

Monthly Comment

Traders Bulletin

Monthly Overview

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Major Technical developments for October:

- **Stockmarkets close well above the lows but still record worst monthly falls since 1987**
- **Gold down by 17.4%, Oil down by 34%**
- **Sterling experiences sharpest drop against the dollar since 1992**
- **Money market spreads start to narrow**

US Market

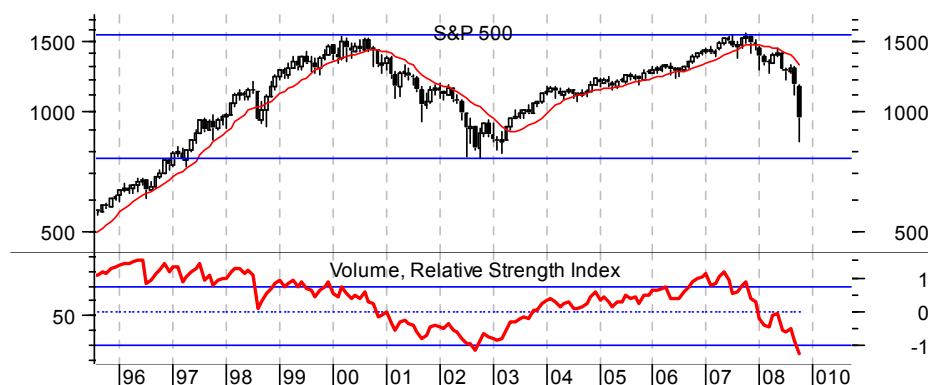
The **S&P 500 (968.75)** recorded its worst monthly falls since the 1987 crash although, thanks to a powerful rally in the last week of the month, the retreat of 21 years ago was actually worse (21.8% vs. 17.7%). The acceleration in the sell-off of almost all asset classes reflected new concerns i.e. that global growth was going to shudder to a halt and that prices were not adequately reflecting the fall-off in earnings that is the inevitable corollary of such an event (and the fact that a company like GE is already missing earnings targets confirms that a major slowdown is underway).

The negative sentiment is reflected in the fact that the 14-week RSI fell to levels not seen at any point in the last 38 years – and from which it has subsequently bounced. Indeed, the fact that there has been a rally from these historically oversold levels raises the question of whether a major bottom has finally formed (if not *the* bottom). There are a couple of other pieces of technical evidence to support this proposition: the first is that the shorter-term oscillators are displaying clear bullish divergence, implying that the selling pressure has abated at the lower levels; the second is that the index was recently 34% below its 40-week moving average – compare that to the 27% differential in 1974 (no other subsequent sell-off comes close); third, last week's rally led to the formation of a 'bullish engulfing pattern' on the weekly candlestick chart which, in this case, was particularly significant since it also incorporated a test of the recent lows.

Taken together these factors present compelling evidence in favour of the argument that the market has seen the worst, at least for now. Put another way, the ingredients are in place for a significant bear market rally.

Equity Indices performance - October

FTSE All Share	-12%
FTSE 100	-10.7%
FTSE Mid 250	-11.9%
FTSE Small Caps	-16.7%
S&P 500	-17.7%
Dow Jones Industrials	-14.1%
Nasdaq Composite	-17.3%
Eurofirst 300	-20.7%
Nikkei 225	-14.6%
Hang Seng	-23.5%



Of course, this does mean that the rally will have kicked off without adequately testing the 2002 lows (at 768 or so – the October low was 844.65) – nor did it drop by fully 50% from its highs, which would have taken it to 782. Perhaps these levels will be tested at a later date as the market experiences its final sell-off – in July 2002, for example, the S&P bottomed out at 775 but then rallied all the way up to 965, an advance of 24.5%. Two and a half months later that low was re-tested but it wasn't until the following March that the rally got going in earnest. As the monthly chart above illustrates, the S&P is slightly more oversold now than it was six years ago and that strengthens the short-term bull case.

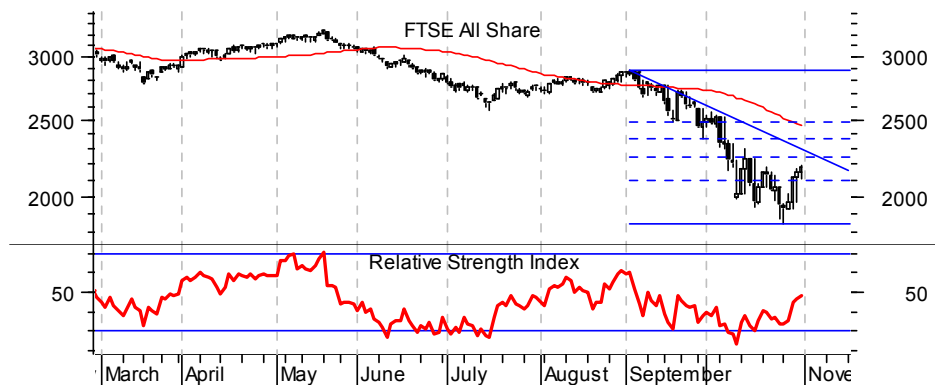
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UK Markets

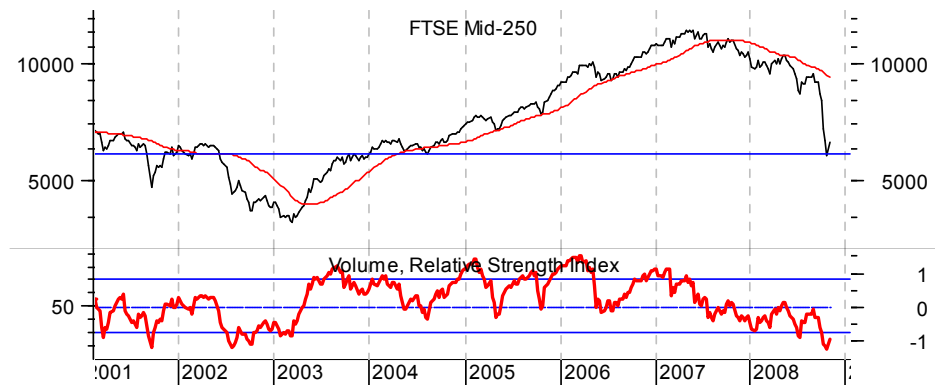
FTSE All Share (2183.69) dropped by 299 points in October – in fact, not as bad as its September performance (when it gave up 385 points), although the loss for the two months is 25% - and that's the worst since 1987. However, it is worth noting that the All Share's closing level for the month was fully 18% above the lows and this is almost entirely due to the major rally that took place last week (its largest ever) – on Monday the index traded down to 1847.25 but by the close of business on Friday it has rallied by 336 points from that level. On one view this can be seen as a reaction to an extremely oversold condition – at those lows the All Share was down by 44% on the year and was 47% below the all-time highs that were recorded fifteen months ago. Needless to say, the momentum indicators confirmed this prognosis – the 14-week RSI had, for example, retreated to levels last seen in the second half of 2002.

Also worth noting is that fact that the index managed to string together a sequence of four consecutive days of gains, and we haven't seen that since the last week of August. This shift in sentiment comes at a time when the 14-day RSI is displaying clear bullish divergence and that in turn implies that selling pressures were actually diminishing as the market bottomed (unlikely as that might sound).

In the near term the index now faces a test in the form of resistance at **2228** – that was the intermediate peak on October 14th and, coincidentally, it is also at that level that the All Share will have retraced approximately 38.2% of the decline that began in earnest in early September. Also, that leg of the downtrend is clearly defined by a trendline and that is also now sitting at around the 2230 level, so it is pretty clear that there are reasons for expecting to see some resistance there. In this market one would expect such resistance to be insuperable, but if it is exceeded then we will be able to say with confidence that a bottom has formed.



The **FTSE Mid 250 (6282.55)** shed 20.3% last month, its worst ever monthly performance, and it would have been a lot worse were it not for the 489-point rally that took place last week (following five consecutive weeks of losses). Unlike the other indices mentioned so far, the 250 index has not come close to testing its 2003 lows (at 3800 or so) and nor is it displaying bullish divergence on any of its momentum oscillators, although there is one reason for optimism – as the chart below shows, the recent move off the lows appears to coincide with a test of support in the form of the lows that were reached in August 2004



The fact that this bounce comes at a time when the index has reached an extremely oversold condition does reinforce the impression that some kind of bottom has formed

but we really need to see a close above 6500 for confirmation.

The rally off the lows by the **FTSE Small Cap Index (1938.55)** has been even less decisive – last week it gained just 35 points after eight consecutive weeks of losses during which it gave up 33% of its value. Nevertheless, the 14-day RSI is displaying a degree of bullish divergence and some support appears to have developed at around 1842, suggesting that there is scope for further upside in the near term. The first area of likely resistance is at 2090 or so, which is the intermediate peak that formed ten days ago.

UK Stocks

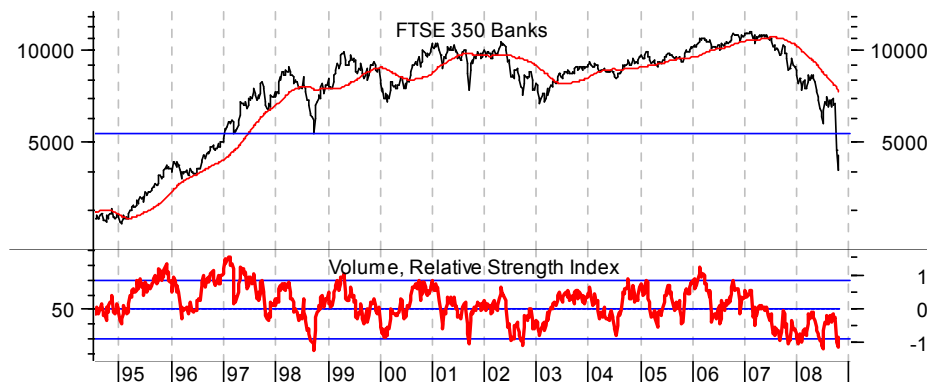
The FTSE-100 was given a significant tonic last week when mining stocks started to rally off the lows despite the fact that metals prices continued to move in the opposite direction. This undoubtedly had something to do with the fact that the sector had reached an extremely oversold condition and, perhaps as a result of that fact, some broking houses had begun recommending it to clients as representing value. I don't intend to comment on that point, but the technical situation is worth highlighting.

As the daily chart for the **FTSE 350 Miners (11908.95)** shows, a low appears to have formed at around 8578 and the fact that this coincides with bullish divergence on the 14-day RSI does imply that this might develop into a lasting bottom.



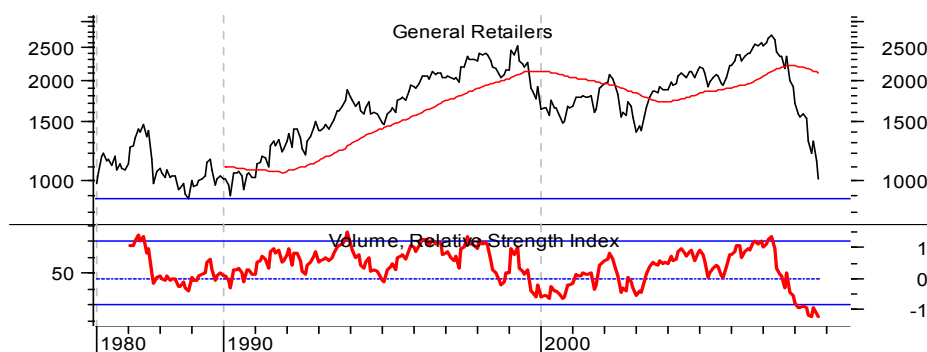
What we really need to see now – to confirm this potentially bullish prognosis – is a break up through the short-term downtrend. At this stage that is going to require a close above 12200 or so i.e. just above the intra-day peak that was reached on Friday, and that would give the sector the impetus to travel up to the next area of potential resistance, which is the intermediate peak that was reached on October 14th, when it topped out at 12752. A move through that level would be very bullish on a short-term view.

There was also a significant move off the bottom by the banks last week – the chart below shows that the **FTSE 350 Banks (4529.68)** rallied by 11.7%, their best one-week performance since 2001. As you would expect, the relentlessly bad news coming out of the sector had ensured that prices had fallen to extremely oversold levels so it is not difficult to argue that they were due for a bounce. However, the chart shows that the recent lows reached by the sector were not matched by new lows on the 14-week RSI and this bullish divergence does reinforce the impression that a bottom might have formed at these levels (after the banks had plunged to their lowest levels since 1996).

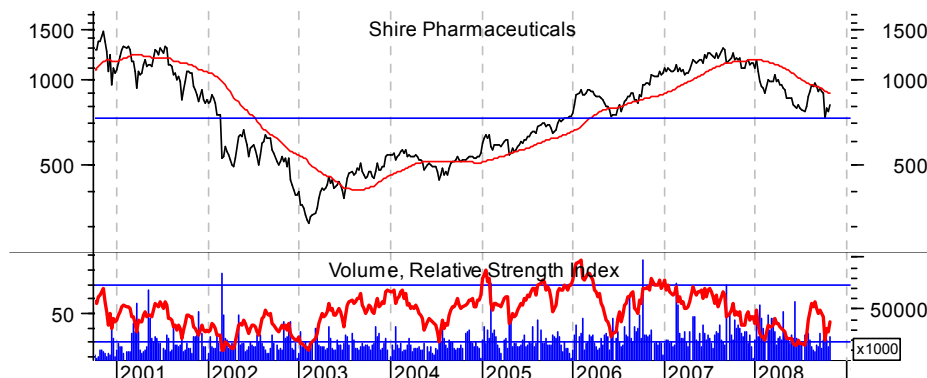


What we really need to see now is some follow-through – and that means a move up through 5000 in the near term. It is clear that the banks are still not out of the woods – the market does not like the terms of Barclay’s capital raising while Lloyds TSB and HBOS are looking for a further £17bn – but the technical picture does at least suggest that there is some grounds for optimism.

Few sectors have been doing worse than the general retailers – as the chart below illustrates thus sector has now dropped back to levels last seen in the 1980s. This is no surprise as all anecdotal evidence points towards consumers reining in their spending in a dramatic fashion, and the point was underlined last week by dire weekly numbers from High Street bellwether John Lewis. This week sees the release of figures from M&S and Next and analysts are expecting little in the way of good news – and that could mean that there is scope for upside. So much bad news has now been factored into prices – and that sector is extremely oversold – that it seems possible that a bottom might not be far off.



Readers will be aware that I have been highlighting the attractions of the pharmaceutical sector lately and the technical outlook for these stocks is still appealing. **AstraZeneca (AZN: 2630p)** has rallied smartly off the lows to the extent that it is now back to within 140p of its highs for the year, and it is not inconceivable that we could see new highs before the year is out. **GlaxoSmithkline (GSK: 1197p)** gained 69.5p last week and looks set to run up to test its short-term downtrend before long, implying a move up to around 1270p. A close above that level would be a very bullish development and, at this stage, looks quite possible.



Shire Pharmaceuticals (SHP: 819p) added 50p last week and, as the chart above shows, this has lifted it neatly off the lows. Last week’s figures were better than expected and there now appears to be scope for a move up to around 968p – that was the recent intermediate peak.

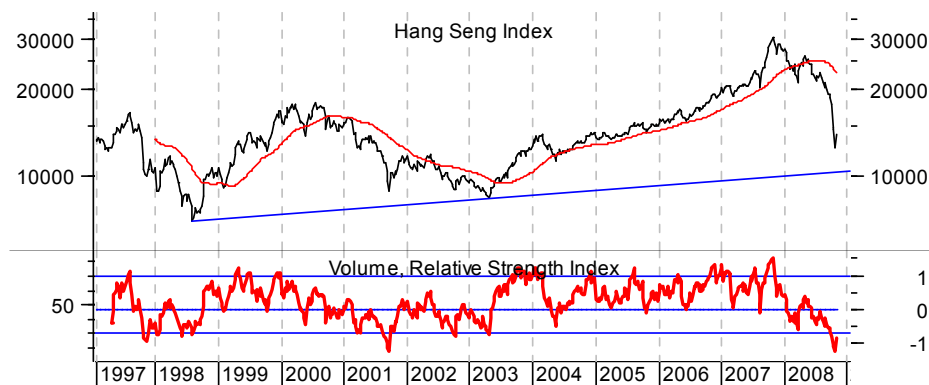
Global Markets

The **Nikkei 225 (8576.98)** traded below 7000 last week for the first time since 1982 and, as I mentioned a week ago, at those levels the Tokyo index had shed close to 62% of its value from last year’s highs. A loss of this magnitude has occurred twice previously over the last thirty years and on each occasion it has acted as the trigger for a major bounce, so it is not altogether surprising that the index subsequently rallied by more than 2000 points, peaking at 9029 on Thursday. Over the last couple of sessions the sellers have moved back in but the impression remains that a significant bottom has formed.



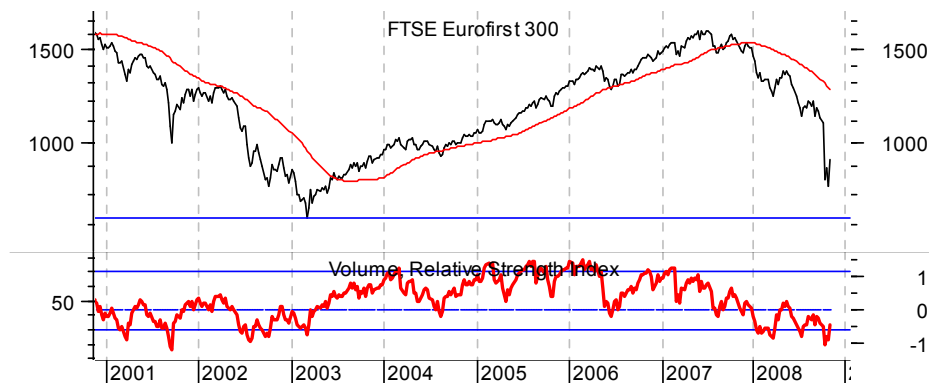
The weekly chart shown above shows that the rally coincided pretty neatly with a test of the 2003 lows and while it is clear that the Nikkei remains highly volatile there are reasons for optimism here.

The **Hang Seng (14344.37)** has also been extremely volatile recently – last week it experienced three sessions where it moved by 10% or more. The net result for the week was a gain of 1350 points (10.7%), having traded as low as 10676. This was the Hong Kong index's first meaningful weekly rise since August and while it is not clear that a bottom has been formed the fact that it was able to rally so spectacularly off the lows does look like a positive at this stage.



At 15500 or so the index will have retraced 38.2% of the decline that began in September and, given the short-term upside momentum that it has recently developed, a rally up to that level has become a realistic expectation (although I would also say that I would expect to see some resistance there).

Last Monday **FTSE Eurofirst 300 (928.81)** traded as low as 784.29 before recovering smartly to post a gain of 99 points for the week (marking its best ever weekly performance). Although the index ended the month with a loss of 134 points the rally

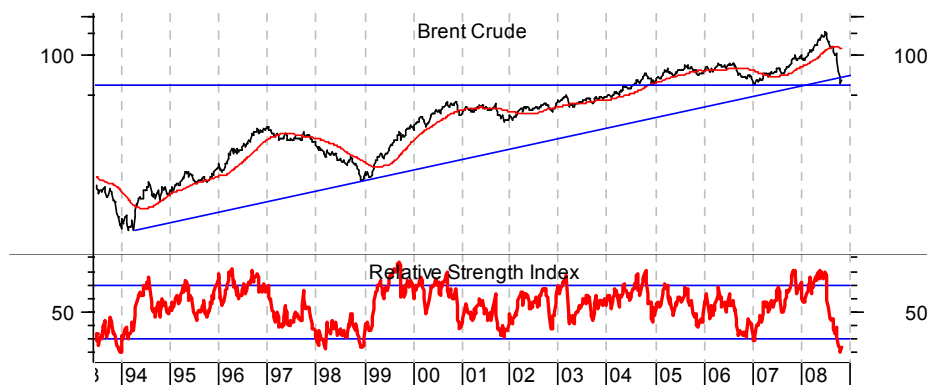


the lows is a positive development and does create the impression that a bottom of sorts has formed. With that in mind, a close above the recent intermediate peak at 966 or so would go a long way towards reinforcing the impression that this index is over the worst.

Commodities

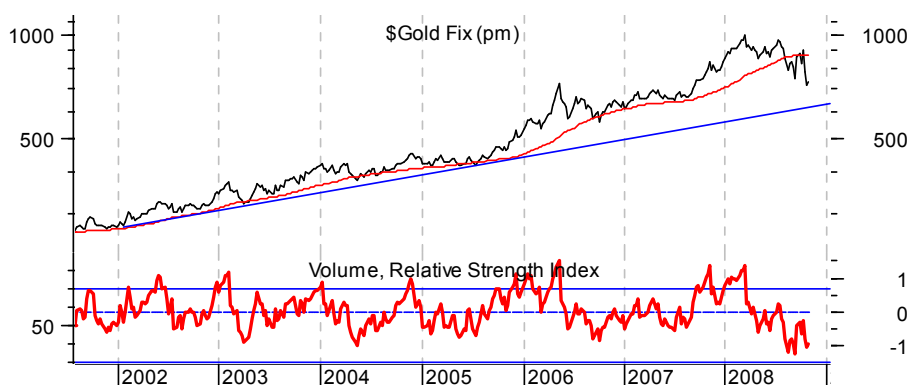
The retreat in commodity prices across the board in October (including gold) demonstrated the extent to which investors had become risk averse – and reinforced the widely-held view that a global slowdown would impact significantly on demand, particularly for metals and energy products.

Brent Crude (\$65.32) regained some lost ground last week but the overall loss for the month of October was a hefty \$34.20 – its largest ever one-month decline in dollar terms, and its fourth consecutive month of losses, during which the price has more than halved. In fact, at the recent lows the price had dropped by 62% since it peaked at above \$152 in July and, given the magnitude of that decline (and the degree to which it had become oversold) one would expect to see some support at current levels. The 14-day RSI is showing bullish divergence and the fact that the lows from January 2007 have also been tested does suggest that there could be scope for a short-term rally from these levels.



In terms of support, the aforementioned lows, at \$56, will be the level to keep an eye on, although a move to the upside seems more likely in the near term. A recovery in equity markets could see the price of crude move back up to around \$81 in a hurry.

Gold (\$730.75) experienced its worst drop of the last twenty five years last month, falling \$154 – 17.4% - taking it back to levels last seen more than a year ago. Unsurprisingly, this has left the price looking extremely oversold but there is little else in the current technical picture to suggest that gold is about to experience a significant revival. In fact, it would not be surprising to see it test its long-term uptrend at some point in the near future, implying a retreat to around \$650.



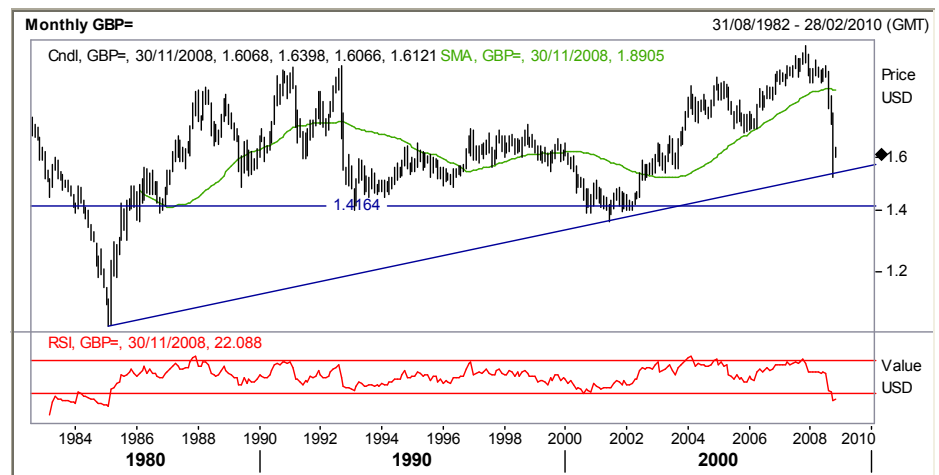
Currencies

Dollar/Yen (98.44) – a couple of weeks ago I highlighted the extent to which the declines in the Japanese equity market were tied to the fortunes of the yen and, specifically, its recent strength relative to the US dollar. There is already plenty of anecdotal evidence to suggest that Japanese car manufacturers are struggling to sell units in the USA and the problem has only been exacerbated by the strength of the currency. However, as the chart below shows, the dollar has recently been gaining ground against the yen (it traded down to 90 not long ago) and this has obviously been a major driver for the recovery in the Nikkei.

From a technical perspective resistance the key level is around 100 yen – there is downtrend resistance at that level and it is also important psychologically. Needless to say, any further yen strength is likely to impact on share prices in Tokyo.



Sterling/Dollar (1.607) - the pound's 17 cent retreat against the dollar was its worst monthly performance since it left the ERM back in 1992. In terms of its 'oversoldness', it has dropped back to levels last seen in 1985, when it got close to parity with the US currency. In other words, it is due for a rally and, in fact, there has been a move off the lows (at 1.5265) already – note also that this coincides with a positive reaction to the long-term (24 year) uptrend. Readers will recall that I forecast a couple of months ago that sterling was heading for a reversion to its long-term mean against the dollar and that has now been achieved. Consequently, while significant further downside now seems likely in the short to medium term it is not difficult to see 'cable' entering a period of consolidation, where it oscillates between 1.55 and 1.70 or so.



3-Month Sterling Libor (5.841) has narrowed by around 50 basis points over the last couple of weeks and while that sounds like an improvement all it means is that the spread over base rates has been maintained. Overnight rates are now just a quarter point or so above base but until the 3-month spread comes down the credit crunch – particularly as it affects consumers – cannot be said to be over.

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