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Reports/Events, Market Psychology and Central Banks, Politics

We are adopting a new format for referencing the period of any report we might note in our analysis, with that abbreviated notation in parenthesis after the report name. This should be equally as clear as our previous format, use less space, and be easier to read.

In spite of the German GDP (3Q 2) confirming earlier figures of plus 0.6% (admittedly a bit stronger than expected previous), and weak French Consumer Spending (OCT) and UK CBI Industrial Trends (NOV), somewhat stronger German Import/Export turnover and (not surprisingly) Domestic Demand (all 3Q 2) have the fixed income and US dollar stuck in short term trading ranges. After yesterday's ECB softening of the very hawkish comments from Monsieur Trichet on Friday, it is not surprising this is within the context of the bid returning to the US dollar, and the Bund and Euribor experiencing a relief rally prior to today's pressure.

There are quite a few decisions yet to be made this week, but we still feel it all boils down to the answers to a few key technical questions. Does the EUR/USD Close back below the 1.1672 Tolerance of last week's minor weekly UP CPR and oscillator support prior to violating 1.1950 Tolerance of the 1.1850-1.1900 resistance? Does the Bund defend its 119.50-.30 support by not failing below the freshly generated congestion support at the trading lows in the 119.00 area, which should allow the more bullish T-note and the Gilt to both hold their respective low "half" support? Will the equities' up trend push extensively higher, as it well might if they can mutually push above very important congestion, Fibonacci retracement and oscillator resistance levels at the December S&P 500 future 1,257 and 1,265 levels, FTSE 5,550-5,600 and DAX 5,160-5,200, or is a stallout against those resistances grounds for a significant selloff, and potential disappointment from a weak finish to the year?

Reports/Events

As noted previous, in spite of a rather thin US reporting calendar as we enter the back half of the mid-month economic release vacuum, the reporting calendar in Europe is typically very robust, and augmented by a strong focus on central banks and bankers.

With the release in series today through Thursday (respectively) of meeting minutes of the previous meetings of the FOMC, Bank of England, and BOJ, along with Governor King's delivery of the BOE Inflation Report to Parliament on Thursday, there will be quite a bit of central bank internal opinion for the markets to digest. Our guess is that if the FOMC still does unanimously consider the Federal Funds rate "accommodative," it will reinforce our previous expectation that they are on a path toward 4.75 percent by the first Chairman Bernanke meeting at the end of March (see the reiteration of our reasoning below), even though this does not seem to be reflected in the short money forwards.

In fact, we feel the Fed has already articulated that there are circumstances already in progress under which they might even raise the Fed Funds rate to well above 4.75 percent, and that is certainly not reflected in the Eurodollar forwards' current price structure (also see below.) We suspect the Bank of England will have been unanimous in their no action

decision, and will use the relatively weakening industrial and consumer trends into account for a dovish tone within that. Consistent with this, we suspect Governor King will be duly concerned about inflation while seeking to calm any fears that the energy price escalation has spilled over into creating second round effects. The BOJ will likely have reflected upon the need to be attendant to a more robust attempt by the economy to shake off the long term weakness. Yet, it will likely not have taken any firm decision to remove accommodation as yet due to the anticipatory nature of the recovery in the wake of the reform centered election coup by Prime Minister Koizumi.

Amidst all of this we also see some very important economic releases, especially as we get into the later part of the week. So all of you turkeys here in the USA who had thoughts of enjoying a quiet extended holiday weekend due to the light late week US reporting calendar, we offer the classic Italian street-wise advice: *fuggedaboutit*. With further ECB insights from Chief Economist Otmar Issing tomorrow morning (US time) after Euro-zone Industrial New Orders (SEP) and Italian Consumer Confidence.(NOV), followed by Thursday's German "Lander" CPI (NOV) and Import Price Index (OCT), French Business Confidence Indicator and Production Outlook Indicator (both NOV) and Euro-zone Current Account (SEP), and Friday's pan-German CPI (NOV P) and IFO - Business Climate (NOV; along with the usual Current Assessment and Expectations breakdown), Italian Business Confidence (NOV), and UK GDP, Private Consumption, Government Spending, Gross Fixed Capital Formation, and Import/Export numbers (all 3Q 2), the markets are due to remain very active into the end of this week in spite of the typical US Thanksgiving bout of *tradus interuptus*.

Especially with the Bund remaining the weak sister that is having trouble rallying too far above its support, and the US dollar decision still critical regarding whether the Euro is prepared to once again follow the yen down the path of extended weakness, the price activity late this week could indeed be very significant.

Market Psychology and Central Banks

While we do not want to digress into a discussion of price trends better addressed in the technical *TrendView*, and these two topics are often separate areas of consideration, the degree to which certain market psychologies are either tied into central bank actions or are defying what appears to be a clear (at least to us) central bank logic warrants combined review of certain aspects of these two areas.

EQUITIES, the FED, and US SHORT MONEY

The strength of the equities to date has confounded all of the naysayers who expected the BOE or FOMC interest rates hikes, US storm damage, European social unrest and political deadlock, or high price of energy to derail them. Admittedly, this author was cautionary on certain of these issues at times. Yet the inability of the markets to sustain any sort of a meaningful technical failure during the October selloff (with Europe not even mimicking the temporary DOWN Breaks in the US) meant that by early this month all of the trend signals had turned UP once again.

Now the question as the markets approach meaningful resistance is as we noted yesterday: Are these markets at a ceiling or a floor, as any extensive violation of that resistance will turn it into support for a broad year-end rally? The extended question then becomes whether any late year rally is sustainable into continued US central bank tightening in 2006? It is easy to imagine the first scenario, as either the more upbeat expectations for holiday shopping or

corporate outlook (sans the US auto makers of course) push the market through resistance, and that is followed by a bout of funds managers who are not fully invested chasing the markets to effect the necessary year-end window dressing. Of course, “year-end” is a bit of a misstatement, as nobody actually waits until December 30th; more likely any escape from the higher resistance foments some aggressive buying into the middle of December.

All of which still leaves the question of the Fed’s agenda as they remain in tightening mode for now. The other interesting aspect is the degree to which the US short money forwards are not even reflecting the full rise to 4.75% by late March, and the extended forwards trading at not much lower than the March and June 2006 contracts are certainly not even hinting at the potential for more of a tightening than that, which would normally be the case in the short money futures price structure during a central bank tightening exercise.

We feel this is misguided on two levels, the first of which being the clear logic that projects rates to the 4.75% level by late March. To reiterate our previous five-point stepped logic:

- 1.) At 4.00% the current Federal Funds rate is still accommodative by historic standards that imply it has not become restrictive until it is at least one-half to one full percentage point above projected GDP growth;
- 2.) The Fed wants rates as high as possible prior to Mr. Greenspan’s retirement so that his successor does not need to raise rates in a way that brings disdain upon the Fed for causing a recession (which is exactly the situation that Mr. Greenspan was stuck with when Mr. Volcker handed over the reins);
- 3.) In any event, the Fed will not be signaling that it has put through the *penultimate* rate hike until it eliminates the “removal of accommodation” language. On current form that means the earliest they might hold steady will be Mr. Greenspan’s last meeting as Chairman in January;
- 4.) Yet, to hold steady in January would create an expectation that they had finished the tightening cycle, and leave quite a bit of pressure on Mr. Bernanke to make his first move as Chairman an easing;
- 5.) Which is an untenable position for a new Chairman, as regardless of anything else (short of an obvious recession beginning in February or early March) Mr. Bernanke’s first task as Chairman is to establish his anti-inflation credentials, and worry about the full employment portion of the Fed’s mandate only once that is addressed.

Having revisited that analysis from *CMO* I–10 (November 2, 2005), note that was just a follow up to the insight we derived from the September FOMC rate increase announcement that included the fact that they still considered this “removal of accommodation.” When this was linked to Mr. Greenspan’s September 27th “history lesson” (National Association for Business Economics annual meeting in Chicago) including that since the mid 1990’s various factors (especially the disintermediation of commercial banks as the primary source of corporate loans) had required the Fed to move rates ever more extensively prior to having the desired effect, it was the basis for our bearishness toward the short money instruments.

As we also noted shortly after that, perhaps in this part of the cycle the trading community was making a mirror image mistake of some sort of error that it had made in expecting the FOMC to raise rates markedly again during the equity market recoveries of 2001 and 2002. Of course, the extensive Eurodollar forwards discounts that prevailed during stock market rallies of that period were quickly reversed when the degree of sustained economic weakness due to the major cyclical correction became obvious, and the Fed actually eased further rather than tightening into early 2003.

Now it seems that nobody can accept that the Fed might be tightening further than most observers imagine. Why not? There is another major clue buried in the September 27th "history lesson": "Yet the *significant monetary tightening of 1994 did not prevent* what must by then have been *the beginnings of the bubble* of the 1990s." (Our italics.) While the potential for a further seasonal year-end rally are in place awaiting the technical push through what is important resistance, we are skeptical that the Fed will stop raising rates until it has created a slowdown of significant enough proportions to drop equity markets back into a considerable correction. And you ask, "What rate might that be?" ANSWER: Pick a number.

While the Fed will adamantly deny any attempt to affect the specific trend or trading level of the equity markets, they have also now signaled that they understand that previous norms of short term interest rate influence on corporate and consumer psychology are no longer relevant, and the only way they can know they have made an impact is to see the consumer discomfort that leads to lower profits at the corporate level. As they are not getting any help from the long term interest rates (the "conundrum") subduing the mighty housing market via a significant increase in mortgage rates, we must presume they can and will continue to raise short rates until they are sure they have not allowed equity market self-sustaining euphoria to create another bubble from which the implosion will be even more troubling than the last.

Hence, what in the world are the Eurodollar short money fixed income future forwards doing priced more or less in line with the June 2006 contract that does not even reflect the full impact of a 4.75% Federal Funds rate? This price structure continues for all of 2006, and extends through 2008. Of course, the equities could have an independent reason to break markedly without the Fed's future weight coming to bear. Yet, if they strengthen to any goodly degree instead, we anticipate the Fed will continue to hike, all the while studiously avoiding any mention of an equity market bubble in spite of what we feel they have signaled is a clear agenda of defusing any of the potential euphoria that led to the last bubble.

SHORT STERLING and the BOE

Not really too much to say here, except that they continue to demonstrate the sort of deft touch that has long been appreciated by both other central banks and most capital market participants. While their lack of desire to cut rates prematurely has been criticized by their domestic manufacturers and industry associations, their desire to move cautiously while assessing the potential second round effects of the energy price escalation has contributed to the strength of a Gilt-Edged market that is the surprise strong sister. As this is not usually the case (especially compared to the weakness in the long end of Europe), it is a bit striking.

Now the question is whether they will actually cut at the next meeting if the consumer and industrial numbers remain weak? The forward contracts here indicate that they believe any rate cut is not sustainable even if one comes through in the near term. We tend to agree, and that is the basis for believing the BOE will not cut rates, and will leave them steady for a while and see if the economy can muddle through. The dilemma with easing is both the degree to which high energy prices (i.e. crude oil at no less than \$50.00 per barrel) might still foment some sort of second round inflation effects that leads the Bank to err on the side of keeping the economy subdued, and competitive short rate pressure from what could be further significant increases in US Fed Funds (see above) and the likelihood of somewhat higher rates on the Continent. This is an instance where "steady as she goes" seems to be the well-reasoned right tack, as opposed to just plain benign neglect.

EUROPEAN CENTRAL BANK

What can we say; where do we even begin? It would be easy enough to criticize based on misguided policy and confusing signals. Yet, the very nature of President Trichet's comments last Friday, and subsequent ECB Council members' distancing their institution from those very hawkish statements yesterday speaks volumes. Following up on the Friday comments one reporter noted that this had gone a long way toward the sort of "maximum predictability" the ECB had aspired. And yesterday's comments? Maybe not so very predictable after all.

Another wag decided that yesterday's "softening" of the Friday blast was in the best tradition of central bankers like Alan Greenspan, and was a clever attempt to keep market participants guessing about the ECB's true intentions. While the "keep 'em guessing" part that caused some serious disruption in European fixed income over the past couple of sessions is undoubtedly true, nothing could be more removed from reality than ECB's long established and constant self-contraction being in the mold of previous clever central bankers from the Fed and Bundesbank. While Mr. Greenspan is a master of obtuse comment that allows folks to read what they will into the tea leaves, or miss some important fact buried in a broader exposition (see above), there is no equivalent overt vacillation that compares with the consistent blatant contradiction that we hear from the ECB.

Just a bit of the hubris and platitudes that were part of Monsieur Trichet's Friday chat are worth review prior to moving on to associated matters. Reports are that his remarks included, "We trust that we have had a very appropriate monetary policy since the introduction of the euro." Well, kind of; there's that little matter of not having applied the sort of deft touch that the rest of the world expects from central bankers regardless of their tacit commitment to inflation vigilance. This should have encouraged the ECB to ease during the soft 2002-2004 economy to further the German economic reforms that are now dead in the water regardless of ECB calls for them to be pushed forward once again (see below.)

As we have noted previous, after the goofy Duisenberg years there had been some hope that President Trichet was going to be more of a pragmatist, supporting a strong commitment to fighting inflation across the cycle, yet (with the wink and nod we used to get from Otto Pohl and the other more enlightened heads of the Bundesbank) allowing for a reasonable degree of inflation when necessary to revive the economy from the bottom of a trough. However much Trichet might be constrained by the specifics of the ECB mandate that only includes draconian inflation fighting, in the event we got Duisenberg II. This finite focus on fighting inflation was the German demand for surrendering the Bundesbank's competent stewardship of the deutschemark to the Euro and ECB, and reminds of one of those proverbial admonitions we recall from time to time: Be careful what you wish for; you just might get it.

Yet, the ultimate height of hubris is likely his subsequent statement (just as he is being blasted by many of the political and industrial leaders on the Continent for the ECB's mishandling of short term interest rates), "But if the UK was in the euro, it would be even better off." Breathtaking.

As to platitudes and wishful thinking, his further exposition included "... (the G7) shares the diagnosis of the situation... ..called for action to address global imbalances and have agreed on... ..increase the savings rate in the United States, structural reforms aimed at enhancing growth potential and market resilience here in Europe and in Japan, and increase domestic investment and/or consumer spending in the economies characterized by persistent current account surpluses." Here, here; certainly admirable goals that would alleviate much of the imbalance in the system if they were accomplished tomorrow. Yet, the actual chance that the

US savings rate will rise just as the Fed's tightening is putting upward pressure on adjustable rate mortgage payments, and credit card companies are demanding a higher percentage of principal be included in monthly payments from January 1, 2006 is about the same as the proverbial snowball's chance in Hades.

As to structural reforms in Europe, we have analyzed that previous and revisit it below, and can only say that we are not holding our breath in the wake of the rather messy German political compromise, social unrest in France, and various industries' concern over the promised ECB rate hikes. Along that same line, does the gentleman really believe that the current politico-economic mix will foment the further consumer spending (especially in Germany) that is necessary to achieve the higher domestic demand that he refers to in his comments? If so, he is likely the only one.

Well regarded analysts have just stated again today that the ECB rate hikes threaten the fragile German recovery, where consumer spending dropped 0.3% last year. Long term high unemployment and the previous SPD reforms only dealing with paring the social safety net (and not attendant labor market reforms) have left German consumers in a rightfully cautious mood that does not allow for any retail renaissance to support an economy that will still likely be driven by export industries. It seems the ECB has been a bad little central bank by being uncharitable toward a populace and political class that was trying to do the right thing, and will only get a lump of coal this Christmas instead of the goodies of which it dreams.

The real dilemma does not even occur for several years down the road. If the situation gets bad enough within the Euro-zone, especially Germany and France, their parsimony may still lead others beside just the Italians to question the benefit of continuing the entire project. Obviously this is a long term issue that we have raised previous, and it will not even become a serious consideration until the next electoral cycle in Germany.

Yet, what the doyens at the ECB seem most unable to fathom from their monetary ivory tower is just the sort of thing that has created the partial disconnect to date: the Euro is as much a political animal (born of the need to lock a reunified Germany into a peacefully integrated Europe) as an economic one. The longer they continue to ignore the political dimension of their mandate (however tacit it may be), the moreso they put the entire project at risk. As opposed to a gloom and doom prediction, on a purely self-serving perspective this analyst sincerely hopes the Euro ultimately survives: there are so many more interesting and important things to analyze in the world that we really would prefer to not have the burden of all of the additional intra-European cross rates once again.

Politics **GERMANY**

As we have already shared our thoughts on the fact that the CDU won the election and lost the government, and many of you are aware of how diabolically bad the situation is, we will be brief. That part of the compromise was to give up the important labor market reform that allowed companies to negotiate on an individual plant basis instead of always needing to hew to national bargaining and agreements essentially eviscerates any of the remaining CDU agenda. Without the ability to fine tune wages and work rules to the actual productivity of individual sites, the lack of ability to hire and fire more actively removes the rational for a more robust employment situation. As such, Germany remains an economy with a weakened

social safety net that can not now offer compensating more active (if somewhat less well paid) employment opportunities to their workers. What a mess.

Along with all of the tax increases (albeit the deferral of the 3% VAT increase until 2007 may produce some near term retail strength), and other things the CDU gave away to avoid the embarrassment of not being able to form a government, another thought occurs to us. Suppose you were an SPD political operative who suddenly found yourself in the enviable position that the right-center opposition had just squeaked in on a much weaker victory than anyone could have imagined only weeks previous. Within all of the supposed collegial compromise that occurred to reach the Grand Coalition agreement, what bits would you most aggressively defend? On a compassionate and caring view, ostensibly those that would advance the political agenda for the benefit of the people; in *real politik*, the ones that made sure the resulting politico-economic situation was a total mess in time for the next election.

Interesting then that the assessment of the Grand Coalition agreement from Volkswagen head Bernd Pischetsrieder is that it is "...the sum of both parties' worst ideas." We couldn't agree more, and have this to add: This sort of static budget analysis fixation on solving the fiscal side of the equation has never worked in the past, and will not work now. That they shifted from a clear tax relief platform to raising taxes of all sorts is especially damning.

Even Bundesbank President Axel Weber has specifically gone on record that, "... (the) overall actual outcome is unconvincing: fiscal consolidation is insufficient." "Historical experiences, however, show that revenue based consolidations are the less successful and sustainable ones. In consequence, credibility not only of the national but also of European budgetary rules will be further undermined." I guess if I am a radical for questioning whether the wrong political and economic moves at this time might put the entire Euro project in jeopardy, so is the head of the Bundesbank (in an admittedly less overt fashion for equally obvious reasons.)

The beauty of it for that SPD political operative is that his party may have unwittingly stumbled into a situation that ensures the CDU does not control the government for a generation after an increasingly likely disastrous Merkel Chancellorship. The SPD can definitely run next time on: "You can't trust them, and they are wholly ineffective."

FRANCE

It would be easy enough to sit here and toss a giant "Anglo-Saxon model" brickbat at the French in light of their recent social unrest. In fact, even if somewhat different than those in continental Europe, there are problems of poverty and unemployment in most developed countries, and it would be a shameful bit of hubris on our part to stoop to specific criticism of the situation. In fact, we feel no small amount of compassion for the French as they begin a painful process that they avoided previous, as it was not part of addressing their particular unrest in the 1960's and 1970's.

While it is obvious that racial relations in the rest of the developed world are not exactly rosy, there is at least a frame of reference that supports multi-culturalism within an assumption of loyalty to the nation in which people live. The French political establishment has moved quickly to reassert their commitment to their significantly different model that everyone who comes to the country not only has an obligation to follow the rules, but also *become* French.

This is basically a call to abandon for the most part previous ethnic and cultural identity to assume a French character, including intellectual achievement, culture and bearing. There is

much for which the French should be commended, and of which they are rightly proud. Yet, this assumption that everyone who either immigrates there, or especially those born there of foreign parents, should want to be culturally French seems one of the things in addition to the poverty and deficient schools (of which the US is admittedly also wholly guilty in their ghettos) that triggered the extensive unrest.

It is very tough to change attitudes among the population at large. That France must now either convince the their elite (including those who have substantially assimilated into good union jobs and governmental offices) that it is time for a multi-cultural model, *or conversely* spend the significant sums necessary to have North African residents feel they have been empowered to pursue that indigenous French identity is a huge, multi-decade job. We do not envy them either way. We also note that their best efforts to meet the Stability and Growth Pact fiscal targets notwithstanding, and their initial indication that they are only “redirecting” certain resources, *this is going to cost an awful lot of money.*

What says the ECB? More social unrest is okay as long as you meet your fiscal targets, or is it time to allow a bit of inflation if necessary to mend the social fabric? It’s a tougher call in France than elsewhere because mainstream interests (including unions and government employees) have proven so adept at the sort of street action that has been effective in preventing the government from imposing reform, or directing resources away from them. There is no doubt that this is at least in part where the recent protesters learned that this behavior is effective.

As a sign of the degree to which the sort of social action that can influence the government is now also a pastime in France (and presumably can become exacerbated again at any time), a police official confirmed that the level of social unrest had dropped to near normal levels at the end of last week. They based this assessment on the number of cars that had been burned in the country the previous evening having dropped to eighty-nine. We suppose every culture is entitled to its own form of outré expression.

If anyone is wondering why we did not include the US in our political review this time, the elite here was the object of extensive analysis (and derision) in *CMO I–10* (November 2, 2005), and as nothing much has changed other than the situation becoming even more contentious and absurd, we refer you back to that for review.

We look forward to providing further comments as the situation warrants, and hope you have found the perspectives helpful.

-Rohr

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