USD/JPY's cliff-hanger drop of almost 400 pips in only 23 minutes, which marked an unprecedented breakout on implied volatility of seven standard deviations (daily chart), up to 16.75%; last seen in 2007. The historic surge in \$/JPY volatility signals further sharp price swings to come.

USD/JPY's high-volatility, directional

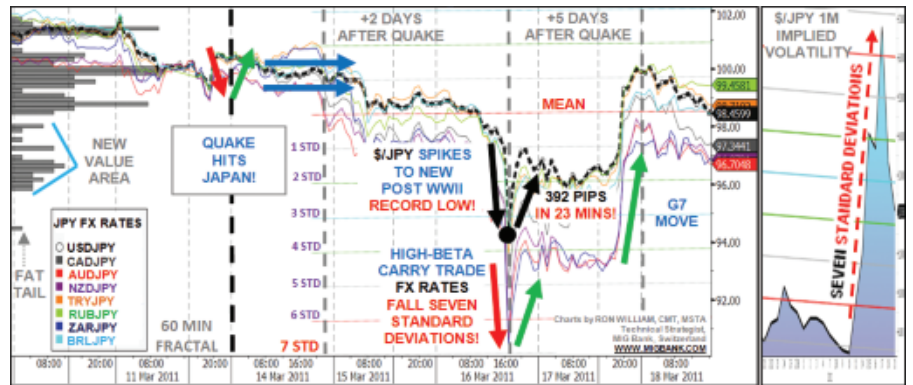


Figure 1 (left pane). High Beta carry-trades fall sharply after \$/JPY's new post WWII record low.

Figure 2 (right pane). USD/JPY 1M Implied Volatility moves 7STD.

Source: Bloomberg Finance LP.

breakout, which carved out a new post WWII record low at \$76.25, occurred over four weeks earlier than recorded after Japan's previous 1995 earthquake in Kobe and may eventually offer a relatively faster, although volatile, positive recovery on the Japanese currency (See Figures 1 and 2).

## USD/JPY strategic price levels at \$82.00 and \$83.30 (Figure 3)

Watch strategic price levels on USD/JPY at \$82.00 (G7 intervention high) and \$83.30 (28th March earthquake high). Both levels serve as very important psychological barriers in the market. We remain bullish over the longer-term, but expect the recent correction to ensue as part of a wave 2 Elliott Wave structure.

A close below \$82.00 would open up further short-term risks beneath key support at \$80.22, then psychological \$80.00, (a strategic level the BoJ is likely to defend), with potential for slippage into \$78.80, before sellers reach their potential climax/exhaustion threshold.

On the other hand, a weekly close above \$85.90 would confirm a longer-term upside reversal is developing. Keep in mind this would also trigger a critical bullish breakout above USD/JPY's multi-year falling wedge pattern and help reverse over 4 years of sizeable long JPY positions (see Figure 4).

## Macro chart dynamics continue to suggest a major turning point

Macro chart dynamics confirms that a major turning point is developing on USD/JPY. Long-term monthly charts exhibit a confluence of bullish evidence (see Figure 5), with our primary focus on the related Elliott Wave structure and DeMark sequential/combo exhaustion buy signals (Figure 6).



Figure 3 (top pane). USD/JPY breaks its major pattern and triggers a v-shape reversal that holds under strategic resistance.

Figure 4 (bottom pane). USD/JPY multi-year wedge pattern nears breakout zone. Source: Bloomberg Finance LP.

USD/JPY is holding within its 3-year wedge pattern floor (on a closing basis), which holds near the 1995 Kobe quake low at \$79.75. The move followed an important structural break from the rate's 8-year descending triangle consolidation, beneath 1998 peak at \$147.66. The pattern's measured objective has also now been met and provides further support. Watch for an eventual bull challenge of the major wedge pattern at \$86.90 and \$89.40.

**DeMark bullish monthly reversal signal remains intact?**

The expanded chart in Figure 6 illustrates DeMark's bullish monthly reversal signal (Sequential & Combo), which developed on the October 2010 low at \$80.39.

A monthly TD Price Flip and sustained close above TD MA1, currently at \$84.27 would be needed to trigger the major upside reversal higher. Only a sustained close beneath the TD Risk line at \$76.80 would negate the signal.

**Long-term Elliott Wave structure & timing**

The long-term five wave impulsive Elliott Wave structure on USD/JPY (taken from 1975) has terminated. The new record low at \$76.25, which broke the 1995 Kobe quake low (Wave III) has added further confirmation (see Figure 7).

Remember, while event shocks historically induce major price reversals, the transition period can take some time and prove rather volatile. An historical parallel of 1995, following the Kobe earthquake shows USD/JPY took up to 3 months to develop a



Figure 5 (left pane). Long-term monthly chart exhibits a confluence of bullish evidence. Figure 6 (right pane). Monthly DeMark buy signal which remains intact.

major reversal, before recovering higher (Figure 8).

**What are the best FX trades to profit from JPY?**

All eyes will remain fixed on USD/JPY while it recovers from historic lows. The global market attention and potential major trend reversal will keep volatility high for some time. Astute investors and traders might find better risk/return trades using other currencies against the Japanese yen, rather than USD/JPY.

Figure 9 illustrates a technical model which measures relative performance (based on proprietary momentum filters) across a range of currencies against the Japanese yen. Each quadrant represents a market's cycle, from "leading" to "weakening" and "lagging" to "improving" stages.

The results derived from this unique

visualisation of relative performance tells us that both the Swiss franc and Norwegian krone are developing positive trade setups against the Japanese yen, (positioned within the lower left "lagging" quadrant). Brazilian real and South African rand follow as secondary FX pairs to keep on the watch list. It is also interesting to note that FX majors USD, EUR and GBP have moved into weakening territory relative to the Japanese yen.

**The Strategy**

We believe USD/JPY is developing a major upside trend reversal, post event shock (earthquake) and co-ordinated G7 intervention. Watch strategic price resistance at \$82.00 (Post G7 intervention high) and \$83.30 (March 28th earthquake high).

Our perspective is that if the recent corrective activity closes below \$82.00, this would open up further short- →

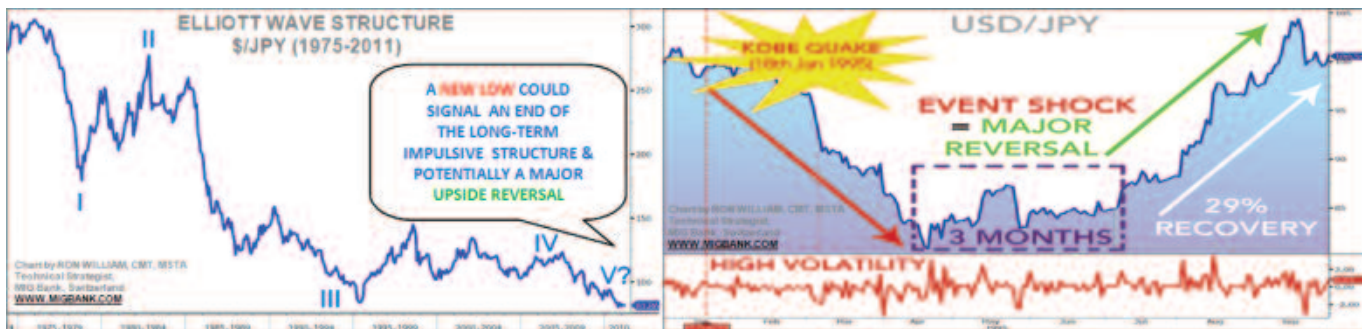


Figure 7 (left pane). Long-term Elliott wave structure on \$/JPY from 1975 is nearing its end and may potentially signal a major upside reversal.

Figure 8 (right pane). Historical parallel of 1995 following the Kobe earthquake shows \$/JPY took up to 3 months to develop a major reversal in the trend, before recovering higher. Source Bloomberg Finance LP.

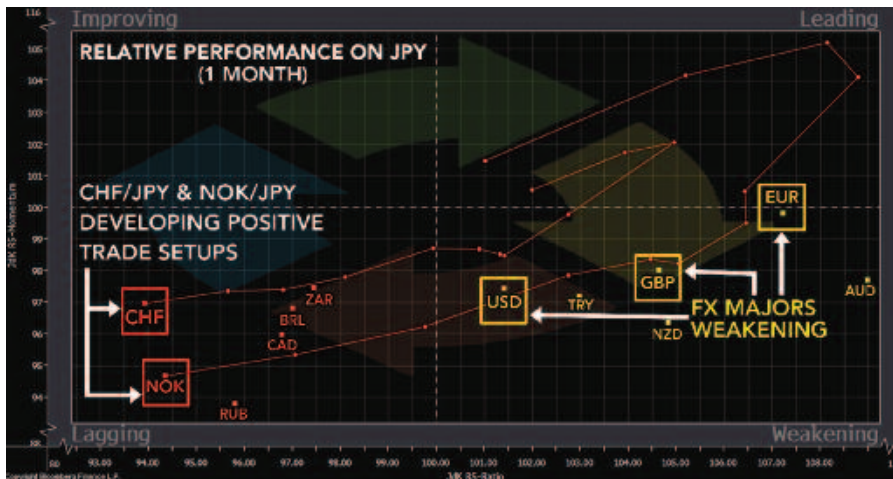


Figure 9. Relative performance on JPY, based on technical momentum filters. Source: Bloomberg Finance LP. Developed by Julius de Kenpaener.

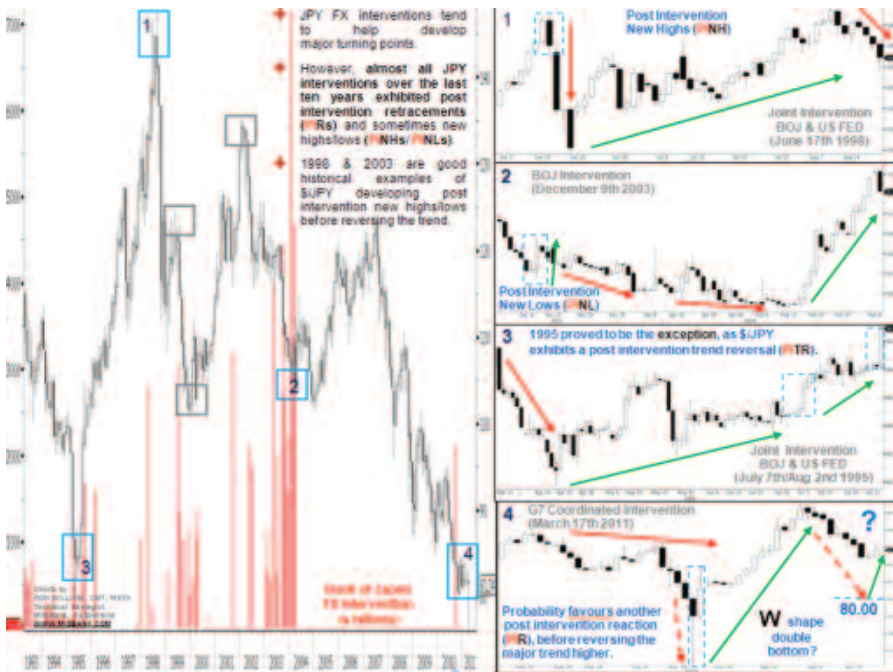


Figure 10 (left pane). An illustrated history of JPY intervention, highlighting major turning points and (right pane) post intervention retracements (PIRs) or new highs/lows (PINHs/PINLs). Source: Bloomberg Finance LP.

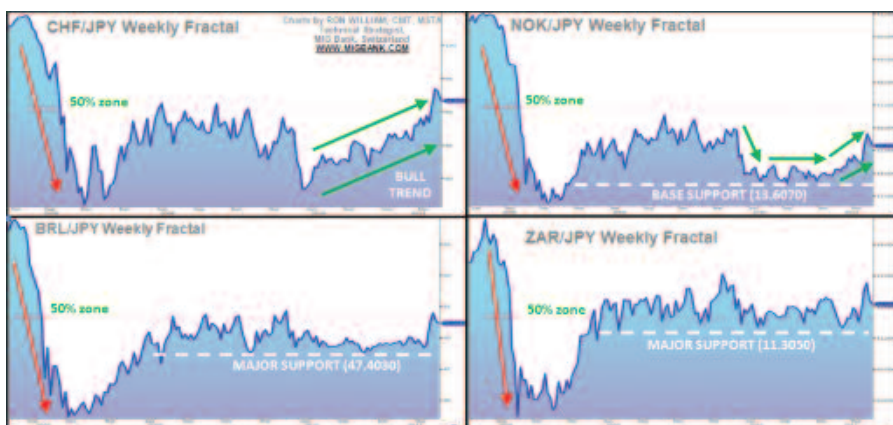


Figure 11. CHF/JPY & NOK/JPY developing positive trade setups, with secondary choices BRL/JPY and ZAR/JPY, exhibiting positive base building. Source: Bloomberg Finance LP.

term risks beneath key support at \$80.22, then psychological \$80.00, (a strategic level the BoJ is likely to defend), with potential for slippage into \$78.80. Probabilities favour a W-shaped bottom or post intervention retracement (PIR, see Figure 10).

This would help the FX rate maximize downside exhaustion/selling climax and mount further tailwind for the long-term Elliott Wave cycle, which is also currently supported by DeMark's monthly Sequential/Combo buy signals.

Only a sustained weekly close above strategic resistance at \$83.30 and \$85.90 will signal a post (event shock) intervention trend reversal (PITR, see Figure 10). Bulls would thereafter need to target \$86.90 and \$89.40 (major wedge pattern), a break of which would offer upside scope into \$93.20 (TD Propulsion Target) and \$95.00 (May 2010 peak).

Historically high price volatility will make trading challenging. Astute investors and traders might find better risk/return trades using other currencies against the Japanese yen, rather than USD/JPY. Leading candidates are the Swiss franc (safe-haven play and holding within a bullish trend-channel), the Norwegian krone and the Russian ruble (both fuelled by high oil prices). Other crosses include the high-yielding, commodity driven Brazilian real and South African rand, which are both building positive base support (see Figure 11). ■



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