ROHR REPORT

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Overview, Reports & Events,…
…FOMC, Transitional Fixed Income Markets, Technical Factors

Overview

In deference to today being the setup for tomorrow's FOMC response, we will be sending another copy of last Friday's ***TrendView* GENERAL UPDATE**, and that will suffice as a substitute for the **Markets** section of the ***Capital Markets Observer***. We also remind everyone that other than this report we are out of the office on holiday today. We suggest anyone who requires a comment reach us on cellular telephone number (USA 1) 847.254.0099. If we are not available, please leave a return telephone number, and designate the message as 'urgent' to facilitate its timely delivery.

After the US Employment report the markets typically enter the first half of the mid-month reporting vacuum prior to the punctuation of the US inflation figures. Yet, with the FOMC tomorrow, the Bank of England Quarterly Inflation Report on Wednesday, and the ECB Monthly Report on Thursday, along with the less influential Bank of Japan meeting at the end of the week, this week is anything but that quiet vacuum. In addition, the fixed income markets have entered a particularly contentious transition phase just as volumes are most likely to diminish into the late summer holiday season (more on this below.)

The September **T-note** future pushing up through the 106-00/-08 resistance now leaves that as support, with higher resistance in the in either the low 107-00 area or more major 108-00 trend resistance. Yet, this has not been accompanied by any significant improvement in the **Gilt** that has only recovered to just above its 109.00-.20 resistance range, and even the **Bund** is stalling at not much better than its 116.80 resistance. While extended near term resistance in the Bund is the 117.26 mid-June high, the major trend resistance is the 117.40 level, with a Tolerance all the way up into the upper 117.00 area.

The long end improvement has occurred with not much of a short money forward recovery in Europe, and even the US has performed fairly poorly. All of which could mean that the long ends are more encouraged by the prospect of enough economic weakness in the US to at least temporarily reinforce the Fed's projections of a cooling economy, while the short money is less convinced it will actually precipitate lower inflation. As such, forbearance by the FOMC at tomorrow's meeting may be temporary, and the US Productivity numbers (Q2 Preliminary) that are released prior to the FOMC tomorrow are likely to show higher Unit Labor Costs than are consistent with any immediate easing of inflation pressures. Which leaves quite a bit of the sustainability of any long end rally contingent on the success of the Fed's forecast that inflation will abate as the cool down progresses.

While this may be right, it flies in the face of both all of the other central banks recent activity and comments, as well as the technical response of the European and UK long end response to the ECB and BoE rate hikes last week.

Reports & Events

While the volume of news does abate a bit this week, its intensity remains very high, as has been the case for the past several weeks. Today's weaker than estimated (with the notable exception of Germany once again) Euro-zone Retail PMI's (JUL) and UK Industrial Production (JUN) are assisting the long end rally in Europe, yet with not much effect on the short money. Tomorrow sees the Japanese Economy Watchers Survey (JUL) and Machine Tool Orders (JUL Preliminary.) In Europe the German Trade Balance and Import Prices precede both their and the Italian Industrial Production numbers (all JUN), with UK House Prices (YoY) and BRC Retail Sales Monitor (JUL.) As noted above, US Nonfarm Productivity (2Q Preliminary) precedes the FOMC Rate Decision and Statement tomorrow afternoon.

Wednesday quiets down a bit, with the Bank of England Quarterly Inflation Report as the primary piece of news. Thursday begins with Japanese Consumer Confidence (JUL) and other data, and continues with German Wholesale Price Index (JUL), French Industrial Production and Trade Balance (both JUN), and the ECB Monthly Report (AUG.) The US is kind of quiet except for the Monthly Budget Statement (JUL), and the fact that there are both 10 year T-note and 30 year T-bond auctions on Wednesday and Thursday, respectively.

Friday sees more active releases that include the segue into next week's mid-month inflation figures punctuation of the typical US reporting vacuum. It begins with Japanese Industrial Production and Capacity Utilization (JUN F) prior to the Bank of Japan Monthly Report. This is followed by German, French and Italian Consumer Price Index (JUL F), along with French and Italian GDP (2Q P), and then the US Import/Export Price Index and Advance Retail Sales (both JUL), and Business Inventories (JUN.) While there is obviously quite a bit of influence from the financial establishment through central bank activity and information releases, there is amazingly not a single actual speech by any financial luminaries this week; likely once again due to the onset of holiday season, when nobody really wants to speak and very few are available to listen.

FOMC

They will pause tomorrow. If there was ever a reason for the ostensibly 'data driven' FOMC to pause, it was last Friday's fourth successive weak US Non-Farm Payrolls (JUL) number. Given all of their forecasts for a cooling economy to rein in inflation, and even the degree to which they characterize high energy prices as ultimately more of a drag than overt inflationary influence than they have classically represented, there seems compelling influence to let their previous tightening work its way through the system prior to any further moves.

While we still believe this will likely prove a mistake which abrogates their duty of inflation diligence first, and concern about full employment and acceptable levels of long term interest rates only after that, the pressure to pause is enormous. A further increase in the Federal Funds rate tomorrow would not just seem out of touch with the current evolution of economic data toward a slower US economy, it will represent a complete betrayal of any 'transparency' effort which Mr. Bernanke has been so keen to institute during a less than ideal phase of the interest rate cycle. Whether or not any economic cooling diminishes inflation pressures to a meaningful enough of a degree to declare victory, having set the expectation that it will do so, the Fed will appear significantly out of touch if it hikes the Fed Funds rate at this time.

As such, we are breaking with our sustained projections since last September and the fall, when we began predicting that the Fed would take much longer and go much farther than most forecasters imagined. Even if it means they must return to increasing the Federal Funds rate later, and possibly more aggressively if their current expectation of a soft landing evolves into the resurgent economy instead, the Fed will pause tomorrow. We feel it will be a brief pause, and will require them to return to increasing the rates again by as early as their October meeting. That is due to demurring tomorrow leaving them assessing the subsequent data from the return to business in September, which will not be available until early October. (The October meeting is a two day affair on Tuesday-Wednesday October 24th-25th.)

Transitional Fixed Income Markets

Of course, all of the uncertainty created by the weak US Non-Farm Payrolls number last Friday in the wake of the other central banks' strong inflation statements last week has also put the fixed income markets into a much more convoluted, divergent phase than we had hoped would evolve since our last extended discussion of the **Fixed Income Psychology** (*Capital Markets Observer* II-30, Tuesday, July 11th.) Instead of the broadly range bound evolution of essentially sideways market activity, these are moreso transitional markets with the long end of the US attempting to lead the way up in its confidence the Fed will prove right that slowing economic conditions will indeed ease inflation pressures.

As such, the T-note surge above resistance in the 106-00/-08 range leaves the door open for a recovery to higher resistance in the in either the low 107-00 area or more major 108-00 trend resistance. Yet, the December Eurodollar is still stalled at no better than roughly the low end of resistance in the 94.55 area, and ranges all the way up to 94.63; and that is after an ostensible 94.52 UP Break out of its major down channel.

All of which leaves even less confidence in the sustainability of any further recovery of the European markets that are burdened by central banks more concerned than the Fed with the continued inflation pressures that are expected to become worse due to economic and fiscal factors. In fact, unless there is enough further US economic weakness to encourage the Fed to actually begin easing rates sooner than not (which we doubt), then the US long end has already pushed up to what may well be unsustainable levels of yield curve inversion, and will be left very vulnerable after any further rally into those higher resistances.

While we have always been among the first to point out that the yield curve is substantially a figment of the market's imagination, and that some modest inversion is sustainable if it is generated by technical factors, a more sustained and extensive inversion than we have already witnessed is unlikely. This is due to any further extensive strength in the long end requiring enough weak economic data and especially strong evidence that inflation has abated to also foment actual easing from the Fed.

Technical Factors

And in that regard, there is a camp which is pointing to the classic role played by the long end in anticipating the turn of the interest rate cycle prior to any actual central bank easing of the base rates. This has indeed been the case for almost every reversal of a rising rate cycle. However, that has also tended to occur from a significantly steep yield curve, not one that is already flat-to-inverted, and at a time when the previous rate hikes have definitively lowered inflation expectations.

There is also the matter of the specific technical activity which normally accompanies that tendency for the long ends to lead the way up from the bottom of the cycle, and which did not occur in any way on the recent rally. In the first instance, there is the recovery of the long ends directly in the wake of the rate hike. It is most often the case that either the long end will sag only modestly for one day on the emotional reaction to the central bank's last round of tightening, or initially trade lower on the day in sympathy with the higher base rate, and then in either event recover to Close back above the pre-rate hike level either the next day, or at the end of the very same session. This was not the case for either the Bund or the Gilt on Thursday, as they both remained under pressure, and only rallied due to the influence of the T-note on Friday.

In addition, the extended short money forwards will normally rally in sympathy with the long ends after a signal that the long dated fixed income is ready to lead the way higher. In the event, while it might have been expected that the Short Sterling forwards would remain weak after the 'shock and awe' of the unexpected BoE hike on Thursday, the Euribor forwards only recovered marginally to levels which still anticipate further hikes, and even Eurodollar forwards remained in line with levels that only point to rates around current levels into the middle and late portion of next year.

On those measures it is very hard to seen where the weak US Non-Farm Payrolls number last Friday fomented enough of a critical near term signal to confirm a bottom in the fixed income markets that indicates a trend reversal; moreso likely a temporary recovery based upon the market giving the Fed forecasts the benefit of the doubt, for now.

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

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