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Peaks and troughs could make interesting ride

TECHNICAL ANALYSIS
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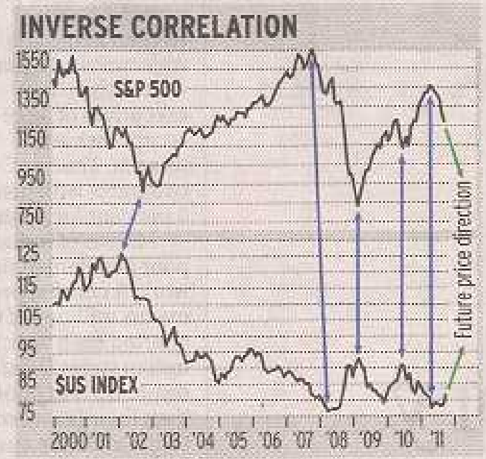
REGULAR readers of this column will be familiar with many of the ways technical analysts use single graphs to predict movement in markets. This week, Alan Clement, an international futures trader and member of the Australian Technical Analysts Association, uses inter-market analysis where two very different financial instruments are examined together to help gain insight into what may be about to unfold.

Clement has charted the stockmarket — in this case the US S&P 500 Index (top line) and the US Dollar Index (lower line). These indices, Clement says, share an inverse correlation, meaning one tends to peak when the other troughs and vice versa.

There are several possibilities put forward by technical analysts as to why this may be the case. One is that when investors reduce risk by selling stocks, they tend to park the proceeds in the world's reserve currency, driving the US dollar up. Conversely, they sell US dollars to buy stocks in a bull market.

Another possibility relates to the fact that many of the top US companies derive the majority of their profits from overseas trade. When the dollar is strong, their overseas income shrinks and the result is a weaker share price. In the inverse, when the US dollar falls in value overseas, earnings are higher when switched into the greenback, pushing share prices up. But regardless of its causes, the effect is what should interest investors.



Looking at the chart, Clement observes that at the end of the dotcom bust in 2002, when the stockmarket finally turned up, the US dollar had already peaked and had started to fall. Then when the stockmarket peaked in late 2007, the US dollar bottomed shortly after. At the post-GFC low in stocks in 2009 there was another peak in the US dollar, and then again as the market pulled back in mid-2010.

In recent months stocks have been sold off hard. And in the past couple of weeks the US dollar has turned up, seemingly reinforcing the existence of this inverse relationship. If this relationship persists, the US dollar could continue to climb until the stockmarket bottoms, which should mark the top for the greenback.

If sharemarket weakness persists and the dollar continues to climb, other markets could be influenced, Clement says. As most commodities are priced in US dollars, they get relatively cheaper as the US dollar rises. Therefore we could see falls across the board in precious metals such as gold and silver, energy commodities such as crude oil and natural gas, as well as other markets such as wheat, corn and coffee. The Australian dollar, too, could see some softening due to a rise in the US dollar, Clement says.

"It's worth noting, however, that inter-market relationships don't last forever, and this one, too, could break down at any time. So when using this methodology, it's best to combine it with other market indications before making investment decisions," Clement says. And, naturally, you should always seek advice from your licensed financial adviser before risking capital.