

# TRADE OF THE MONTH

## DOLLAR REVERSAL AHEAD?

Much has been made of advances in the U.S. Dollar Index since it bottomed in March. Conceived in the early 1970s, the index represents a weighted average of exchange rates in six major world currencies: the euro, British pound, Japanese yen, Canadian dollar, Swiss franc and Swedish krona. Valued at 100 upon inception, the "dollar" recorded highs above 160 in the 1980s.

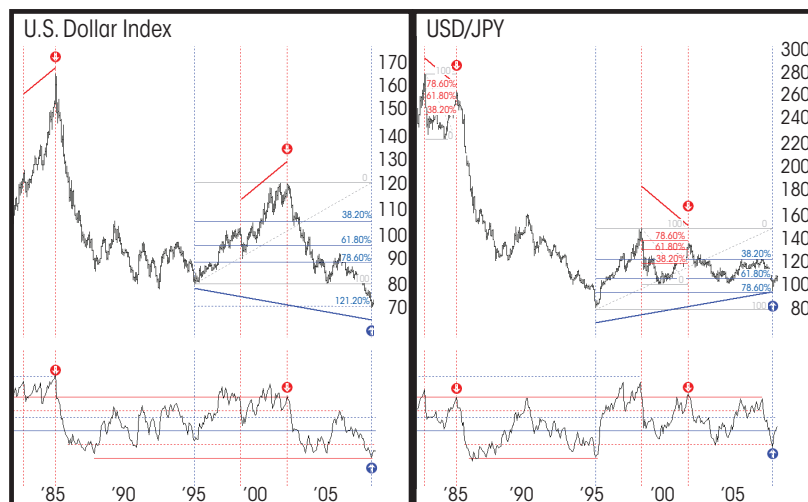
This instrument has received considerable attention in recent years, having fallen more than 50 percent from its highs. This isn't the first time the index has traded this low, having repeatedly held the 80 level several times since 1991 until finally falling lower in 2007. Now trading in the low 70s, the index recorded all-time lows in March 2008—but has risen ever since.

The increase has not been even among the six major currencies, however. The euro continues to climb, while the British and Canadian currencies actually peaked several months earlier. Since bottoming, the sharpest gains for the dollar have been made against the yen, a relationship with historical precedent.

When the dollar peaked in 1985, the yen recorded a swing high near 263. Interestingly, this was not a higher high for the dollar/yen. Two years earlier, in 1982, the greenback traded higher near 278. The 1985 swing high represented divergent price action relative to the higher high in the dollar, ultimately leading to a multiyear reversal. Could this pattern repeat?

In Figure 1, I compare the Dollar Index to the Japanese yen, using both price and sentiment via a 14-period Relative Strength Index (RSI). Horizontal lines on the RSI indicate historical support and resistance levels; blue and red represent bullish and bearish markets

**FIGURE 1:** Japanese Yen Leads the Dollar Index



Source: TradeStation

respectively. These levels typically hold at important inflection points.

Using Fibonacci trading tactics, I place retracement grids over two relevant swings in the Japanese yen from 1982 to 1985 and 1998 to 2002 (red vertical lines). In both cases, the dollar made higher highs, while the yen made lower highs (red trendlines). This divergent price action forewarned that the uptrend in the Dollar Index was in jeopardy. In each instance, the yen held below the 78.6 percent retracement level, in turn holding a horizontal bearish market level in the RSI (red arrows).

### IS HISTORY REPEATING?

Fast-forward to 2008 and—on a larger scale—a similar theme is unfolding. This time, I plot a retracement grid from their similar swing lows of 1995 to 2008 (blue vertical lines) to individual swing highs (near 120 for the dollar and 148 for the yen). While the dollar made lower lows near 71 at its 127 percent retracement level, the yen

made a higher low above its 78.6 percent retracement level near 95. In both instances, this occurred at a bearish market support level (blue arrows). The yen is actually breaking into a bullish market zone in RSI on the monthly chart as well—a potentially lucrative long-term reversal.

### THE TRADE

**Buy:** Dollar/yen on dips below 108 to as low as 100; add to any breakout above 110.

**Stop:** Place stops below 98, the 78.6 percent retracement of the current bull swing, and trail the trade above 110.

**Target:** Targets begin at 118, with long-term potential to retest the last swing high from 1998 near 148.

By Jeffery E. Lay, CMT, president of Talon Eight LLC. For more information, see [TalonEight.com](http://TalonEight.com). Lay does not hold a position in dollar/yen as of this writing in late July.