

Rohr Report

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Overview, Reports & Events,...

...US Inflation, FOMC, Equity Market Psychology

Overview

As the markets are significantly conforming to our previous indications of weak equities, stabilized fixed income (with a weak bias remaining in the short end), and a strengthening US dollar, we are skipping the **Markets** analysis section of this issue of ***CAPITAL MARKETS OBSERVER***, and including a very brief summary in this overview instead. We will be distributing a ***TRENDVIEW GENERAL UPDATE*** tomorrow to update all of the technical levels and trend views in the wake of Mr. Bernanke's testimony today. It is especially important whether he characterizes the impact of high energy prices as moreso inflationary, or an economic drag.

In general, the sustained unsettled geopolitical climate along with a strong global economy continues to keep the bid in the energy markets, and we suspect that will keep an inflation vigilance bias in whatever information emanates from the major central banks. As such, there is ample incentive to believe discounted short money forwards will remain weak, while the long ends are possibly capable of sustaining lower support such **T-note** 104-20/-16 range (with a Tolerance to 104-12), **Bund** mid 115.00 area, and **Gilt** 109.00 area. The buck remains buoyant, with **US Dollar Index** activity above .8700 resistance potentially releasing it for a move to either .8800 area, or more likely somewhere near .8900. Yet, as it has been the best arbiter of the sustainable US dollar trend, a **EUR/USD** Close below 1.2460 Tolerance of the 1.2500 area support is still necessary to confirm immediate further US dollar strength.

The equities are more of a split decision, as the **DJIA** has left a **DOWN Break** below the 11,000 area trend channel (from the major mid-June 10,698.80 low) and the more critical low end support at 10,900-10,870, both of which are now resistance on any recovery. While that puts the DJIA more definitively back into the lower major range than any previous attempted failures back in early-mid June, it has yet to Close below the initial support at 10,650, and the September **S&P 500** future refuses to remain below the 1,241.20 (daily Area Gap from the June 14th Close) Tolerance of the 1,250-1,245 support. It will need to fail that level on a subsequent weekly Close to really drag the rest of the international equities down further in the near term. In spite of being all over the map in the past week or so, we suspect the energy markets will remain firm unless and until the lead contract Crude Oil Closes below the previous significant UP Breaks in the 72.50-.00 range. While that appears at risk in the August contract, the soon to be lead contract September future has almost a three dollar premium, and that leaves quite a burden of proof on the bears.

Reports & Events

While the volume of news this week is limited, its intensity is significant. While there are other important economic impacts in the form of the already mostly strong economic releases, and pending European economic data, the real impact will be from the US today and tomorrow.

This morning's US CPI (JUN) and Mr. Bernanke's US Senate policy report (which spills over into tomorrow's similar testimony before the House) are the key factors, especially with the potential surprises from the subsequent Q&A that will leave Mr. Bernanke working without a script once again. And all of that is followed by tomorrow afternoon's coincidental release of the June 29th FOMC meeting minutes, which will be a very interesting bit of information after the Chairman's testimony. (More on all of that below.)

We must allow that tomorrow's UK Retail Sales (JUN), and similar French and Italian consumer spending numbers on Friday, along with the first look at UK Q2GDP may have some impact. Yet, with no US numbers on Friday it is likely that the market response to whatever comes from the US numbers, Mr. Bernanke and the FOMC minutes today and tomorrow will set the overall trends into next week's even more important Beige Book (Wednesday) and US Advance Q2 GDP (Friday.)

US Inflation

Just a brief word here about the pressures which continue to push the central banks toward tightening in the near term. Two factors are most prominent: the degree to which headline inflation is the real indication for the central banks and the markets, regardless of how much the central banks are committed to promoting the "core" number as a means to keep the potential second round inflation psychology in check. The second is the influences which will see even the core indication continue to rise over the near term.

The philosophy and practice which underpins the use of a "core" inflation indication is the rightful need of the central banks and other analysts to eliminate undue fluctuation in their assessment of inflation tendencies. In addition to the obvious geopolitical disruptions, this has been most pronounced in the past when extreme winter conditions have frozen the ports on the US eastern seaboard. The short term inability to unload energy cargoes at a time of strong demand naturally created temporary spikes in prices which would exaggerate near term inflation indications with no obvious long term effect.

Yet, in the current situation, strong global economies are creating sustained demand that takes up the production capacity at current market rates. Even allowing that there is a bit of a geopolitical instability premium in the energy price structure, overall supply/demand balance does not provide any indication that energy prices are going to fall back to pre-2005 levels anytime soon. As Mr. Greenspan noted on many occasions, energy prices were not an inflationary factor as long as the price surge was temporary. We believe we have gone well beyond the time frame and economic backdrop which allows any reasonable observer to conclude that expensive energy is a transitory factor.

As such, the "core" inflation indications which eliminate food and (most prominently) energy expense do not reflect the actual inflation experienced by the population at large. While the suppression of those indications is good policy for month-on-month smoothing, for full year comparisons the headline data is the reality.

That said, even the core is now impacted by some factors which are rightfully included in that reading. Most prominent is the US "owner equivalent rents." Quite a few folks assert that this is a technical adjustment that should not be of major concern. *Au contraire*, this is actually the inflationary aspects of the extreme real estate asset bubble coming home to roost, exacerbated by the higher energy expense as well.

One of the somewhat unique aspects of the US taxation system is the degree to which municipalities fund various functions based upon real estate taxes, especially their education systems. As landlords deal with significant increases in the valuations of their properties fomenting higher real estate tax bills, and need to cover higher cooling and heating expense which is substantially their responsibility as well, rents are going sharply higher. As these contracts are only reset once every year or two, landlords view it as their right to anticipate further increases in both areas. Even if energy prices were to drop back a bit, the increases to date will keep year-to-year rent comparisons strong for some time.

Therefore, the shift from the core inflation view to a more realistic view that the headline data is the reality on the yearly comparison is likely to continue. What the FOMC needs to do about that is the next question.

FOMC

The Federal Reserve is finding itself in an economic environment that has quickly shifted from the sanguine final years of the Greenspan era into a more challenging, contentious phase. As the primary culprit is energy prices, as we have noted previous the only real solution is a contraction. While the current situation may lack the extreme inflation which Mr. Volcker inherited from the largely ineffectual G. William Miller, the cross currents of a global economy which remains strong in spite of high energy prices, and an expectation that the US can and will remain the significant global demand driver continue to support high prices.

As such, while the FOMC may fear the opprobrium attached to causing a significant slowdown or (dare we say it) recession, any lack of attention to cooling US growth enough to cause a ripple in the sustained strength of the rest of the global economy will only require more painful medicine later. On current form, the Fed has failed to pull the punchbowl, as witnessed by both the resilience and the orderly nature of the US equity market decline (not necessarily a bad thing), and more importantly the strength of the Chinese economy. Regarding the latter, what potential is there for any significant retracement of energy prices while the world's other great energy guzzler maintains such strong growth?

It is incumbent on the FOMC to deal with the potential and real inflation threat first, and then worry about ensuring it does not cause an economic meltdown. That is not only their explicit mandate; it is common sense in the current environment. There were many times in the much more contentious and volatile late 1970's and early 1980's when Mr. Volcker had to first slam on the brakes to the point where everyone feared the engine might seize, and then quickly supply enough fuel to alleviate those concerns. We are certain that Mr. Bernanke and his cohorts can accomplish the same in a much more forgiving global economic environment, if they have the will to actually assume responsibility for the ensuing slowdown.

Equity Market Psychology

'Funny old markets' is how the equities might best be described at present. The fact is that the most robust developed economy is Europe, yet the DAX is the weak sister among the major equity indexes. Meanwhile the US S&P 500 refuses to so far Close below its near term technical support, and that is best understood by anticipation of further central bank activity. While the US economy also sustains enough growth to encourage some further tightening, the general psychology is that the Fed has come so far that it may pause sooner than not; likely after one more base rate increase in August.

On the other hand, the recent strength in European economic indications would have many believe the ECB remains primed for several more rate increases prior to being done. We do not necessarily believe that this is the case, as the continued influence of high energy prices will more likely encourage the FOMC to still go farther than most people can still believe is advisable at present, especially if the factors discussed above continue as significant influences. If that is the case, the ultimate cooling of the US economy being more pronounced than many observers suspect at present will likely send the necessary ripple through the world economy to restrain the other central banks at some future point.

Yet, that will take time to unfold, and immediate impact of Mr. Bernanke's testimony is most important regarding the glaring impact of high energy prices. While he will need to note the potential inflationary impact, he may also spend a great deal of time discussing the negative impact on US consumer discretionary spending in other areas. If that creates a sense that the Fed is ready to pause in order to see what happens to buoyant corporate spending plans if consumer activity slips, then it may actually be constructive toward the equities, and even the fixed income in the short run.

While we still believe the Fed will need to pull the punchbowl from the party, it may be that the markets interpret any concern Mr. Bernanke expresses about a drag from high energy prices as constructive in the near term. As the party is indeed global, and a major portion of the revelry is centered in Asia, it likely takes an actual recession in the US to weaken things enough to rein in any second round inflation risk. That includes both the mitigation of any demand-pull inflation potential, as well as softening global demand to a degree that will actually weaken energy prices. As we have noted previous, the latter will have some salutary geopolitical implications as well.

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

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