The 4-year Cycle In Practice—Major Low Expected In 2006

Matthias Geissbuhler, CFA

Time is an important but often neglected factor in technical analysis. It’s not only important to determine which way the market will go and by how much it will move but also to examine when this will happen. One way to answer the last question is by looking at time cycles.

Cycles are determined by the period and amplitude. The period represents the time that passes between two consecutive wave troughs (bottoms) and is meant to be constant. The amplitude represents the height of the wave. The Principle of Proportionality states that cycles with longer periods (lengths) should have proportionally wider amplitudes. In the world of financial markets a great quantity of cycles exist. In the following notes I will examine the so called “4 year cycle”, or “Presidential Cycle”. The idea behind this cycle is, that government will actively seek to influence the economic cycle in such a way that a re-election is likely. Therefore fiscal and also monetary policy tends to be accumulative in the year running up to election and turns restrictive just after the election is won. The impact of such an economic policy influences the financial markets. The election year (1) is usually strong and a good one for the stock markets. The midyears (2 and 3) are normally weak. The preelection year (4) is again strong. Looking at the following chart of the S&P 500 we can clearly see how this cycle worked in the last 45 years.

Source: Bloomberg

Cycle troughs or major lows can be seen in the years 1962, 1966, 1970, 1974, 1978, 1982, 1987, 1990, 1994, 1998 and 2002. Arrows mark the lows. The only exception is the low in 1987, which came one year later than the cycle would have anticipated. If we conclude that this repetitive pattern is going to continue, we can expect another important low in the stock markets sometimes in 2006. This would perfectly fit, as 2006 is a midyear and the more restrictive money supply will likely impact the economy and the stock markets by this time.

So far we answered the question of “when” the next trough might arrive. Another question is the size of the expected pullback. The next chart shows three support lines starting back in 1987, 1990 and 1994 (all three were major lows). These trendlines provide support for the S&P 500 at around 750, 890 and 1000 points respectively. Looking at the Fibonacci retracements, a 50% correction from the all time high of 1518 would bring us back to 760. From the current level of 1200 the 38% retracement gives us a price target of 745. These two numbers match perfectly the lowest trendline starting back in 1987.

Source: Bloomberg

Putting the two things together, I conclude that a major low is in the cards for 2006. My worst case projection is a pullback of the S&P 500 to 750, which should act as a major support area.

Matthias Geissbuhler, CFA, graduate from University of St. Gallen (HSG) in Switzerland, worked both at ATAG Asset Management and Armand von Ernst & Co. On January 1 2004 he joined Bank CIAL (Switzerland) where he works in the Investment Management and Research department. Besides doing fundamental as well as technical analysis, he manages two equity funds. Matt is a CMT Level II Candidate. He can be reached at +41 61 264 14 48 or Matthias.Geissbuehler@cial.ch.

Technical Analysis of Foreign Exchange Markets

William J.P. Dale CIM, DMS, FCSI

The Foreign Exchange (forex) Market is the largest, most liquid market in the world. It is best described as a decentralized, continuous auction place. A unique feature of forex markets is that they are actually a double auction where all trades are pairs trades involving a simultaneous buy and sell of a currency pair.

Average daily turnover in the forex spot market is $1.9 Trillion, with another $130 Billion traded in the futures markets. The US Dollar is on one side of 89% of all spot transactions, with the Dollar / Euro currency pair accounting for 28% of all transactions. The United Kingdom is the largest trading center, with 39% of transactions originating there. The popularity of these markets is growing, with spot volume up 36% since 2001, and futures volume up 77%.

Many factors affect forex rates, including:
- Supply and Demand
- Psychology
- Interest Rate Differentials
- Inflation / Commodity Prices
- Economic Activity / Productivity
- Balance of Payments and Current Accounts

Forex has a specialized terminology that traders must learn. Some important terms include:
- Exchange Rates refer to quotes where one party is trading their home currency. For example, a US trader trades the Euro and USD and asks for the Euro Exchange Rate.
- Cross Rates refers to an exchange rate where the home currency is not party to the trade. In this example, a UK trader asks for the Euro/Yen Cross Rate.

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Right now my brain feels a little like it is made of mayonnaise. With Shelley Lebeck retiring, Marie moving into her role, Tom MacMahon’s position being eliminated (they have given their full cooperation to this effort) and two new people joining us soon, (one of them starts Tuesday) your MTA staff has been giving the full court press to our technology changeover.

The new technology platform will make it possible to serve the membership better and to know the history of member activity completely. With 149 pages of standard reports and the ability to track every contact from the membership and from prospects, this new tool will provide far more opportunities to the membership and facilitate MTA future growth on a world-wide basis. It will make the MTA a more virtual organization than we ever thought possible.

However, no transition is ever as simple or straight forward as one would like it to be. Everything happens at once. With staff changes happening, it makes sense for current staff to have input for the history and for new staff to be trained on the new tool. I’m pleased to report that as of yesterday our input to Avectra to the initial data conversion is now complete. Next week we start looking at test data on the new MTA live platform. We are still shooting for a “go-live” date this fall. As we move toward that date, we will be asking everyone to validate your data on the website. We are pleased to report that as of yesterday our input to the new tool will provide far more opportunities to the membership and facilitate our future growth on a world-wide basis. It will make the MTA a more virtual organization than we ever thought possible.

MTA Office E-mail Directory

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People Directory

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While the summer may suggest a slowdown in many areas of our business, this does not include the MTA. Last month I mentioned two Board members leaving, this month I want to welcome Steve Poser and Charlie Kirkpatrick to our Board. Both are seasoned veterans of the market and bring a lot of experience and insight to our group. Internally, as I mentioned Saturday night at the MTA Conference in my speech to everyone, John Kirby has been hired back as our Executive Director for the next year, Shelley Lebeck has retired and we are in the process of going through the chairs of our committees, reassessing our goals and objectives. As you can see, money never sleeps and it would seem, neither does the MTA. On another note, it is likely not much of a surprise with everyone that we have ongoing issues and disputes with IFTA. These issues have revolved around accreditation both globally and within the different regions. As a CSTA member and ex-President, I have a clear bias towards the international community so I am cautiously optimistic that we can work all these issues out. As well all know, technicians should be on the same page globally. These discussions continue and I am hopeful that it will come to a resolution soon. Our doors to discuss any issues of contention are always open and I will make sure to keep everyone in the loop as things move along.

Thank you,

John R. Kirby
Executive Director
Relative Strength in the Real World

At the May seminar, Jeff Parent introduces the concept of relative strength and then builds upon that concept to develop a framework for identifying the strongest stocks. In simplest terms, relative strength (RS) compares the change in value of one price against another over the same time frame. In common use, the relative strengths of a stock is compared to the value of all other stocks in the market, and each value is assigned a percentile rank to aid in comparison. This is one of the cornerstones of William O’Neil’s CAN SLIM strategy, and RS rankings are one of the features of Investor’s Business Daily. In this strategy, only stocks with a RS value greater than 80, on a scale of 1 to 99, are considered as candidates for purchase. O’Neil does not disclose how he calculates RS.

James O’Shaughnessy provided quantitative evidence that RS works in What Works on Wall Street. His research indicates that RS is the only growth variable that consistently beats the market. In this test, buying the 50 stocks with the highest RS, defined as the biggest winners in terms of the previous year’s price appreciation, significantly outperformed the market. O’Shaughnessy also demonstrated that the 50 worst performing stocks in the previous year continued to under perform the market over at least the next year.

These two successful investment strategies, and many others, rely on RS as a critical component. RS strategies, with backtested results, have been documented in financial literature since at least 1945. Relative Velocity Calculations were defined by H. M. Gartley in that year and published in the Financial Analysts Journal (http://www.airnpubs.org/faj/issues/v51n1/pdf/0510018a.pdf).

There is also a significant amount of academic research validating the usefulness of RS. In “Momentum,” an October 2001 University Of Illinois working paper, Narasimhan Jagadeesh and Sheridan Titman show that there is substantial evidence indicating that stocks that perform the best (worst) over a three- to 12-month period tend to continue to perform well (poorly) over the subsequent three to 12 months. They found that momentum trading strategies designed to exploit this phenomenon have been consistently profitable in the United States and in most developed markets. It was also demonstrated that stocks with high earnings momentum outperform stocks with low earnings momentum. Their article reviewed the evidence of price and earnings momentum and offered potential explanations for the momentum effect. It can be downloaded from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=299107.

In 2001, Charles D. Kirkpatrick II, CMT, received the Charles Dow Award for his paper, “Stock Selection: A Test of Relative Stock Values Reported over 17 ½ Years.” This paper can be downloaded from http://www.mta.org/awards/01/2001DowAwardb.pdf. To understand the value of relative strength in the real world, one needs only to update the performance of his methodology since publication:

Using the methods disclosed in the paper, Kirkpatrick has outperformed the S&P in 17 of 23 full years for his Growth Portfolio and in 6 of 6 complete years for his Value Portfolio. This out performance has been by a significant margin, providing real world evidence that relative strength works.

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MTA Welcomes...
Tim Licitra

I have recently graduated from the University of Rhode Island with a Bachelor’s degree in Marketing. I entered URI on a Centennial Scholarship and appeared on the Dean’s List. I enjoy following various sports such as football, baseball, and hockey, and like to keep busy by playing golf, running, watching movies, and reading. I am deeply interested in marketing and am looking forward to my time here with MTA.

Practice Exams & Quiz Cards

Practice Exams for CMT Levels 1, 2 & 3 and flash cards for CMT Levels 1 & 2 are available for purchase through Electric Books from your personal home page. They are based on the suggested readings and can be used as part of a candidate’s overall preparation for the CMT exams. They should not be seen as the actual exam questions.

2005 IFTA Conference
Vancouver, BC

The next Annual IFTA Conference will be held November 3-5, 2005 at the Pan Pacific Hotel in Vancouver, BC, Canada. Come learn in a spectacular setting on the Pacific Ocean. Details and registration information is available on the CSTA Website: www.csta.org
Introduction to Technical Analysis

by Ralph J. Acampora, CMT

Ralph is a founding member of the MTA. At the recent seminar in New York, he presented an overview of the basics of technical analysis. This article summarizes that presentation. The full presentation can be downloaded from the MTA web site.

The entire study of all aspects of technical analysis is based upon three logical assumptions:
1. The stock market is a discounter: Price movement precedes the actual event.
2. There is a constant battle between sellers and buyers that quantifies the forces of supply and demand. This results in market activity known as accumulation (when buyers create demand for the limited supply) or distribution (when sellers create an excess supply).
3. The amount of buying or selling activity over a designated period of time indicates the magnitude of upside or downside potential, a concept referred to as relativity. Major buying (base building) precedes a major advance; a minor top (distribution) foreshadows a minor decline, and vice versa.

Summarizing these three assumptions into a single phrase, Ralph told the audience to remember that, “In price there is knowledge.”

Technical analysts employ a wide variety of tools, but the most basic, and perhaps the most important is the price chart. There are four types of charts:
1. Line Charts simply plot and connect the closing prices. They reflect price changes over a defined time frame. Analysts can employ more advanced tools, such as moving averages or relative strength, to a line chart to anticipate future price movements.
2. Bar Charts consist of a vertical line (bar) representing the high and low of price, with a small tick on the right side of this bar to represent the closing price. A second bar, directly below the price corresponds to volume. There are three commonly used time frames for bar charts: daily, weekly, and monthly (with the H/L/C and volume for each period). Shorter or longer timeframes may also be used. In addition to the tools available on a line chart, analysts can spot price gaps indicating an imbalance of supply and demand at the open on bar charts.
3. Candlestick Charts illustrate price using a thick vertical bar to represent the open, high, low, and close in price. When the bar is clear that means it was a positive day, week or month where the close is above the open. When the bar is dark it means that it was a down day, week or month with the close below the open. A second bar, directly below the price, can be shown on the chart to correspond to volume. Candlestick charts are similar to bar charts, but provide users with additional patterns that can be used to confirm trading decisions.
4. Point and Figure Charts ignore time and focus only on price action. Every sequential trade of one full point or more is recorded on an intra-day basis and plotted with a small ‘x’ if prices move up or a small ‘o’ if prices decline. Important features of point and figure charts include:
   • No high/low/close
   • No volume
   • No time
   • No price gaps
   • Clearly depict intra-day price reversals
   • Offers a more accurate assessment of accumulation versus distribution during consolidation phases
   • Allows for the projection of intermediate-to-long-term price objectives

When looking at charts, a skilled technician is able to spot the direction of the price trend and key support and resistance levels, as illustrated in Figure 1.

Ralph presented a schematic representing the long-term rise and fall of a stock’s price to demonstrate the phases of price activity. This hypothetical diagram (Figure 2) contains four primary moves and two secondary reactions. The stock commences with a major base (#1) - a zone of accumulation that takes months, if not years to form. In technical analysis, price movement is relative: the bigger the base, the bigger the eventual upside move (#2). The same holds true for the distribution areas (#4) - the greater the top, the greater the downside plunge (#5). Like the perennial changing of seasons, the cycle begins once again with another major bottom (#1).

The pattern we just described refers to primary behavior. There are also periods of time when counter-trend (secondary) activity will occur. During the mark-up phase, (#2) stocks will undergo some consolidation, near-term profit-taking (#3) before resuming their long-term upturns. In the mark-down phase (#5) stocks will experience near-term stabilization or rallies (#6) before continuing their major downtrends.

Figure 1 - Illustrations of Trend

Figure 2 - Phases of Price Activity
appropriate chart period intervals, in other words, trading workspace. First, traders should establish identification of key drivers. The corporation is to reduce counterparty risk. They are highly liquid and the role of the clearing corporation is to reduce counterparty risk. Many popular currencies are quoted in American Terms, an example, a 1.8805 quote for GBP indicating One British Pound = 1.8805 U.S. Dollars. Major currencies quoted in American terms include the British Pound (GBP) also referred to as Pound Sterling, the Euro (EUR) and the Australian Dollar (AUD).

- **Bips and Pips**: A Bip is the smallest unit of measurement in the bond market (1/100th). A Pip is the smallest unit of measurement in the currency market (1/10000th). Most currencies are quoted in 1/10000th of a unit (four decimal places), one major exception is the JPY which is quoted in 1/100th.

Foreign Exchange Derivatives trade in multiple markets, and different rules apply in each market. However, the principles of technical analysis can be applied universally across the markets to decide on the timing of a buy or sell. The three primary trading venues for forex are the Interbank Spot Market, the Forward Market, and Exchange Traded Futures. In the Interbank Spot Market, trades are made for immediate delivery, in practice settling the same day or within a two day period. In the Forward Market, settlement occurs some number of days to years in the future. Quotes differ between the two markets, a function of interest rate differentials. Forwards will trade at a discount or premium price to spot exchange rates because the market will arbitrage away any advantage for depositors switching currencies for the purpose of obtaining higher yields. If interest rates in country A are 2% lower than in country B, A’s currency will trade at a premium with respect to B’s.

When trading in the Forward Market, traders enjoy several benefits over the Exchange Traded Futures including customized delivery dates and customized contract size. However, they carry counterparty risk and the contracts are illiquid prior to delivery. Exchange Traded Futures are traded in regulated markets. These contracts offer standardized delivery dates and trade in standardized contract sizes. They are highly liquid and the role of the clearing corporation is to reduce counterparty risk.

Regardless of the market or timeframe, Dale identified several guidelines to set up your Forex trading workspace. First, traders should establish appropriate chart period intervals, in other words, divide the trading session into the amount of bar data you want to see per day. Forex is a 24-hour market, resulting in 1,440 minutes per day. For trend identification, he offered the following guidelines:

- Micro Term - 90 min
- Short Term – 288 min
- Medium Term – Daily
- Long Term – Weekly
- Macro Term - Monthly

After selecting a timeframe, traders must choose their markets and become familiar with key economic data. The technician needs to be aware of key releases to watch how the market reacts; often these data points occur in conjunction with significant pattern completions or at lines of support / resistance. Identifying the key drivers of the economy and whether or not the economy is based on natural resources, manufacturing or if it is an export driven economy will allow traders to set up appropriate Intermarket Analysis charts.

Dale presented examples of techniques to systematize your analysis. He suggests trading with the mid term trend. He draws trendlines and adds indicators appropriate to this time frame. It is important to look to the past to determine what the indicators are telling you, especially for clues in the indicators for indication of an upcoming trend reversal. Also, use the chart to look for clues to support / resistances levels.

As an ideal signal setup, he suggested the following:

- RSI has reversed at bullish oversold area (usually in the 40’s but look to the past for clues on where that level is for any particular currency), effectively having a higher low.
- Rising momentum signaled simply by higher highs and higher lows.
- ADX is below 20 and is ideally bottoming. An indicator on the ADX line can help identify bottoming behavior.
- 3-10 Oscillator giving confirmation of buy by moving higher.
- As an additional confirmation, traders can look for ADX crossing above 20 and/or price moving outside of a Keltner channel. These additional criteria offer strong confirmations.

The complete presentation can be downloaded from the MTA web site.

*William J.P. Dale CIM, DMS, FCSI, Vice President and Portfolio Manager, RBC Dominion Securities, presented background on the foreign exchange markets and demonstrated how to build a trading methodology at the New York Seminar.*
Technical Analysis for Fixed Income

Rob Kepler, MKP

Beginning with a simple checklist and moving through charts to develop a complete trading model, Kepler left the audience with an understanding of what it takes to succeed in the fixed income markets. The checklist is deceptively simple:

- What is the trend? Up, Down, Sideways
  - Chart patterns, trendlines, moving averages, breakouts.
- How good is the trend?
  - ADX, volume trend, open interest trend
- What is momentum (market velocity) doing?
  -Confirming price, or diverging?
- Extended?
- What is the landscape?
  -Sentiment, flow of funds, COT.
- Risk Management
  -Where do we enter? Where do we exit?

On long-term charts, the trend can usually be spotted without difficulty:

When looking at a chart, volume may be viewed as a confirming indicator on patterns in the fixed income markets. Moving average bands or envelopes offer support/resistance and trend targets. When price or yield hit the envelopes, look to see if momentum, using an indicator such as the 39-week rate-of-change is diverging.

Sentiment is one of last things to look at. Sentiment can set the landscape for off-side positions. It is important to remember that sentiment is like momentum, it can stay skewed in one direction if the price trend is very strong. COT data (Commitment of Trader) can help highlight when futures investors are leaning too far one way. Commercials/hedgers tend to be on right side of most market turns. It is helpful to look for key support/resistance areas that fail to support hedgers’ views. Tracking bond mutual fund flows may also help identify climax price lows and diverging price tops.

Technical analysis can be applied to spread products (corp., agency, swap, mortgage spreads to treasuries) to help identify the better fixed income sectors to be in, a concept similar to relative strength for stock selection. Spreads in the fixed income markets can also be used to spot extreme financial stress and to develop intermarket views. If the spread of corporate bonds to swaps or treasuries is falling (tightening), this suggests better corporate bond performance relative to treasuries and usually correlates with rising equity index action. Rising (spread widening) trends often signal under-performance in corporate bonds and weaker equity action.

Applying technical analysis to yield spreads can help to determine curve direction (which part of curve will perform better). In the example below, the 10s/30s curve on the right side of the chart represents the 30yr yield - 10yr yield. A rising (steepening) line means the 10yr security outperforms the 30yr security. On the left side, it can be seen that the 30yr offered better performance as the yield curve declined.

Putting it all together into a trend trading model, Kepler showed that volatility adjusted moving averages can be applied to signal the trend. Volatility Bands can offer targets. He uses a volatility-based stop to protect from disasters. ADX is useful as a trend gauge to help filter the trend view, and daily momentum can offer profit taking signals or a signal to add on to an existing position.

The complete presentation can be downloaded from the MTA web site.

Rob Kepler, MKP Capital Management, LLC, demonstrated how to build a trading methodology in the fixed income markets at the New York Seminar.
Newmont Mining (NEM)
Bullish Case

by Nicolas Di Carlo

The stock of Newmont Mining bottomed on May 16th this year and proceeded higher, forming an inverted Head & Shoulder pattern. It has successfully broken above its neckline and come back to test it. Before completing the inverted H&S formation, NEM had already broken above the downtrend line drawn from the March top, tested it and resumed its way higher.

As shown in the bottom clip of Figure 1, the RSI stood up to its reputation of being a leading indicator as it also developed an inverted Head & Shoulders pattern and broke its neckline well in advance of price. The indicator also demonstrated a bullish divergence with the price. At the moment, the RSI is above its rising uptrend line and shows yet no sign of a possible top.

The horizontal lines on the right side of Figure 1 show the potential targets, the line at 43 being a projection based on the inverted Head & Shoulders with the two other lines at 46.60 and 50 being the resistances from the previous tops.

On the weekly chart (Figure 2) there appears to be a 6-month cycle operating in that stock as it is roughly the time that separates the last 4 major turns: 2nd December 2003 top, 10th May 2004 bottom, 17th November 2004 and 16th May 2005. Although four occurrences are not enough to confirm the existence of the cycle, it adds weight to the possibility that the stock has attained a significant low.

We can see how the last two years of sideways trading provided what is called an A-B-C flat correction in Elliott Wave parlance. EW is not necessarily the most reliable tool to analyze individual stocks, but Elliott works well in commodities and given that the price of Newmont Mining is highly correlated to the price of gold, I think that it makes sense to use it here.

From here we can make new price projections for this potential upmove; the 5th wave up has to travel at least 78.6 % of the distance of wave 4, which puts a minimum target at around 47 which is also the area of the last intermediate top. The next target would be the end of wave 3 at 50, then 55 where wave 5 would be equal to wave 1. And finally, 60.50 where wave 5 would be equal to 1.272 (square root of 1.618) times wave 1, which is also the level of the 1996 top. If we take into account the fact that 5th wave generally extends in commodities, Newmont Mining could reach new all-time highs in the coming years.

While a daily close below the neckline of the inverted Head & Shoulder on the daily chart would put a serious doubt on this bullish scenario, a daily close below 35 would probably definitely invalidate it.

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Disclaimer: this article is intended for educational purpose only. It is not a trade recommendation to buy, sell or hold any security whatsoever. Any decisions in financial markets are solely the responsibility of the reader, and the author does not assume any responsibility at all for those individual decisions. Please make your own research and take responsibility for your acts.
MTA Regional Chapter Contact Information

If you are visiting any of these chapter areas over the next several months and might be willing to make a presentation to the local group, please contact the regional chapter chair as noted to work something out. Some are long-standing chapters, some are trying to get started, but ALL of them are in need of speakers now and then.

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