

## ROHR REPORT

# *CAPITAL MARKETS OBSERVER*

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## Overview, Reports & Events,...

### ...Inflation, Hedge Fund Regulation, International Miscellany

#### Overview

While last week saw some reasonably important news, it seems our instincts on the markets respecting this week's abundance of major early month economic data releases were correct, and that has buffered the activity to date. In fact, as important as this week is, any decisions will still need confirmation after the back-to-back release next Wednesday and Thursday (October 11-12) of the minutes of the September 20<sup>th</sup> FOMC meeting, and Beige Book in preparation for the next one on October 24-25. That said, it is impossible to ignore the potentially decisive impact of the very robust reports and events this week. This is reinforced by the degree to which all of the financial markets were consolidating last week at or near significant intermediate term or major technical decision levels.

It reminds us of the scene in the movie 'JAWS' when chief Brody (Roy Scheider) gets his first glimpse of the Great White, and in a stunned mumble advises the grizzled shark hunter Quint (the late great Robert Shaw), "You're gonna need a bigger boat." While we do not suggest sizes for our reader's boats, whatever market psychology and risk management technique one is sailing into this week's waters, they best be seaworthy. This is just the sort of week when the things popping up ad hoc can turn the hunter into the hunted.

While we will convey all of the details in the **Reports and Events** section below, in addition to regular reports, as well as RBA, BoE and ECB interest rate decisions and Monsieur Trichet's press conference, the week is full of observations from financial luminaries. Not the least of these might be the combined insights emanating from the Thursday-Friday Chicago Fed 'International Financial Instability Conference'; hopefully it does not make a near term contribution to the very phenomena it seeks to address.

Contemporary with (yet not actually attending) the conference luncheon on Thursday, Philly Fed President Plosser will give his first major speech since assuming his new position. Subject? Monetary policy; there's certainly nothing like trial by fire. Yet, so far we like what we hear. Insofar as his remarks last week pointed out that the recent sharp drop in oil prices will favorably affect the September Consumer Price Index, he also warned against assuming this meant lower inflation.

And the markets continue to hover near important trend decisive levels. None moreso than the December T-note that is so far only slipping back in orderly fashion toward the major decision level at the low end of the 108-00/107-16 support range. The ability of the T-note to hold tests of the mid 107-00s on any near term setbacks is very important (with the current initial dip very likely to do so as the first retest of multiple UP Breaks.) That will confirm the reversal of the dynamic January-May down trend (with a minor extension into June.) Continued resilience will encourage the current rally from the late-June 104-00 area lows to extend up into significantly higher resistances, with salutary effect on other long ends.

While the next higher meaningful resistance is as nearby as the 110-00/-16 area, that is likely moot: the higher broad channel resistances which still leave the T-note in a long term down trend (albeit quite a bit more gradual than the recent trend) are not until the mid 112-00 and mid 114-00 areas. Therefore, the fixed income bears need a Negation of the 107-16 support to put the bull trend leader (albeit with more upside volatility in the Bund at times) back into a failure which reinstates the aggressive down trend.

If so, it could easily fail below next support at 106-00/105-24, or even fall back to or through the 104-00 summer lows at the more major historic support. All of which would likely be accompanied and augmented by a **Bund** failure back below the upper 117.00s, and ultimately the low 117.00-116.80 support held on multiple early-mid September tests.

However, if the bears can not get the T-note bull genie back into the bottle, they will likely suffer a sustained intermediate term rally back up to extended resistances. That is true even if the US long end remains a bear across the long term cycle, and breaks back below the 108-00/107-16 support range later.

Of course, given the significant inversion in the yield curve, this also has considerable implications for the US short money forwards. Even though the September 2007 **Eurodollar** has failed near 95.25 area resistance, it still has various near term trend supports in the 95.06-.03 range, and would ultimately need to fail back below its temporarily aborted (and quickly reinstated) 94.94 UP Break once again to get fully back into its bear mode. That is a very critical point for any inflation hawks. Only that sort of failure and downside follow through to the 94.60 area is consistent with the current 5.25 percent Fed Funds rate, and will reinforce the idea that the Fed is not going to cut over the intermediate term.

Of note, the longer term evolution of oscillator indications would likely leave this contract oversold if it ever does get back down to the 94.60 area, Could the Fed actually go on hold for the next full year if the economic data strengthens a bit? The bulls are counting on getting at least two cuts by next summer, with the Fed holding steady being the worst case scenario;. If there's a hike, there is no possible way to justify the recently inflated US short money forward values in the near term. With their short money remaining weaker than the US, any failure of either Eurodollar support level will empower the bears in Europe.

The balance of the markets are also near important levels, with the energy markets remaining weak enough to be the most critical. Yet, November Crude **Oil** has held the top end of the 60.00-59.00 support, and **Heating Oil** and **Natural Gas** forwards still anticipate hefty seasonal price recoveries. OPEC has also signaled it is unlikely to allow this recent source of diminished inflation tendencies to maintain its current dynamic weakness.

What will be especially interesting is how well the fixed income fares on any further equity market strength which sees the **DJIA** sustain itself back above the 11,750 all-time high from back in January 2000. Near term support remains in the 11,480 area, with extended resistances at 11,900 and 12,150-200.

While the US dollar has still not pushed through key near term resistance, it looks firm near the **EUR/USD** 1.2630 recent trading low, with the **US Dollar Index** already up into interim resistance at .8600-17, and especially recently more erratic **GBP/USD** trading below more important support in the 1.8700 area (weekly channel support) prior to recovering.

## Reports & Events

As a general note, US economic report releases seem clustered into Monday, Wednesday and Friday, as is typical when the calendar week is indeed the full first week of the month. However, as noted above there are other important US events on Thursday. We will also see the UK HBOS House (SEP) at some undetermined point this week.

At the literal top of the week Japan releases the Tankan Indices and Outlooks (Q3), as well as Labor Cash Earnings and Overtime Earnings figures (AUG.) Of course, all of the major European and pan-Euro-zone Purchasing Managers Manufacturing Surveys (SEP) follow, with the equivalent US numbers and Construction Spending (AUG) after that, along with the late release of the Italian Budget Balance (SEP.)

Early Tuesday is the Australian AiG Performance of Manufacturing Index (SEP), Retail Sales and Building Approvals (both AUG), along with the Japanese Monetary Base figures (SEP.) This is followed by some rather important European releases, such as the UK Construction PMI (SEP), and the Euro-zone Unemployment Rate and Producer Price Index (both AUG.) The only US news of note is likely the early morning Challenger Layoffs Survey (SEP.) The Fed's Hoenig also speaks later on in the evening on the economy.

That leaves the early Australian Wednesday Trade Balance and Reserve Bank of Australia rate decision less than critical, unless they surprise with an actual change from 6.00 percent, or issue a statement. Otherwise, anything influential which comes out of the ECB's Trichet speech at EU Parliament hearing on banking is the potential significant influence in front of the major Services PMI's (SEP), and Euro-zone Retail Sales (AUG), the UK BRC Shop Price Index (SEP), (the sometimes interesting) US ADP Employment Change (SEP) and Factory Orders (AUG), and lunchtime (US) speeches by the Fed's Geithner and Chairman Bernanke. However, the more important speech might be the one in New York later that evening by the Fed's Kohn on the economic outlook.

Thursday begins with the Australian AiG Performance of Service Index and Cashcard Retail Index (both SEP), as well as National Australia Bank's Quarterly Business Survey (Q3), and a couple of appearances by BOJ Deputy Governor Muto. These are followed by the much more important BoE MPC and ECB interest rate decisions, and of course President Trichet's post-rate decision press conference. If it were not for the Thursday-Friday Chicago Fed 'International Financial Instability Conference' (actually the ninth annual 'International Banking Conference', which is focusing on that topic this year) and a separate speech by Dr. Plosser, it would be a pretty dull Weekly Initial Jobless Claims Thursday in the US.

Friday sees the Japanese Leading and Coincident Economic Indices (AUG), UK Industrial and Manufacturing Production (AUG), German Factory Orders (AUG), and (one of our favorites) the OECD Composite Leading Indicator (AUG) even before we get to the US Employment report (SEP) and various important components. And for those of you who have not had enough to command your attention during the week, you can contemplate the release of the UK NIESR GDP Estimate (Sep) prior to the markets opening next Sunday evening.

## Inflation

As neither perennial bulls nor bears, we always attempt to achieve a balanced view of the trends, with aggressive perspectives only during the most dynamic intermediate term phases. And the most challenging yet rewarding part of that is to get it right when broad fundamental background and technical indications are both in flux. We have noted above how critical the technical condition of the fixed income has become in the wake of the recent strength of the long ends and US short money, while the European short money languishes.

As important as the technical indications can be at times, the real trend of interest is always dictated across time by the sustained trend of the long end. At the end of the day (or cycle as the case may be) it is still all about real yields, and that has to do with the current data and future perceptions for inflation. Right now there is a significant benefit of the doubt afforded the Fed's confidence in their forecast that the likely slowing in the economy will similarly subdue inflation in spite of any near term influence from a possible energy price resurgence (see **Iranian Enrichment Program** below.)

The heavily inverted US yield curve even has many believing that Bernanke & Co. are already late in preventing a serious recession in the US. This is not unusual at this phase in the cycle. Even as the estimable Mr. Greenspan's regime fades into fond memory, it pays to recall that there were more than a few phases when he was accused of being significantly behind the curve. These mostly revolved around his desire to lower inflation expectations, which encouraged him to leave the Fed Funds rate slightly above the long dated yields for sustained periods even while easing (albeit not nearly as large an inversion as at present.)

As we have made our view plain previous that there is a good possibility that elevated energy and other prices leave room for any modest premature reinvigoration of the US economy to keep inflation at a higher level than the Fed's comfort zone, we were very interested in the latest issue of John Mauldin's excellent *Thoughts from the Frontline Weekly Newsletter*. While he sometimes provides extensive excerpts or full analysis from other well regarded sources, some of his best insights are his own analysis, which was the case last Friday.

We hope you find the selective excerpts below and attached table (DFEDinfTRIM) of interest. His views significantly reinforce our own previously expressed perceptions. Based on that there remains at least a fair chance that the December T-note might still Negate the recent UP Breaks in the mid 107-00 area, and the pricing of Eurodollar forwards that require a drop to 4.75% Fed Funds by next summer to justify current premiums may be misguided. If so, it is one more clear example of the lack of predictive value of short money forwards that we have highlighted on many previous occasions. Now on to Mr. Mauldin's comments...

### **Trimming Inflation**

Measuring inflation is not easy. The Department of Labor creates the Consumer Price Index (CPI). The Department of Commerce creates the Personal Consumption Index (PCE). The market seems to pay more attention to CPI, but the Fed (read Greenspan and now Bernanke) prefers to look at PCE. And they really like core PCE, which takes out food and energy, because otherwise the number can be too volatile for sensitive central banker stomachs.

But however you measure it, getting it right is important. If you allow inflation to become pervasive and persistent, it does nasty things to economies and markets. No US central banker ever wants to revisit the 70s. While it is popular in certain circles to depict

Bernanke as Bomber Ben, a reference to his remark in a speech about dropping cash from helicopters, you can be sure that he understands that inflation at too high a level is just as pernicious as deflation. There is a fine grey line they walk, but the general consensus seems to be that when inflation is over 2% it is too high.

Inflation is well over 2%. It may even still be rising, as some data we will look at suggests. So why did the Fed stop raising rates? Are they not worried about inflation?

The answer is that they think (hope?) that a slowing economy will ease the pressure on inflation without having to resort to further rate increases. If the economy is indeed slowing, the thinking seems to be that to pile on with more interest rate increases would simply add to the problem and maybe even cause a recession. That has been the pattern in the past. If the economy remains strong or gets stronger, they can always increase rates later.

I think this is the correct approach. But that makes the Fed very data dependent. Each bit of new data becomes ever more important. The futures market is pricing in a 30% chance of a rate cut at the January meeting, and the odds in the futures market of a rate cut increase with each meeting. That means the futures market thinks the economy will be visibly slower in the not too distant future, otherwise why forecast a rate cut? (We will visit this point later when we look at the recent stock market action and my conversation with Larry Kudlow this week.)

#### **The Inflation Trend is Not Your Friend**

As noted above, the headlines said that inflation as measured by PCE only rose 0.1% of August. In July PCE rose 0.8%. That means inflation is falling, right? Well, maybe.

June was "only" 0.3%, yet May was 0.7%. As you can see, the monthly numbers can be quite volatile. As I wrote last month, Dallas Fed president Richard Fisher argues that a six month trending average is actually the best measure.

Without going into the detail we did last month, the Dallas Fed has developed a new methodology for measuring inflation, called the Trimmed Mean PCE. It was developed by Dallas Fed economist Jim Dolmas.

Dolmas notes (quite correctly, I think) that to exclude food and energy, just because they are volatile, ignores the other quite volatile measures of inflation that are still left in. Further, energy and food inflation do have meaning in the real world.

What Dolmas does is use a statistical device called "trimming." From the field of statistics, trim analysis borrows the idea of ignoring a few "outliers." A *trimmed mean*, for example, is calculated by discarding a certain number of lowest and highest values and then computing the mean of those that remain.

How accurate is his new measure? Dolmas suggests it is a lot more accurate: "That is to say, compared to the usual ... measure, on average the monthly trimmed mean measure would be expected to come closer to true monthly core inflation by roughly .75 of a percentage point, when the inflation rates are expressed in annual terms." That is huge, at least in my book, especially when we look at how much the difference is with the Fed's favorite methodology.

The Dallas Fed uses the same data as the Department of Commerce does to create the PCE. I have to compliment them that they have updated their web site from data released today. The charts below compare PCE, core PCE (ex food and energy) and the Trimmed PCE. The numbers show what the rate would be on an annualized basis for one, six and twelve month's worth of data. ([Hwww.dallasfed.org/data/pce/index.html](http://www.dallasfed.org/data/pce/index.html))

The trend is not your friend. Inflation on a 6 month and a 12 month basis has been trending up for the last six months in all three series. The 1 month numbers, while more volatile, are well above the 2% comfort threshold.

If you are so inclined, you can make an argument using just the 1 month numbers that inflation may be starting to slow down, but the truth is that one month's worth of inflation data is pretty much useless as a predictor.

What we can see is that inflation, at least through August, has not gone away. If inflation is still this high at the end of the year, then the Fed is going to be forced to think about raising rates, not lowering them. Can you have a slowing economy and rising inflation? The answer is yes. Remember that 70's show? Bottom line? The Fed will fight inflation, even risking a recession, as to not do so risks an even worse recession in the future.

Now, the probability is that a slowing economy will indeed bring inflation down. But it is not the only possibility. That is why the Fed is on hold, waiting for more data. There will only be one more month's worth of data between now and the November meeting. That will not be enough to justify a move either way. But at the January meeting, they will have seen three more month's worth of data. A trend will be established: either up, down or flat. The futures market is betting down.

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### Hedge Fund Regulation

Insofar as hedge funds (and automated trading system brethren which populate some of the more mainstream securities firms as well) are significant trend drivers in the modern markets, their regulation and monitoring are fair game for review from time to time. Yet, typical of the process is the unfortunate penchant toward over-reaction from the political class as a driver for the most aggressive action by regulators. While most regulators are savvy enough to avoid being completely in thrall of the politicians demands, the 'stridency index' is often determined by the relative phase of the now permanent election cycle as well; hence the direct proportionality to the pols need for "we care about the little guy" sound bites.

However, balance and consistency are much better keys to proper address of matters where stifling innovation is also detrimental to the 'little guy', even if an invisible form which escapes their awareness. One of the best concise summaries of the need for regulators to temper their response in the wake of the recent Amaranth dilemma was Thursday's Financial Times LEX column. Below are my thoughts back to them (which they posted in the web-based reader comments), and attached is a scan of the original LEX remarks (FTThegdeSCAN.)

“Excellent summary of the need for the regs to keep their heads in the Amaranth aftermath.

“As many of the largest funds are already registered, LEX performs a service for the entire industry and investors by focusing on first principles of size and suitability. Those who would make political hay of one fund's unfortunate lack of aggressive risk management would do well to keep this in mind.”

## International Miscellany

### Iranian Enrichment Program

We really respect the way the Iranians are completely out-financing the West in this entire uranium enrichment negotiation. From all recent reports, including one in Friday's Financial Times, it seems the EU-Iran talks are not accomplishing anything; *and these are talks about resuming talks!!* The best comment at the end of that particular article was a quote from Condi Rice, “...talks about talks clearly won't go on very much longer.” Really? Or what? The Iranian brinkmanship skills are that much more impressive insofar as their near term position is as tenuous as the West's; they are just doing a much better job of playing their hand.

The fact is that Iran has a series of significant problems which leave it weak below the hard line veneer. Among others, it seems there is little opportunity for its young and unemployed, and some significant drug abuse problems, which can only be that much more embarrassing for an Islamic republic. Certainly nobody in the West, and especially the US, can claim any better results on the latter front. Yet, it seems likely that it is even that much more troubling to the leaders of a country which bases its government upon religious law.

Beyond that one of Iran's most telling vulnerabilities is their reliance on refined petroleum product imports over which the West (and to some major degree this includes the US) has significant control. Yet, nobody wants to go there right now, because it is the most volatile thing the West could do; a blatant attempt to send the country into economic chaos as part of destabilizing the religious oligarchy. As militant as the rhetoric from Washington sounds, given their recent results with regime change maybe they are considering it's a case of better the devil you know. In any event, as a conventional invasion is out of the question for many good reasons, suspension of imports would be a sort of non-nuclear 'nuclear option'; which is kind of ironic considering that's exactly what the West is attempting to control.

This is one good reason why the fear that the Iranians would shut the Straights of Hormuz if they are pressured at the UN is nonsense. In preventing the oil that the West will find a way to source through other global channels (albeit at much higher prices) from getting out, they will also bring their own economy to a screeching halt as they also keep essential gasoline supplies from getting in. Even so, the West tiptoes fearfully around in the master diplomats' diminishing concentric circles. Yet, 'talks about talks' will have run their course very soon; and what then? There are much more experienced hands who can supply a better answer than humble market analysts, and we defer to them.

What we do know is that after the seasonal sweet spot in the weather, and much the same in the geopolitical climate, we are skeptical that the Crude Oil market has much more downside as the clock ticks by. This is in spite of recent weakness due to speculative liquidation from those who stayed too long at the ball. Chances are that this is not good news for the equity markets, even if they do make a new high in the near term. It is quite a bit more problematic for the fixed income where extending the duration of the energy price bubble may finally become a blatant further inflation factor, as well as a drag on the developed economies.

## **Japan**

While it is a forgone conclusion that new administrations will spout inspiring words to motivate faithful followers and the country at large, we found a good bit of the recent pronouncements by new Japanese Prime Minister Shinzo Abe less than comforting. We can only imagine what his neighbors felt. As reported in the Financial Times, "... (Mr. Abe) on Friday promised to create a 'new Japan' that was more assertive abroad and more proud of its traditions at home..." and "...instill greater pride and patriotism."

According to the FT, he did not spend much time in his speech addressing how to improve strained relations with China and South Korea, aside from saying he would work for "future-oriented discussions", a phrase often employed by his predecessor. To us that sounds like another blatant attempt to shuffle all of that nasty imperialist WWII abuse of the neighbors under the carpet again. We hope that is not a harbinger of the type of national instincts the Japanese government seeks to foment; especially with the US seeking to allow more of Japan's security requirements to migrate to the control of Tokyo.

Yet, a minor item points to what may be a natural delimiter on his ability to maintain an aggressive militant view. In an administration already packed with "like-minded social conservatives", it seems some of the top appointments are aimed at establishing a US-style national security council. Oh, goody; a Greek NSC. Well, in that case we can fully expect that by sometime into 2008 Mr. Abe will be mired in a government eavesdropping or foreign bribery scandal that may nudge his administration back to the political center.

## **Greek GDP Metric/US Dollar**

Having spent quite a few years in the analysis business, we are friends with some folks who are more creative, instinctive, finger-in-the-air analysts with perspectives that at times broaden our definitive decision technical approach. It turns out that we were at lunch with one such individual last Tuesday, and had no qualms about telling him he had obviously become totally daft for suggesting a Mustang Ranch Inflation Index; a measure of how quickly the price of sexual services was increasing. After all, he noted, if you can base a grass roots indication on something as pernicious as a Big Mac, why not?

Well, we ordered up a giant plate of crow on Friday after seeing the news on the Greek government's decision to include 'black' (i.e. underground) economy turnover in their official revision of GDP numbers (going back to 2000!!) That includes prostitution and money laundering. This pumps their numbers up to where they miraculously are well within the bounds of the EU 3% of GDP government deficit requirement.

While we can only imagine that anyone who has not been in a coma over the weekend has heard no small number of sophomoric observations on this, the following ends with what is only a half-humorous observation. First of all, one feels bad for all of the ministers and governments that fell due to dalliances with call girls while enrapt in nothing more than black economy research. However, applying economic concepts such as inflation/deflation and easing or tightening is likely best left until after EU bureaucrats complete what will no doubt be aggressive exploration of this area. And no doubt there are more than a few fact-finding missions being planned, with volunteers espousing their commitment in classic terms: "It's not pretty, but somebody's gotta do it."

Yet, all of this does seem to offer at least a tacit explanation of the resilience of the greenback in the face of recent weak US economic data and yields. If the US were to adopt the Greek metric, and include gambling and drugs turnover as well, it could *post haste* knock a couple of percentage points off of the fiscal deficit. As the US Congress is always keen to consider creative couching of fiscal (and other) matters, expect timely legislative action on any such suggestion from the Congressional Budget Office.

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

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