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Reports/Markets, the Fed, US Dollar, Politics/Comparative Culture

As we head out of today's focus on US reports into tomorrow's important European economic releases, it is important to take a step back to survey the timing of the influences which are impacting markets that have seemingly taken fairly important trend decisions in the wake of the early week influence from the FOMC decision and announcement. There are also some broad considerations in the equities and foreign exchange that require review for both their trend implications, and their influence on other areas.

However, before we embark on our journey into such weighty matters, we would like to share an important entry into the 2005 "Best Response from an Economist" contest (which we just invented), as there is a late arrival that has surged past the field. Prior to Tuesday's FOMC announcement a normally astute member of the electronic financial press (and it seems the mainstream press is very involved at this point as well) asked the senior economist at a respected international securities firm what has become a ubiquitous mendacious question. After a most elaborate and involved preface, he finally got to the ultimate point of inquiring, "What does the Fed consider a "neutral" short term interest rate?" The analyst's answer was outstanding for sheer honesty, accuracy and especially brevity that are going to be hard to beat (also for being delivered in a most matter-of-fact manner): "They don't know."

While he subsequently elaborated on the cross-currents impacting the US economy from the various factors of which we are all aware, the fact is that we agree there is likely more uncertainty at the Fed as to what actually represents neutral than most casual observers would care to allow. In that regard please see today's Financial Times editorial ("Fed rhetoric catches up with reality") that does a fine job of summarizing these conflicting influences. The sharp focus on what is a neutral Federal Funds rate may be misplaced in any event; as we have noted previous, we thought central bank best practice involved adjusting the rate to *either side* of "neutral" across the cycle (more on this below.)

Reports/Markets

As markets continue to trade orderly after the early week rescue of the March US T-note from near the important interim support at 108-00, and back above the short term 108-14 DOWN Break (now support), we are not surprised by today's mixed reaction to this morning's mixed news. This included much stronger than expected, yet always volatile UK Retail Sales (NOV) being offset by the somewhat weaker than expected US CPI (NOV.) This was accompanied by a seemingly stronger than expected Empire State Manufacturing Index (DEC) where a look at the components left us wondering how the headline number did indeed end up higher (especially with employment and prices indications all dropping), and weekly Initial Jobless Claims (DEC 10), with a higher than expected Industrial Production and Capacity Utilization

(NOV, including upward revisions to OCT) currently providing fixed income bears with some relief from their torment of the past couple of sessions.

Yet, on a reporting basis, it will all boil down to whether tomorrow's German IFO (DEC) and Euro-zone CPI (NOV) will allow the renewed upside leader Bund to escape the 121.30 resistance on a weekly Close, and whether the March S&P future sustains its rally at no worse than the vicinity of the violated lead contract 1,265 resistance. Of course, especially for the foreign exchange markets (and potentially the others) there will be an important final US influence from a Current Account Balance that is estimated to continue its erosion into extremely negative ground, as has been presaged by Wednesday's abysmal Trade Balance. More on just how much that matters is reviewed in the US Dollar section below.

Yet, all technical levels and trend views remain very much the same as Tuesday's ***TrendView*** **GENERAL UPDATE**, and yesterday's **BRIEF UPDATE** which focused on next resistance levels in the long dated fixed income and S&P 500 future. We refer you back to those for any in depth analysis, and would only like to add the important next levels of support for the US dollar after it recent sustained decline. While these are important for the near term trend, the higher resistances in the buck are more important (especially as the EUR/USD aggressive up channel from the last test of 1.1672 two weeks ago is up to the 1.1900 level tomorrow); so long as it continues to fail from freshly established resistances (including failed UP Breaks), the supports mentioned below are also likely to eventually be violated as part of a broader US dollar intermediate term down trend.

Whether that is a broad correction to back near its major lows, or a return to a full blown bear market is both yet to be seen, and moot for the purpose of managing the intermediate-term trend evolution. The important near term US dollar supports are: EUR/USD 1.2150-1.2200; US Dollar Index .8880-50; GBP/USD 1.8000-1.8100; USD/CHF 1.2700-1.2650; and AUD/USD .7600 (important overall trend level as well: see Tuesday's **GENERAL UPDATE**.) There is also a modest consideration of whether the USD/JPY holds the 116.00 and 115.00 levels now that it has cracked the low 118.00 support without so much as a hiccup, although that is distinctly separate from the other US dollar trend indications, as is the ability of the protracted USD/CAD down trend to hold the 1.1450-00 area.

The Fed

THE YIELD CURVE

Before we discuss any other influences on the Fed as they grapple with the complexities of the current US economic and interest rate picture, we note the comment from former Fed governor Alan Blinder prior to Tuesday's FOMC decision. While much of the rest of the world (present analyst *excluded*) has had their knickers in a knot for some time now over the potential for further FOMC rate hikes to create an inverted yield curve, he offered a very interesting perspective on the implications of any such inversion.

He essentially said that opposed to previous sharp Federal Reserve interest rate hikes leading to inversions that were specifically intended to crunch the economy in the face of what were obvious excessive inflation pressures, this one was different. Any gradual shift into an inversion in this era of excess world savings and a continued appetite for US long dated debt would be sustainable in the short run without any particular implications of an overt attempt by the Fed to cause a recession. Interesting.

FEDERAL FUNDS
As noted above, the expectation that the exact level at which Federal Funds have reached "neutral" is a critical arbiter of just when the Fed will be done raising rates is specious at best, and very possibly counter productive. It is the central banks job to adjust short term rates to *either side* of neutral. Reaching neutral and doggedly holding rates there this is just the sort of inept approach for which we (and many other informed observers) have criticized the ECB, especially when the nearly deflationary 2003 conditions did not motivate them to assist Herr Schroeder with the sort of economic stimulus that might have allowed for more of the reforms that they are always castigating EU governments for not delivering.

The sort of deft touch that the Fed and the Bank of England (and the old Bundesbank) have demonstrated in that regard (which the ECB lacks due to an aggressive, some would say rabid, adherence to their strict inflation avoidance mandate) is the essence of central bank excellence. It would be hypocritical to now chide the Fed for taking whatever action it deemed necessary to accomplish its goals because some parties feel that any move above that elusive "neutral" is an over-reaction.

And the signs that factors which might compel the Fed's to move the rates further than most observers expect continue to gather. In the first instance, the US equity markets seem to be keeping their bid in spite of a clear signal that there is every likelihood that the FOMC will indeed push Fed Funds to 4.75% at new Chairman Bernanke's first meeting on March 28th. As the US equity market futures expire today, with final settlement tomorrow morning, it appears that the March contract is going to maintain its bid out above the violated lead contract 1,265 resistance. It will need to drop back below last week's 1,274.50 lead contract high (left by the December contract) by tomorrow's Close to not leave a default transposition to a weekly Close above that previous high.

Admittedly, the next resistance is as nearby as the weekly oscillator and topping line in the 1,285-87 range. Yet, that still leaves a significant burden of proof on equity bears to knock the S&P future back below the serial supports that extend back down to the 1,250-45 area, or allow that the market can continue to trend higher with some near term corrections. As noted previous, equity market activity might be more of an influence on the Fed's future interest rate decisions than they will ever acknowledge, or mostly anyone else will believe. For more on that please refer back to ***CMO*** I-13, Monday, November 28, 2005 regarding Mr. Greenspan's late September comments that, "…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.)

LABOR COSTS
One of the other key factors facing the Fed into next year is the prospect of higher labor costs as unions seek to be more militant once again on behalf on members who have seen various forms of higher energy expense, and that the dire predictions of economic problems in the wake of various crises have in reality left equity markets at the highs, with most companies (American auto makers excepted) doing very well. Possible labor militancy was presaged to some degree by the breakup of the AFL-CIO labor union earlier this year. While most casual observers considered this simply another sign of disarray, more astute observers understood that the rebel faction was specifically looking to become more activist once again, and this was going to invigorate the potential for strike activity.

Now we are faced with a potential New York City transit workers strike tomorrow. This is after the powerful German IG Metall union has demanded five percent wage increases for workers in the wake of a very improved economic mood, and the energy expense their members have absorbed likely being exacerbated by the planned 2007 three percent hike in VAT. Heck, even the crippled US United Auto Workers union that just gave concessions to GM and Delphi are saying that the 2007 negotiations "will not be a cake walk." (American slang for "won't be easy.") As noted previous, labor has been accommodative during what was a spell of economic weakness, and is now (somewhat rightfully) asking, "Where's mine; how about me?" Whether they can get any of this to stick in a globalized economy is, of course, another matter altogether. Yet, the incipient pressures will be there.

US Dollar

DARK MATTER

And now for something really different: financial "dark matter." In a study for the *Center for International Development* at Harvard University's Kennedy School of Government, director Ricardo Hausmann and visiting professor of public affairs Federico Sturzenegger review the well-traveled scare scenario of the burgeoning US current account deficit (expected to top $700bn this year for a total of than $5,000bn) fomenting a US dollar collapse that triggers a stampede away from US debt, and the sort of sharp rise in interest rates that can only result in a sharp global recession. Yet, they have what they feel is both a good question, and a hypothetical answer. Their question is (as quoted from last Thursday's Financial Times comment section; see attached "FTdarkmat.pdf"): "If this is such an open and shut case, why have markets not precipitated the crisis already?"

While we allow that a significant segment of the financial community can be preoccupied with the assumptions in the current frame of reference (remember the Dot.com Bubble), this is a fairly well circulated notion that we agree has had surprisingly little impact on the markets. Their hypothetical reason for this is that the current account deficit does not matter nearly as much as most analysts believe. While this too is a notion that has gained quite a bit of currency (no pun intended), nobody has been able to explain why that might be.

The two professors have what is at least a plausible consideration that might go a long way to understanding this: US (and to a great degree UK) offshore investments carry more earning power that creates the equivalent of additional asset weight ("dark matter"), including "…a substantial amount of know-how that increases its earning potential. It explains why the US can earn more on its assets than it pays on its liabilities and why foreigners cannot do the same." "Once dark matter is considered, the world is surprisingly balanced." The full study is available at the *Center for International Development* website (http://www.cid.harvard.edu/.) You will need to input this web address yourself, as we have suppressed the hyperlink feature of this URL because some of our clients' virus protection software will screen out emails which include these.

Quite an interesting consideration, as it ultimately means that a sustained recovery of the US dollar might be possible even if there is only a modest improvement in the current account deficit. Indeed, this also might mean that the trading and investment community's fixation on the US current account leads to intermediate term trend psychologies that are not necessarily relevant to the long term trend. Of course, this also counts on the degree to which the US and UK maintain their monopolies on talented financial engineers, and at the rate other cultures education systems are besting especially the US, we would not endlessly count on the superior quality of US "know-how." However, any shift based on that is likely the sort of thing that will not be precipitous in nature. As it regards actually capitalizing on those trends, we will continue to focus on actual price tendencies, and there are other influences at work at present that do not necessarily bode as well as this sanguine view for the US dollar.

GOLD vs. USD
One of those is the significant rise in the price of gold. While it is always futile to micro analyze the relationship between gold and interest rates, the sustained rally in both the US currency and the gold market has been proceeding for all of 2005, and there is a palpable sense that the classic inflation expectations that attend sustained up trends in precious metals are not consistent with a further improvement of the US dollar as well. This happens to also come at a time when a very important technical support for the US dollar is lapsing: the tax advantaged repatriation that ends on December 31st (see ***CMO*** I-15, Thursday, December 8, 2005.) As we inquired previous, “What if the impetus for the rally that carried the US dollar onto UP Breaks from major bottoms against the Euro at 1.1900, and at .9035 on the US Dollar Index was this heavy temporary influx, and what happens when it is over?”

The beginnings of that answer have seemed to occur with the US dollar failures back below those levels this week. Whether that turns into a more sustained US dollar down trend is yet to be seen, and some respect for the price of gold also dropping precipitously in the past several sessions should also be included in any assessment of the situation. Yet, there are some definitive differences between the selloff in the gold market and the US dollar. While they have also backed off a bit from their highs this week, the general trend of commodity prices remains quite strong, as seen in the resilience of the CRB Index.

Secondly, technically there is a very big qualitative difference between the drops of gold and the US dollar, even though the near term percentage moves have been somewhat similar. The gold is dropping straight down from an extremely sharp extension of the rally that it has maintained since the last lows in May of 2001. As dramatic as the near term selloff looks, it is only part of the way back down to major congestion and trend support in the $450 and $400 areas. Of note, the up trend in gold has also been buffered in US dollar terms by the rise of the buck, and its price in dollars will be underpinned by any further weakness of the currency. Of course, the selloff in the CRB Index is also from a very sharp rise to a new high, and will likely be similarly buffered at lower levels.

Conversely, the weakness of the US dollar, while appearing more orderly (except against the radically reinvigorated Japanese yen) is the culmination of a market that seemed to be establishing UP Breakouts from very major technical bottoms against many other currencies, and is now failing to sustain those up signals. As opposed to a market that will then hold fairly soon against one of the next levels of serial support, those that experience failures of major signals from broad bottoms tend to revert back to much more bearish tendencies. Whether that is part of a reinstatement of the major bear trend, or a very broad consolidation of the rise since the end of 2004 is yet to be seen. As noted previous, a major correction would be very similar to the Euro’s bottoming activity through 2001 and 2002, and can be effectively viewed as a return to a bear trend until the US dollar is closer to the old lows.

Politics/Comparative Culture

FRANCE: DISTURBANCES, DOHA AND THE E.U.
As we noted previous, while it would have been easy to sit here and toss a giant Anglo-Saxon model brickbat at the French in light of their recent social unrest, that would have been a shameful exercise of hubris on our part. In fact, we expressed compassion for France, as it begins a painful process that was necessary elsewhere previous, and it avoided previous due to certain factors not being required to address their particular social unrest in the 1960’s and

1970's. In reviewing this further we sought to avoid too much insight from either their European neighbors or ostensible critics in the US.

We have found some of the most interesting insights from a well-respected French source. Dominique Moisi, Deputy Director of the French Institute of International Relations echoed informed voices on both sides of the political divide in comments to *Sydney Morning Herald* Paris correspondent James Button (November 12, 2005) that "…governments of both right and left have neglected these neighborhoods for 30 years."

"There is no constituency for radical reform, he says. Those who would benefit are not engaged in politics, and the average taxpayer has no desire to spend the money. Referring to the inhabitants of the affected areas, he says, "They feel despised by the "francais de souche" — ethnic French — and often feel hatred in return. Mix these together and you get a sense of the fury that has shaken France.

"In the National Assembly, where not one of 574 deputies is from an Arab or Muslim background, though Muslims make up nearly 10 per cent of the population of 60 million, Prime Minister Dominic de Villepin declared that the Republic faced "a moment of truth". Then, like an Australian treasurer on budget day, he introduced a modest package of social initiatives for troubled areas."

As we noted previous (***CMO*** I-12, Tuesday, November 22, 2005), the French political establishment moved quickly to reassert their commitment to their model of 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. 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 French 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 *huge* amounts necessary to have their 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. The latter approach will almost surely eliminate any chance that France will be able to meet the Stability and Growth Pact fiscal guidelines.

There are more reasons inherent in the dilemma noted above that relate back to France's colonial past, and are also an impediment to becoming the modern competitive state. These are summed up very nicely in Mr. Moisi's editorial in Monday's Financial Times (attached as FTfran01.pdf, which is not in the normal FT attachment format, as there was a minor problem with the print function.) In it he poignantly notes "The ability to confront the past is a sign of a confident and open society and was one of the key factors in Europe's recovery after the second world war."

This sort of insecurity seems to also constrain France from making necessary concessions on agricultural supports in either the EU budget negotiations or Doha Round trade talks that would liberate a superior producer of agricultural goods to take advantage of their expertise in other areas as well. Continuing the grandeur of a colonial and agrarian past seems an obsession of the French elite. Yet, as Mr. Moisi notes, "The public… …recently chose Yannick Noah, the mixed-race former tennis champion, as its most popular French hero in an opinion poll. France is much healthier than its elites. It needs a leader who will help it regain confidence in itself and in politics." With the entire establishment on both sides of the traditional political divide in disrepute as well as disarray on this important social issue, it is likely to get very interesting into the next elections.

UK: JUSTIFIABLE FAMICIDE

Last, but by no means least, after pointing out the various forms of outré behavior exhibited by the French (street action as a national pastime) and Americans (post- and now it seems intra-Thanksgiving holiday shopping that requires body armor for protection from other shoppers), we heard this interesting report out of the UK. It seems scientists there have determined that the traditional Christmas Day holiday meal might be responsible for much of the family bickering that occurs during the celebration. It is good to see scientific inquiry elsewhere has become as frivolous as that in the US; dare we ask if the government funded this study?

Their conclusion was that the over-indulgence in turkey (which normally seems to have some sort calming effect due to the modest amounts of L-tryptophan it contains), Brussels sprouts, stuffing and plum pudding, along with significant imbibement left people more irritable than normal, and likely to quarrel with relatives. A few key questions come to mind: Did they create a control group of folks to determine what level of acrimony existed just because they could not stand their relatives in the first place? Were there separate groups to determine the exact degree of over-indulgence necessary to trigger more animosity than usual? Have the QC for the Defense industry organizations been apprised of this potential new mitigation factor for spontaneous homicidal tendencies? (Future headline in the *Sun*: "Little Nigel Acquitted on L-tryptophan Defense!!")

As there is already so much (both institutionally and culturally) for which we in the US must thank our British cousins, it's good to know that the traditional festive dinner is really at the heart of why our relatives get on our nerves over the holidays, and not that they are a bunch of self-obsessed, fat, flatulent morons. Thanks again.

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

-Rohr