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Technical Research

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Updated Reflections on the U.S. Dollar

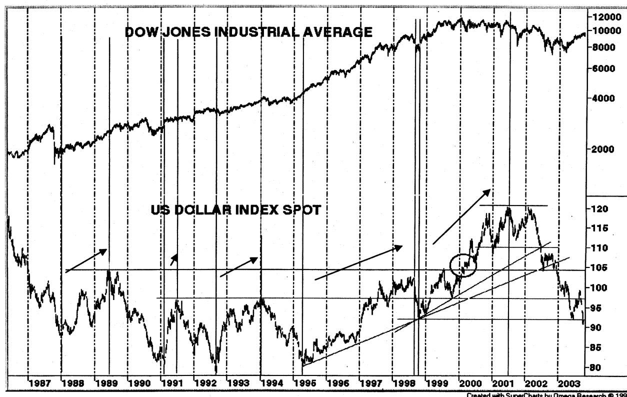
"Technical Research" is drawn from our full Market Interpretations, dated October 15, 2003; order No. US10L089. The report is also available online on Smith Barney's Global Equities Online (GEO) system, Smith Barney Direct, and FC Linx.

Introduction

Using the U.S. Dollar Spot Index as our guide (see Figure 1), we can see the dollar has been in a structural declining trend since early 2002. In the course of this decline, an eight-year uptrend on the chart has been violated, and our technical work is still pointing to lower levels, perhaps another 10% to near 80, which is the lower level of the 12-year trading range preceding the dollar breakout in 2000.

Figure 1

DJIA/U.S. Dollar Spot Index



Source: Bloomberg

History

In the April 22, 1996, issue of *Market Interpretations*, we addressed the then-emerging advancing trend for the U.S. dollar using the Finex USDX Futures contract. The general concern at the time was that the strengthening dollar could tumble stocks, particularly because of its potential negative effect on U.S. multinational companies. On the contrary, however, our study then of the dollar's trend progression over the longer term (defined as the multiyear trading range in force for the dollar) seemed to allay that concern and is particularly interesting.

Our dollar proxy used to be the Finex U.S. dollar contract, which is calculated on a perpetual basis. But due to liquidity considerations, our current proxy is the Spot/Cash index, a nearly exact pattern replica.

Looking at Figure 1, the dollar had essentially been in a trading range of roughly between 80–85 and 100–105 for years. The observation of the dollar's strengthening trend in 1996, which we expected at the time could rise once again to the upper trading range level, extended through 1999. The trend carried with it the bullish technical observation that, throughout the then ten-year trading range, a strengthening dollar was, in fact, accompanied by a *stable to rising* equity market trend (encouraging foreign money to test the U.S. equity market waters).

In addition, U.S. multinationals appeared profitable at the time and had apparently fine-tuned their hedging strategies to overcome the dollar's rise, as most globally exposed sectors were market leaders during the period. Our technical stock market indicators also pointed toward a buoyant market ahead.

Contrarily, one can see that the declining equity market periods (representing the bear markets of 1987, 1990, 1994, and 1998) correspond to a weakening underlying dollar structure. Although a weakening dollar does not *mandate* a falling market (note the one exception in 1992, and perhaps the one that makes the rule), when the equity market *has* been weak during the trading range, it has *always* been against a weakening dollar.

However, we set forth the caveat that *were* the dollar to break out of its trading range, the equity market would be in uncharted waters. In May 2000, the U.S. dollar broke out of its 12-year trading range (see *Market Interpretations*, dated May 11, 2000), indeed entering those uncharted waters. Therefore, we suggested that the observed relationships between the U.S. dollar and the equity market might alter accordingly.

Understanding that the relationship between the equity market and dollar fluctuations may not be as straightforward as it had been during the trading range, what might be the implications of such excess dollar strength? In the spring of 2000, the equity market was already presenting its own technical evidence of fragility. The strengthening dollar presented another ingredient in the stew of a "survival of the fittest" scenario (see *Market Interpretations,* dated May 4, 2000). We asked: "How might the strengthening dollar

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above the 12-year trading range affect the U.S. multinational stocks today in an evermore competitive global environment?"

2000–02 in Retrospect

The dollar indeed strengthened into uncharted waters, and equities churned at the all-time highs, building a significant top. So in hindsight, we know that the equity markets did not respond as positively to an *even stronger* dollar as they did during the 12-year trading range against a strong dollar. The U.S. equity markets suffered a severe bear market decline, even in the face of lower interest rates.

In retrospect, now we also understand that 2000–02 represented a period of *a unique global currency development*, that of the euro. We have been suggesting recently that the entire 2000 lift of the dollar into uncharted waters, and the subsequent January 2002 decline, may well have reflected a phenomenon related to the euro currency announcement and its subsequent introduction. This temporary dollar strength represented what we have been calling the "*black market bubble.*"

In 2000, the effective date of euro currency release was set for January 2002. This created problems, we believe, for the underground economies denominated in francs, marks, and lira, representing the future euro currency members, etc. For those stocks to become legal euro tender in early 2002, the only logical way to do so was to exchange those monies first into dollars. This, we speculate, pushed the dollar to extremes not seen in 14 or more years.

Then, the moment the euro currency was issued in January 2002, the dollars were transferred into euros, carrying the dollar back down into its 12-year trading range. Our long term, more structural, technical *Sell* signal on the dollar was registered in May 2002, at 113.00, and has been in place ever since.

Therefore, we could (discounting the "black market bubble") effectively consider that the U.S. dollar simply rose toward the upper level of its trading range and since 2002 is now again in retreat. Our experience with a weakening dollar might thus still be confined to the swing of the 12-year trading range.

Perspectives

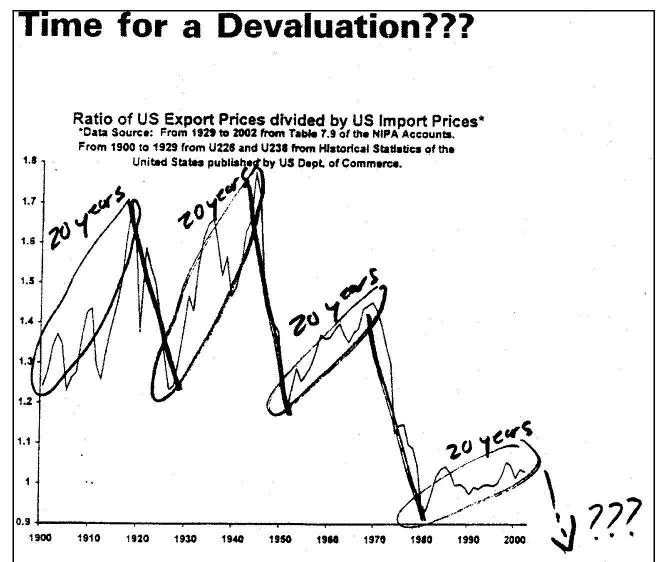
Differing dollar opinions are plentiful, and we suspect the economic environmental variables are so numerous as to make each experience, or each cycle, a little different and generalities difficult to define:

- A strong dollar is good because it keeps import costs and, therefore, inflation down, but is bad because it hurts exports and increases the trade deficit.
- A falling dollar may now be politically desirable in the face of a huge U.S. trade deficit as an added boost to a hopefully recovering economy, benefiting exports over imports.

Our friend Jim Paulsen, Ph.D., chief investment strategist at Wells Capital Management, published a very interesting chart recently (see Figure 2) going back to 1900 that focused on the ratio between U.S. export to U.S. import prices. He suggests, "A decline in export prices relative to import prices is similar to a period of U.S. dollar weakness." His observation is that "This ratio has collapsed about every 20 years or has undergone three major periods of 'devaluation' since 1900" and "may be nearing another period of major currency devaluation — that is, a period where dollar export prices weaken relative to dollar import prices."

Figure 2

Ratio of U.S. Export Prices Divided by U.S. Import Prices



Source: Wells Capital Management

- For now, from a technical perspective, we are projecting a return for the dollar toward 85, 80, or to the lower trading range band (see Figure 1). As and if those targets are met, and we must later deal with the possibility of any further decline, we will do so as the technical indicators guide us.

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- A falling dollar generally lifts inflation and can result from and/or cause an outflow of foreign capital. A slipping dollar now could reverse the inflow of foreign capital over the last decade and could weaken the dollar further (and eventually push interest rates up as a result).
- A large and rising current deficit eventually results in a weak dollar. The 1985 Plaza Accord response to such a large deficit was to arrange for a weaker dollar. To this 1985 dollar depreciation, the equity markets responded eventually, as official interest rates were raised in 1987.

A gradual dollar ease could simply slow the flow of foreign funds. However, a more severe drop in the dollar could provide a psychological shock and a less orderly adjustment, as foreign capital flows might more actively pull out. This, were it to occur at a later date, would not be a positive for the U.S. equity markets, as foreign holdings have come to represent a large portion of U.S. Treasuries, corporate bonds, and equities.

There may be a few outstanding questions to contemplate: 1) What if the lower trading band on the dollar is broken? The dollar will once again be in uncharted waters; and 2) What does the dollar profile communicate about gold? The U.S. is printing more and more dollars and other countries are printing more of their currencies in a competitive devaluation to protect their own economies from a strengthening currency. On the face of all these printed dollars, where might there be a store of value if they are no longer funneled back into U.S. Treasuries? Perhaps gold?

Our technical bull market case for gold remains in place and perhaps becomes more relevant in the face of the technical dollar profile. We might even be able to present a technical argument that gold is in its early bull phase relative to *other* major currencies, as well as the dollar. We hope to present this technical evidence over the weeks to come.

Louise Yamada

Groups: Week's Shifts

Air Freight & Logistics; Apparel, Accessories & Luxury Goods; Distillers & Vintners; Internet Retail; and Real Estate Investment Trusts were upgraded to our technical *Hold* list from *Avoid*. Data Processing & Outsourced Services was downgraded to *Avoid*.

In Air Freight & Logistics, heavyweight **United Parcel 'B'** (UPS-67.40) is poised to challenge resistance at 70, and a breakout could lead with follow-through to the all-time high at 76. UPS has traded in a neutral range for most of its history, and a move through 67 would break the stock out of a three-plus-year trading range. Support lies at 62. **FedEx Corp.** (FDX-73.65) has been in an uptrend since 1991. Having already attained an all-time high, FDX still has readable targets through 85. Support lies at 67. **Ryder System Inc.** (R-31.28) is on the verge of breaking out at 32, whereby targets toward 41 would be readable. Support lies at 28.

In Apparel, Accessories & Luxury Goods, **Liz Claiborne** (LIZ-36.92) continues to make new highs. Now that 37 has essentially been attained, a new upside target of 41 is readable. Support levels lie at 33 and 30. **VF Corp.** (VFC-41.40), showing more of a neutral profile, has the potential for a challenge of the upper end of its nearly two-year trading range at 45. Support lies at 37. **Jones Apparel** (JNY-33.15) has yet to break out of its two-year downtrend but appears on the verge. A move to 34 would accomplish that, with upside then possible to 38. Support lies at 30.

In Distillers & Vintners, the sole component, **Brown-Forman 'B'** (BFB-84.10), broke out at 83, putting in place a readable objective of 89. With no further resistance, however, higher prices cannot be ruled out. Support levels lie at 76 and 68.

In Internet Retail, the sole component, **eBay Inc.** (EBAY-58.53), still looks favorable from an intermediate- to longer-term perspective based on price. However, due to the apparent loss of upward momentum, stop-loss protection should be utilized under support levels of 57, 53, or 50 for capital preservation. The only remaining resistance lies at the all-time high of 63.

In REITs, **Apartment Investment & Management** (AIV-41.98) recently broke out through 40, providing a readable target of 46. Support levels lie at 39 and 37. **Equity Office Properties** (EOP-28.88) also looks favorable, having broken out at 28 and through its 200-week moving average. Next resistance lies at 31 and at the all-time high of 33, and support lies at 26. **Equity Residential** (EQR-29.70) is challenging its all-time high at 30, and a breakout would offer readable targets through 38. Support lies at 28. For **Plum Creek Timber Co.** (PCL-27.11), 28 would be a breakout, providing a target reading of 31. Support lies at 25. **ProLogis** (PLD-31.84) continues to look quite strong and, despite the fact that it is trading at an all-time high, can still be bought, as a target of 37 is readable. **Simon Property Group** (SPG-45.15) still has a readable target of 49 and may also be bought at the current price. Added to the impressive price patterns and underlying

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momentum, the total returns make this group that much more attractive.

Data Processing & Outsourced Services, downgraded to *Avoid*, should be eliminated from individual portfolios due to the relative strength underperformance. For those who are more concerned with absolute price performance, however, refer to Figure 3 for support levels, and utilize stop-loss protection under these levels for capital preservation.

Susan Stern

Figure 3

Support / Resistance Stock Table

Sub-Industry/Component	Closing Price 10/14/2003	Support	Resistance
Data Processing & Outsourcing Svcs			
Automatic Data Processing (ADP)	38.85	36, 33	40, 45
Concord EFS Inc. (CE)	13.72	12, 8	16, 18
Computer Sciences (CSC)	40.60	37, 32	44, 49
Convergys Corp. (CVG)	19.42	18, 15	20, 27
Electronic Data Systems (EDS)	21.97	20, 15	25, 39
First Data (FDC)	37.20	37, 34	44
Fiserv Inc. (FISV)	38.36	35, 30	40, 47
Paychex Inc. (PAYX)	37.85	34, 29	42, 46
SunGard Data Systems (SDS)	29.00	25, 20	31, 35
Sabre Holdling Corp. (TSG)	22.14	22, 15	27, 36

Source: Smith Barney

Global Interest Rates: Trends Show a Striking Resemblance to Late 1998 / Early 1999

In reviewing global interest rate trends, we were intrigued by just how much the current interest rate backup technically resembled the late 1998/early 1999 time period, suggesting rates may have further to rise. For example, while the basing process in rates in 1998–99 took several months, unlike the current reversal that occurred more quickly, perhaps due to the influence of mortgage hedging strategies, the 1998–99 reversal marked only the beginning of a more sustained move (see Figures 4–7).

Comparing both time periods, we were also struck by the similarities in terms of their overbought conditions (a sign of strength). (Note that in discussing yields, the position of overbought and oversold [OB/OS] levels are reversed, OB appears at the bottom of the stochastic range, while OS is at the top of the range.) However, once interest rates reversed, the overbought conditions of 1998 and mid-2003 quickly dissolved. Currently, global interest rate markets are generally oversold. Similar oversold conditions were also present in early 1999, but did not mark an end to the backup; instead, the trend of global interest rates was only in the early stages of a more sustainable backup (see Figures 4–7).

For example, even after an oversold condition developed in 1999, the U.S. 10-year yield, which was then at 5.00%, ultimately backed up to 6.60%. In early 1999, the 10-year yield in the U.K. was at 5.00% as a market established an oversold level; however, the backup proved to be only halfway completed. In Germany and Australia, a similar trend was evident (see Figures 4–7). Japan was an exception, as almost two-thirds of the backup was in place when the market became oversold.

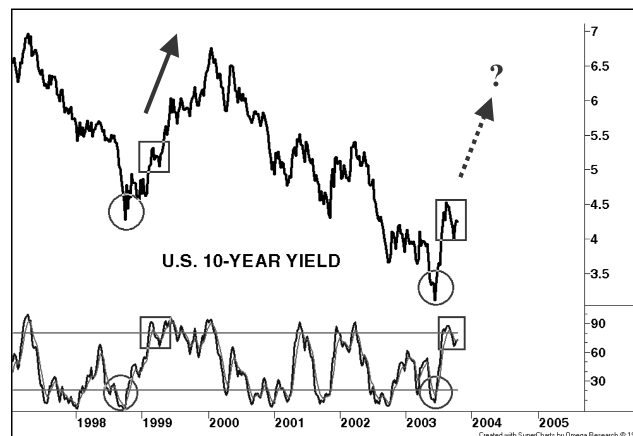
If we applied the extent of the backup in rates in 1998–99, after the market reached oversold levels, to the current level of interest rates, we would be able to project a target for the U.S. 10-year yield to 5.50%. This target remains within our concept of a transitional trading range for the U.S. 10-year of between 3.5% and 5.5% prior to a potential new structural trend of rising rates. Using the same criteria, we could project targets for the U.K. 10-year (4.92%) to 6.00%, for the German 10-year (4.20%) to 5.40%, and for the Australian 10-year (5.50%) to 7.00%.

Based on these global interest rate trends, investors may be anticipating an improving global economic outlook, a development that may bode well for global equity markets.

Ronald F. Daino

Figure 4

U.S. 10-Year Yield



Source: Bloomberg

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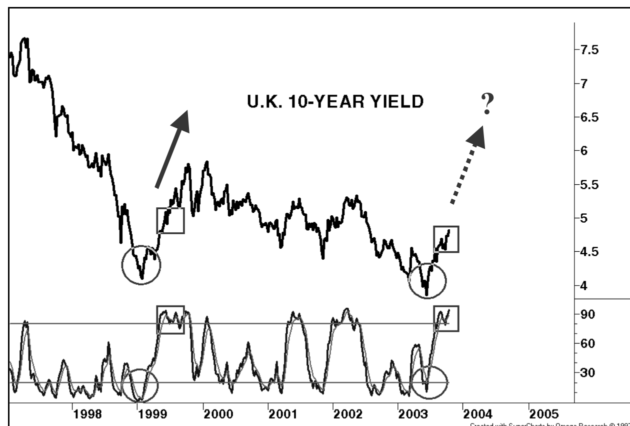
Figure 5

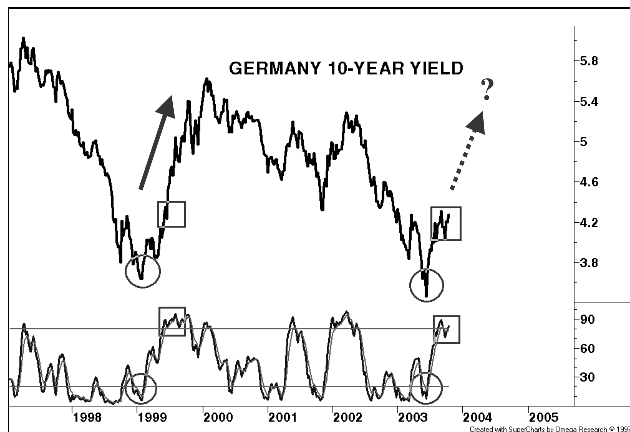
U.K. 10-Year Yield



Source: Bloomberg

Figure 6

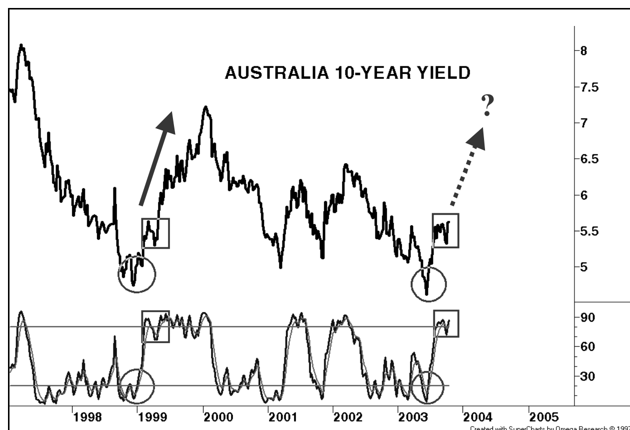
Germany 10-Year Yield



Source: Bloomberg

Figure 7

Australia 10-Year Yield



Source: Bloomberg

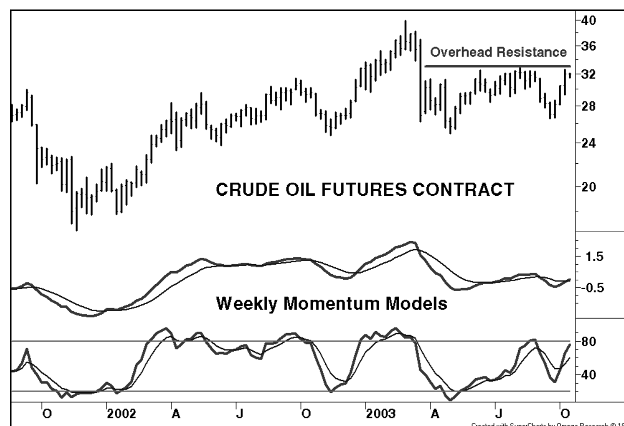
Energy: Crude Oil on the Move Again

Since bottoming near $27.00 a barrel in mid-September, the Crude Oil continuous contract (CL1-$31.95) has rallied and is currently challenging its early August highs near $32.50. On October 1, short-term models turned positive and were followed by intermediate-term *Buy* signals on October 5. With momentum readings rising, we believe the price of crude has the potential to close above overhead resistance at $32.50, which would give us a readable upside target to $33.00–$35.00 (see Figure 8).

Ronald F. Daino

Figure 8

Crude Oil Futures Contract



Source: Bloomberg

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