

The dollar vs. the Nasdaq: A trick to click

By Tim O'Sullivan

One trick to finding buy and sell signals on the U.S. dollar is to find a correlated indicator of the country's economic condition. Here, we will examine recent correlations between the Nasdaq and the dollar, as the two have tracked — and at times diverged from — the U.S. economic condition.

The dollar vs. the Swiss franc (USD/CHF) is the one major currency pair resistant to psychological economic complications. The euro doesn't qualify because of the economic collision course of 12 nations with different macroeconomic policies, different productivity numbers, different inflation, different rates of mad cow infection, etc. The British pound has submerged as a "minor" major, dwarfed by the 12-member Euro organization. The Japanese yen, still very much a major currency, carries perceptions of instability despite representing the world's second largest economy. But Switzerland, stereotyped as insular and remote, traditionally has been the currency to sell when the U.S. dollar represented the must-own economy. The opposite is true, too. Depending on global bond yields, investors flock to the Swiss franc as the currency of choice when the U.S. economy stumbles.

As the 1990s ended, the sizzling, tech-laden Nasdaq had emerged as the prime indicator of economic dominance. (Note: the chart indexes USD/CHF to the Nasdaq as of March 23, 1999. To parallel the magnitude of the two indicators' percentage moves, USD/CHF is leveraged a modest 5:1. This means a 1% nominal change in the USD/CHF price translates into a 5% change here, well within the typical 50:1 leverage available through both spot and futures brokers.) The correlation between the rising Nasdaq and dollar strengthening at Circle 1 was so strong and predictable that traders

said the dollar traded "tick for tick" with the Nasdaq. Two underlying fundamental factors supported this.

First, the Nasdaq's phenomenal and consistent double-digit growth for years enticed the European community to allocate massive amounts of capital to the U.S. tech revolution. To purchase these equities, Europeans had to buy U.S. dollars.

Second, the dollar also benefited from the 150 basis point differential favoring dollar-denominated fixed

percentage gap formed nearly seven times the average over this two-year period (Circle 5).

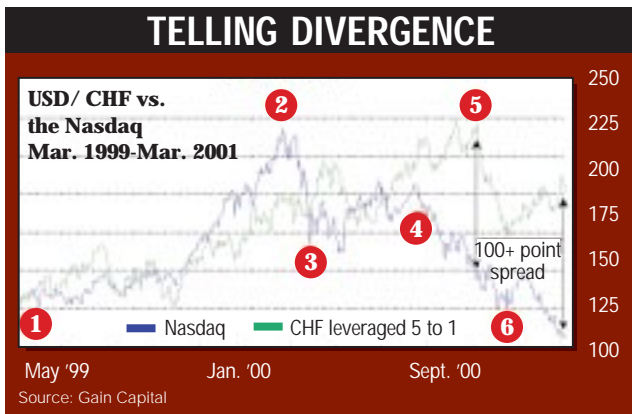
There was no way dollar strength could continue in the wake of a faltering mother ship. Soon enough, dollar buyers evaporated as the U.S. economy crumbled (Circle 5). The subsequent 15% dollar decline was the first significant dollar sell-off since the third quarter of 1999.

At Circle 6, the dollar bottoms on Jan. 1, 2001, in tandem with a short-lived Nasdaq bounce. Widespread fear of slowing growth in the United States normally would resurrect the correlation. By looking at the graph, however, it's clear that these two correlation buddies diverged again.

Beyond Circle 6, the *de rigueur* search for any positive yield pushed the investment community into U.S. fixed income assets. At 6%, U.S. Treasuries yielded significantly more than both their European counterparts (5.5% in the United Kingdom and 4.75% for the European Union) and Japan (0.25%). Here again, the dollar outperforms but under a different capital markets scenario.

Correlation trades favor position trades, particularly when macroeconomic trends exhibit high continuation probabilities. Since February 2001, the correlation between USD/CHF and the Nasdaq has broken down and the two have diverged. Given the messy economic picture in the United States and the abstruse complications of its slowing economy on the rest of the world, a trade may have materialized. In this case, the USD/CHF vs. Nasdaq spread differential has leapt back above the late November 2000 levels. Could this mean the dollar will fall or the Nasdaq will rise? Take your pick — you now know the trick.

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income instruments vs. European counterparts. Plus, inflation remained historically low following five years of rising productivity.

Between March and April 2000 (Circle 2), the Nasdaq dropped precipitously. As the index plunged, the dollar barely dipped before ascending again. Momentum players saw little reason to question U.S. economic strength and every major sell-off of the previous five years turned out to be a buying opportunity. At Circle 3, both the Nasdaq and the dollar surged as new money came in to pick the bottom. Circle 3 represents the buying opportunity for those who missed Circle 1 and roused a second wave of European buyers.

At Circle 4, the historical relationship started to break down. The nascent Nasdaq rally wilted in July 2000, resumed another feeble climb, then began a sustained period of decline still in place in early April 2001. Contrary to expectations, dollar strength continued until a per-

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