

## **ROHR REPORT**

# ***CAPITAL MARKETS OBSERVER***

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## **Overview, Reports & Events, Brief Market Update,... ...Debt Tech, Central Banks, Inflation, Excess**

### **Overview**

With late summer bank holidays behind us, this 'back to business' *CAPITAL MARKETS OBSERVER* is by nature a bit longer than most. This is due both to the rather contentious fundamental and technical considerations in the fixed income markets, the degree to which the US dollar may have finally (thank goodness) entered a more sustained trend again at the end of last week, and the degree to which the latter is not consistent with the previous seemingly intractable influence of near term interest rate vacillation.

In fact, quite a bit of what transpired last week was inconsistent with the previous received intermarket influence wisdom, and that is often a sign that secular trends are about to emerge once again. Most notable were the lack of any positive influence back into the equities from the energy market's continued weakness after last Thursday's release of energy stocks reports. As noted previous, that factor along with the general weakness of the commodity and metals markets spoke more so of general weakness which likely fomented the recovery of the long dated fixed income markets in spite of extremely bearish statistical and hawkish central bank influences. While the weakness of the energy markets that is supposed to be negative for the fixed income in the current paradigm is indeed encouraging equity market strength, that has yet to create a full fledged fixed income failure.

Yet, none of that explains the renewed, if so far modest, sustained strength of the US dollar, which had previous been well correlated to movement of the yields. One of the only ways in which that can be reconciled is if the buck is waiting for the more extensive trend decision to evolve in the fixed income, and thinks the Fed has it wrong, and in spite of the current easing of yields in the near term will ultimately need to get back on a firming track later this year. Extensive review of the background of this and the technical structure of the debt markets follows in the overall commentary sections. Due to the extensive discussion of the technical contingencies in the fixed income in the Debt Tech section, we will keep to the essential technical levels and trend views for fixed income markets in the this overview.

As we have noted previous, the question facing fixed income, and by extension the equities and foreign exchange, is whether the Fed has really done enough to sustain a significant US economic cool down, and what are the actual implications for inflation? The fly in the ointment of the Fed's forecasts is whether any slowing to trend growth they have actually fomented is indeed enough to also cause timely inflation relief. There is also the issue of whether 'core' inflation is meaningful with sustained high energy prices, which remains the case in spite of their recent short term weakness. All of which leaves the reputations of the new Fed chairman and relatively untested FOMC members to live or die by a stance that is more contrarian in both style and substance relative to the other major central banks' positions than at any time in recent or even extended memory.

## Reports & Events

While there have been some important reports already this week, they have ended up being fairly balanced in light of modestly less bearish European inflation indications this morning. We suspect the coda to everything seen so far will be the speech by US Treasury Secretary Paulson this morning, and balance of inflation indicators throughout the week. We suspect that in deference to his new colleagues at the Fed, Mr. Paulson will be circumspect on global inflation; why needlessly add to suspicion of a lack of inflation vigilance at the Fed, and upset the long dated fixed income at a time when it is supporting the rest of the curve.

Yet, whatever he says, the markets will still need to deal with tomorrow's French Non-Farm Payrolls (Q2 Final) and Italian CPI (AUG Final), and the often volatile UK Retail Sales (AUG) along with Euro-Zone Labor Costs (Q2 annualized.) All of which is prior to the US Import Price Index and Retail Sales (both AUG.)

Of course, Friday is the real crunch in any event, as along with some other European data the Euro-Zone CPI (AUG) precedes the no doubt very critical US CPI (AUG), Empire State Manufacturing Index (SEP), Industrial Production and Capacity Utilization (AUG), and University of Michigan Consumer Sentiment index (SEP Preliminary.) After which, the Fed's Hoenig wraps up the week with a speech on, of all things, the Federal Reserve.

## Brief Market Update

As we will be distributing a *TrendView* **GENERAL UPDATE** to address the extended technical levels and trend views for the markets response to the late week critical news and events, the following brief overview is consistent with previous projections, and should suffice for now; this will also allow us to proceed more timely to the major technical and fundamental background in the extended commentary.

The basic tendency of the fixed income remains the 'mirror image' intermarket influence which we explored at length in *Capital Markets Observer* II-35 (Monday, August 14<sup>th</sup>) by which the Bund is attempting to lead the way down, and is consistently interrupted by the buoyancy of the US T-note. This is of course the exact opposite of tendencies during 2004 and much of 2005, when the economic growth momentum was the opposite of current tendencies in the US and Euro-zone economies.

In the words of that great master of the malapropism, New York Yankees player and manager Yogi Berra, this week in the fixed income markets... "...is like déjà vu all over again." Stronger than expected UK and European inflation news yesterday pushed the markets down until the US 10-year T-note auction was well received enough to squeeze the markets higher late in the day. The first overtly constructive influence on the fixed income in the past couple of weeks from Europe arrived in the form of today's somewhat weaker than expected German EU Harmonized CPI (AUG) and UK Quarterly (3 months to July annualized comparison) Average Earnings and Manufacturing Unit Wage Costs.

As such, the fixed income seems to have held the most critical support in the form of the December Bund 116.80 Tolerance of lead contract major 117.26-.05 UP Breaks. If the Bund looked like it was going to post a weekly Close below that level, next significant support is not until the 116.00-115.80 range. Conversely, by continuing to hold it, the market is more likely

to push back up to at least near the recent December contract high of the rally at 117.81, or even extend back up to the lead contract resistance in the low-mid 118.00s.

The crux of the extended matter there is likely whether the December **T-note** can sustain more of a further recovery above the 107-00/-08 area, which could lead to a test of the more major resistance in the 108-00 area. Similarly, December **Gilt** holding the lower of the 109.60 (weekly UP Break and MAs) and 109.35 supports was interesting, and if the T-note leads, the weak sister could also be ready to rally back up into the low-mid 110.00 resistance as well. Short money forwards are likely to be influenced by the decision of the long end, in spite of the intrinsic weakness of the UK and Europe.

The other markets remain the same as previously reported, with a modest upward bias in the equities as long as the **DJIA** continues to Close above the top of 11,100-11,300 resistance, which likely enables a push up to the mid-May 11,580 DOWN CPR that is within striking distance once again of the 11,750 all-time high. The somewhat equivalent levels in **S&P 500** future remain a critical secondary indication, with the congestion and gaps in the 1,301-1,306 range now held by the December contract on the recent selloff. That means the market is back into an entire higher trading range that does projects higher resistance on continuation and contract congestion in the 1,320-25 range, with extended resistance on the contract at 1,335-40 (which would represent a major new continuation high), and extended resistance in the 1,347-50 range. As the European and Japanese equities had already led the recent rally, we suspect they will follow the lead of the US market.

The foreign exchange remains a grinding affair, with the previous modest US dollar weakness quietly reversed, even though that is in the wake of the modestly lower yields. **EUR/USD** once again never quite reached the 1.2930-50 resistance range, and is now sagging below its near term support in the mid 1.2700 area (now resistance). Yet, as noted previous, the buck seems to be waiting for the more major decision from the yields prior to establishing a more decisive trend. **US Dollar Index** did not even reach its recent mid .8400 area congestion, with further support into the .8400-.8350 range, prior to pushing up through resistance in the upper .8500s. Support is back in the .8530 area, with interim resistance around .8600, yet more major resistance now until the .8700 area.

While energy markets also remain weak, the sharp October **Crude Oil** failure back below the major weekly continuation pattern UP Break and Tolerance in the 68.00-67.39 area (low end of which is the bottom of a still open weekly upward Breakaway Gap out of the pattern, now reinforced by weekly MA 41) and 65.00 congestion is now nearing more important trend support in the 62.00 and 60.00 areas.

## **Debt Tech**

The discount in the second month (December) Bund as it moved to lead contract status last Thursday is one of those classic fixed income expiration rollover situations where the second month is immediately tested around significantly lower support; in this instance the 116.80 Tolerance of the low 117.00 area significant UP Breaks. The consistent classical tendency is for the discounted second month of the long dated fixed income to return to only continue markedly lower if it can immediately break the next lower significant support. Otherwise, it tends to levitate back up its own previous highs of the rally (in this case 117.80 area), or even to the higher resistance which the lead contract tested prior to expiration, which is back in the mid 118.00 area in this case.

Of course, this will need to be led by the more buoyant T-note sustaining itself above the top of the 107-00/-08 resistance for a move the 108-00 area. Yet, with almost no discount in the December T-note and a very limited discount in the Gilt, quite a bit of what transpires from here will rely upon the current downside leader Bund not exhibiting any overtly bearish tendencies below the 116.80 area. This is especially the case from late this week, when the overall Bund up channel from the last major lows in early July project trend support into the area of the 116.69 trading low slippage below 116.80 last week.

As the long ends are a significant influence back into the short money forwards, we suspect that even the totally stale Euribor and weak Short Sterling will have trouble seeing their discounted forwards weaken any further if the long ends exhibit near term strength; even if that is only back up into the more major 108-00 area resistance in the T-note.

### Central Banks

Gentle Ben and the Vigilantes. Spaghetti western? New rap group? US border private militia? No, none of that. Sadly, it is the state of the relationship between the US Federal Reserve under new chairman Ben Bernanke (and relatively untested FOMC) and the balance of the major central banks. We can not remember a time when the major central banks have been so out of synchronization to the point of overt criticism of each others' policy stances.

This was most recently and pointedly reflected in the comments by Bank of England Chief Economist and MPC member Charles Bean's Jackson Hole (August 26<sup>th</sup>) paper critiquing other previous analysis offered at the symposium. The most telling statement summarizing quite a bit of what is wrong with the Fed's continued focus on 'core' inflation is the assertion, "The fact that the rise in oil prices is the flip side of the globalization shock to me renders highly suspect the practice of focussing (*sic*) on measures of core inflation that strip out energy prices while retaining the falling goods prices."

This is also very consistent with ECB President Trichet's August 31<sup>st</sup> post-meeting press conference comments two weeks ago. In response to the FT Deutschland correspondent's query, he noted that there was not much basis for believing that recent strength in long term interest rate instruments (which had created a modestly inverted yield curve in the US) was grounds for optimism on lower overall international interest rates. While allowing that the long term rates were one indication which the ECB watches closely, none of the other factors which would support such a view had yet come into alignment in any way. And one of the key factors which he revisited at the end of that answer was the degree to which energy prices were going to remain relatively high in historic terms in spite of recent slippage.

Often people joke about the things which they find vexing. That Mr. Bernanke's response to a question regarding inflation after his August 31<sup>st</sup> speech on productivity was to jest that quite a few folks ask him whether anyone at the Fed ever fuels their cars and homes or eats is telling insofar as his rather extensive experience and acute acumen for the topic left him no better response than that. He then continued his defense of why the Fed will not allow itself to be drawn into a distorted short term assessment of inflation based upon transitory factors like higher energy prices. (??) There is quite a bit more on this and other factors below.

## Inflation

Anticipation of Friday morning's release of a potentially weak July OECD Composite Leading Indicator very likely contributed to the long ends bottoming Thursday, given the June release was the first sign of weakness after consistently strong indications on this forward looking report. While the fixed income recovery in the wake of weak OECD CLI was interesting, it did not incorporate other recent OECD indications that are less constructive to the fixed income. While their August 29<sup>th</sup> Consumer Price Index review showed some moderation, it reinforced that this is from relatively high levels.

Their broader interim economic outlook for OECD countries (September 5<sup>th</sup>) had some even more telling indications. Most interesting were the following observations: "The US economy is running at around full capacity." "Household consumption slowed less and has in fact tended to accelerate in recent months, consistent with a pick-up in compensation, and so have exports, pointing to robust GDP growth in the third quarter." "In the United States, the Federal Reserve paused in August but further tightening may turn out to be warranted if activity and prices do not slow down over the next few months,..."

While we were going to revisit all of our previous reasons why core inflation is no longer a relevant measure of price escalation in an era of sustained high energy prices (which will remain the case unless crude oil falls back below \$50.00 per barrel), one of our favorite economic commentators has already summarized all of those views in an excellent item from Monday's Financial Times. Dr. Stephen Cecchetti (Rosenberg professor of global finance at the International Business School, Brandeis University) has summed up those factors in a most elegant manner in the attached copy of that full FT comment.

Once again revisiting the same factors which we (and Alan Greenspan for that matter) agree upon, energy prices which have remained consistently high can no longer be considered a distortion needing to be smoothed out of the inflation indications. As Professor Cecchetti notes, "Since 1995 energy prices have been increasing at rates that are consistently faster than those of other prices. As a result, the consumer price index excluding food and energy has been a biased measure of headline inflation,..."

The one area which he did not specifically review in this instance which he had dissected previous is the influence of higher real estate values and rents. This is especially important at this time, as the Fed and various other observers are now attempting to move the inflation discussion away from even core CPI, which is beginning to reflect those increases in rent levels based upon the previous escalation of real estate values.

The Fed is now telling us to focus on one of their other favorite measures (and indeed one relevant measure of inflation), the PCE. Of course, as this does not include the rent increase component, it suits the Fed's agenda in the psychological war to keep any second round effects subdued by attempting to convince the public that inflation is not as bad as all of those nasty energy prices would seem to indicate. However, serial shifts in the benchmark which any central bank indicates is the 'true' measure of inflation can only be suspect, weakening their overall credibility.

The Fed's basis for saying their official measure of rent increases does not really count in the actual inflation picture is that these are "owner implied rents." That is the statistical finesse by which they extrapolate the opportunity cost of someone not renting their residence. The logic behind excluding this from any reasonable assessment of inflation is that almost none of the seventy percent of US of US adults who own their own home would ever actually rent it,

because they are residing in it. Fair enough. Yet, there was a reason that “owner implied rents” were included in these figures in the first instance which must still have some relevance.

As noted previous (*CAPITAL MARKETS OBSERVER* II-31, July 19<sup>th</sup>), 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 energy 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. And that affects every one of the thirty percent of individuals who do not own their own homes. Further, the increases in municipal taxes are also a form of inflation which is certainly being experienced by most individuals that are supporting school districts with budgets skewed higher from energy costs and salaries.

## Excess

We presume most business people and portfolio managers who have been around for more than a few years have some sort of the same mental file that we keep on the incredibly misguided things that exceptionally smart people do from time to time. Having been around the derivatives and securities business for longer than we shall mention here, we have seen major ego-driven takeovers proceed in spite of dramatically changed market circumstances (especially in the immediate wake of the 1987 stock market debacle), and investment bankers and dealers who went out for bonus celebration dinners where the vintage imbibement expense pushed their tab well above the down payment on a house.

While these transgressions were met with the due level of opprobrium for their negative impact on the fortunes or reputation of the perpetrators' firms, there have been two recent instances of personal actions which while not necessarily reflecting on the firms of the individuals involved, are incredible to the point of being beyond belief (except for being reported by reputable news sources.)

The first is the case of Walter Anderson, a US telecommunications businessman, who recently pled guilty to evading more than \$100m in taxes in the biggest individual tax fraud in US history. And that was just the portion of his fraud that for which the US government had incontrovertible evidence. The basis for this massive deception was hiding \$450m in earnings from offshore art dealings, investments and two telecommunications companies. What is it that would lead someone who is smart enough to enrich themselves by that vast amount of money to believe that the dogged investigators at the IRS and FBI would not eventually strip back the layers of shell companies and false identities?

While much less spectacular, the other instance of excess which landed in the international press of late is the top Hong Kong securities firm banker who won a settlement against a vendor in court. If it were not for the amounts involved and the serial failures to employ common sense, this would hardly be worthy of note. Yet, the settlement for the full refund which Monica Wong received from Mirko Sacconi was HK\$62m (\$8m, €6m, £4m); which had been paid in advance; for salsa lessons. Admittedly, Mr. Sacconi is a 15-time world

champion salsa dancer. The failures here are profound. Ms. Wong, the daughter of a shipping tycoon, claimed that Mr. Saccani humiliated her during a practice in a restaurant in 2004. Yet, upon agreed termination of the contract over that *faux pas*, he refused to refund the fee, which seems no less exorbitant insofar as it was for eight years of lessons.

Speaking of lessons, there are likely several here. First, for Ms. Wong, roll up the windows on the Bentley so none of this is lost due to any interference from air turbulence: Whatever the attractions of public retention of such a high profile instructor, there are no dance lessons that are worth \$1,000,000 per year for eight years. In any event, if the guy is such a great teacher, why was it going to take that long? Next time buy the guy's book, video, CD and dance steps floor diagram. Second, Mr. Saccani, a bit of tolerance would have netted much more prestige and compensation than was warranted by simple dance instruction.

In that regard we can only imagine (and indeed these are only our musings, as we have no relationship with, or knowledge of, either party other than what we read in the press) what the comments from the respective families must have been. Hypothetically, we consider that Gaynor Fairweather (the wife of Mr. Saccani) might have humbly inquired, "Why did you have to open your *biiiiiiiiig* mouth?" Similarly, we can only surmise the response of Ms. Wong's family as details of her deal with Mr. Saccani came to light: "You paid *how much* for *what*!?" Of course, we'll never know exactly what was said; and most likely in the opinion of all involved and any reasonable observers, that is probably just 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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