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Overview, Reports & Events,…
…Inflation (again) and Growth, US Data Discrepancy, Miscellany

Overview

Today's overview is a bit lengthier than usual due to the need to thoroughly address the quantum shift in the market psychology and potential trend outlook from last Friday's news releases and market response. This week's Wednesday-Thursday back-to-back release of minutes from the September 20th FOMC meeting and Beige Book in preparation for the next (October 24-25) will likely be the most telling news in what would normally be the mid-month US reporting vacuum after the Employment report.

Yet, last week's really big news that obviously reset the frame of reference for all of the fixed income markets (and influenced others) was the significantly larger than normal rebasing of benchmark Current Employment Statistics from the Bureau of Labor Statistics. The addition of 810,000 jobs to the previous figures for the year to March 2006 was striking; so much so that the BLS is researching the possible sources for this record discrepancy. The press release (CESbmkREV2006.pdf) is attached, and we have more to say on this below.

As we noted last week, the markets were entering a phase where the obvious enthusiasm in the fixed income was subject to surprises for various reasons. These included the lack of volume reinforcement for the technical up trend, as well as the 'street' dwelling on only the comments from the various Federal Reserve officials which referred to housing weakness instead of their notation that so far this has had limited effect on the broader economy. Yet, it took until Friday for our previous reference to "You're gonna need a bigger boat" to actually become the reality in the markets. It looks like the Great White finally surfaced in the CES revision that turned the bullish fixed income hunters into the hunted on Friday.

Yet, even prior to that, the comments from Mr. Bernanke himself were at worst balanced, with pointed inflation remarks from Mr. Kohn. The speech by new Philly Fed President Charles Plosser was that much more explicit on risks remaining moreso to the upside on inflation than the downside of the economy. We revisit two brief excerpts from right near the end:

"In short, my sense is that the housing sector is going through a painful, but necessary, adjustment and this has slowed overall growth somewhat of late. But the expansion is still on firm footing, and growth is likely to accelerate in 2007. So market interest rates are probably under relatively little downward pressure..." "…we need to remain vigilant and recognize that maintaining the current stance of policy, or even firming further, may be in the best interests of the economy's long run performance."

Yet, the stock market and quite a few other markets seemed to be buying into assumptions of Fed easing by early next year as the beginning of a general loosening cycle. While the reasons for this are multifaceted, there is an underlying statistical psychology which may be the most influential factor, even though it is not necessarily reliable under the circumstances.

In light of the major BLS CES discrepancy, it is easy to feel that Mark Twain probably had it right in his apocryphal quote (*Autobiography*, 1924) from Benjamin Disraeli, "There are three kinds of lies: lies, damned lies and statistics." We have seen recent evidence that a goodly portion of the analytic community (including securities firm research departments) are taking quite a bit of comfort from statistical correlations based upon the premiums in the Eurodollar (short term interest rate) future forwards. The degree to which serious analysts continue to believe in some sort of predictive value in this forward pricing is incredible. It maintains in spite of Eurodollar forwards being completely misguided in expectations for rapid FOMC tightening after the equity market recovery from late 2001 into early 2002

The statistical studies we have seen suggest premium pricing of Eurodollar forwards for more than a couple of months after cash Fed Funds hit a new high is a 'sure sign' the next FOMC rate move is down. Yet, those are based on data from the mid-1980's onward, which reflect intermediate term rate cycles. None of them bothers to go back the mid 1970's bottom of the last major economic cycle and equity market low; a bit short-sighted, isn't it?

An extensive interest rate trend comparison between the late 1970's and past five years is available in our previous major report: **SPECIAL MARKET HIGHLIGHT: 1970's Redux: Son of Stagflation** (Monday, March 21, 2005.) While this may seem somewhat dated, it still contains some relevant observations, which now include the way that the DJIA revisited the previous (late 1960's-early 1970's highs) in 1976 prior to another major correction. That said, it is interesting that the DJIA managed to hold in the face of Friday's sharp fixed income selloff for a weekly Close fully 100 points above the January 2000 old all-time high. Might this be a sign that in the face of what *might* be coming next in interest rates, the equity market is once again attempting to "disconnect from its moorings" (as Mr. Greenspan observed it had by early 1996 in his September 2005 *Economic Flexibility* speech)?

That report is still available in the **Sample Reports** page on our website at www.rohrintl.com. It includes a review of similarities between equity market activity after major cycle highs, with a similar subsequent yield curve 'conundrum' (pages 4-8), and the wildly massive mispricing of Eurodollar forwards (pages 9-11.) In early 2002 (up until May) they were actually 'predicting' Fed Funds pushing back up from 1.75% to 3.00%-4.00% by the end of the year, and surging back to 5.00%-6.00% by the end of 2003. In the event, they dropped to 1.00%.

Once again, this was based upon the expectations of an entire generation of analysts and investors who failed to research the important major cycle tendencies which lie outside of their direct experience. Their frame of reference is intermediate term cycles from mid-1980's through 2000. Given the much broader trend and cycle influences which have significantly distorted the markets since the major economic and market cycle high back in 2000, these are no longer a reliable guide to intermediate term trends. It calls for independent thinking, and a close eye on the real tendencies for the economy instead of statistical comparisons.

While the fixed income bulls may yet be proven right about the housing sector weakness spilling over more forcefully into the general economy, that is yet to be seen. On recent form the Fed Chairman is more dovish, yet others in the system feel strongly that unless housing does lead to a general crunch, the more likely outcome is US economic reinvigoration on the back of corporate capital investment; and that is further encouraged by the positive sentiment flowing from an exuberant equity market. We have noted previous that extensive near term equity market strength might be self-limiting, and that seems more likely now than ever.

As to the actual technical contingencies in the markets, those have clarified in the wake of Friday's price movements, even allowing that the jury is still out on the energy market influence with the **Crude Oil** parked in the 59.00-60.00 area (from which it is likely to swing 5.00 either way prior to reaching the next critical support/resistance.)

The fixed income has seen the tone setting **T-note** sinking back in less than orderly fashion toward the major decision level at the low end of 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. If it holds, it continues to reinforce 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 higher resistances, with salutary effect on other long ends. If it fails, it could easily also fall back below next support at 106-00/105-24, and 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.

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 around its 95.25 area resistance, it still has near term support 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, whether the weak sister **Gilt** languishing against 109.60 or 109.35 supports, the more volatile Bund, or the upside trend leader T-note, the long ends maintained their daily MACDs in an UP signal until they all turned DOWN in the past couple of sessions. Any overt T-note trend support failure below the mid 107-00s (which is now also the daily up channel trend support from the significant early July low) will reinforce all of the worst tendencies of the long dated fixed income. Where this comes back to be important for the short money is their own across-the-board daily MACD return to balance (from UP.) This is especially important in light of the continued relative weakness of European short money, which looked to the US for any ray of hope for easing.

What will be especially interesting is how well the fixed income fares on any further equity market strength which sees the **DJIA** sustain itself above the 11,750 all-time high, which is now near term support. Below that, near term support is in the 11,630-00 and 11,480 areas, while extended weekly oscillator resistances have risen to 11,950 and 12,200.

As to the influence of the CES rebasing on foreign exchange, the buck finally strengthened at the end of the week to a degree which was near term trend decisive. With notable exceptions of **GBP/USD** and **AUD/USD**, it made near term highs through important interim resistances. **EUR/USD** is through its recent 1.2630 trading low, with the **US Dollar Index** above its interim resistance in the .8600-17 range. This opens the door to moves back to next resistances in the 1.2500 area and .8700 area, respectively, in which case the others should fall in line with weakening against in the face of further US dollar strength. Indeed those are only the next interim targets for what may be more extensive strength in the US dollar if it begins to look like the Fed is not going to ease anytime soon. While we are never great fans of near term

interest rates driving major foreign exchange trends, there is so much focus on it right now this is likely to become at least a bit of a near term self-fulfilling prophesy.

Reports & Events

While there are fewer decisive reports this week, the exceptions are weighty. In addition to the Federal Reserve information already noted above, Thursday morning the ECB publishes its October Monthly Bulletin, and that can be fairly influential content at times. This was the case with the September release, which is reviewed further in the **Inflation and Growth** section below. While it is sometimes less than critical due to the lack of actual movement, the Bank of Japan does announce its interest rate decision on Friday. The more important news is likely to be the Monthly Report, and any hints of further liquidity withdrawal. While there are also a goodly number of pronouncements by financial luminaries this week, quite a bit of that deals moreso with politics, compliance and education than direct comment on economic or interest rate outlooks. As such, we are limiting our notation of them below to those which seem to have some ability to impact the markets.

Today's German Trade Balance and Current Account, and Industrial Production (all AUG), and the UK PPI (SEP) saw the weaker than expected UK numbers offset stronger German Industrial Production so far this morning. With no fixed income or foreign exchange trading today in the US, we expect no big changes from here. If North Korean nuclear testing is not enough to blast the equity markets, we have no current anticipation that trading will amount to anything decisive through the balance of the day.

Tuesday sees National Australia Bank's Business Survey (SEP) and Japanese Machine Orders (AUG) early, followed by the Japanese Economy Watchers Survey (SEP.) In Europe it's French and Italian Industrial Production (both AUG) and the UK Trade Balance (AUG) and BRC Retail Sales (SEP.) The only report in the US is the Wholesale Inventories (AUG), followed by the UK Leading and Coincident Indicator Indices (AUG.) The market influences wrap up with ECB President Trichet speaking to the EU Parliament's Economic Committee.

While he also speaks again early Wednesday morning (US time), as the topic is 'economic and financial integration in the Euro region', it is unlikely to have much impact unless he strays off topic. Wednesday morning is also the release of Japanese Machine Tool Orders (SEP), and Reserve Bank of Australia Governor Stevens speaks on the economy, which could be very interesting given Australia's position as a major commodity exporter. After that is the Euro-zone Gross Domestic Product and associated data; yet, as the Q2 Final numbers these are unlikely of much interest, due to being the revision of a revision. The last release of the day are the minutes of the September 20th FOMC meeting.

Thursday begins with the Australian Westpac Consumer Confidence (OCT) and Employment figures (SEP), and Japanese Consumer Confidence (SEP.) It continues with what could be a very important set of German Consumer Price Index data (SEP.) This is both because they are estimated to be no worse than the August numbers, the ECB's Quaden speaks at an inflation conference shortly afterward, and the previously noted ECB October Monthly Bulletin release is shortly after that; quite a confluence of information. That is followed by the UK BCC Economic Survey (Q3), US Trade Balance (AUG) and usual Weekly Jobless Claims (which were weaker than expected last week.) Only after exposition on topics that would seem to be less than exciting from the ECB's Trichet, Weber and Mersch, as well as the Fed's Mishkin, is the likely very interesting Federal Reserve Beige Book released.

Early Friday is the Bank of Japan interest rate decision, along with their Monthly Report, Governor Fukui's regular press conference, and release of their Industrial Production figures (AUG Final.) In Europe there is only French CPI (SEP) and Construction Costs (Q2), followed by a speech from ECB's Stark on "The Euro Area's Role in the Global Economy", which has limited scope for any surprises. All of which concludes with the beginning of the punctuation mark in the middle of the US mid-month reporting vacuum in the form of the US Import Price Index, Advance Retail Sales (both SEP), and Michigan Sentiment Index (OCT Preliminary) prior to what is likely to be some very critical US PPI and CPI data (SEP) next Tuesday and Wednesday, respectively.

Inflation (again) and Growth

While we do not mean to dwell on it, the comments in the past week from various central bankers continue to reinforce our question of whether the current bout of economic weakness is sufficient to also quell inflation. Allowing that inflation tendencies lag growth or contraction, the signs so far are not propitious, and the BLS revision to benchmark Current Employment Statistics does seem to raise a question of whether the economy is even as weak as current indications suggest.

If all of this current weakness if from a higher base, does it really point to a slowdown unless the US housing weakness spills over more markedly into the general economy? Last week's remarks from Mr. Kohn, and Dr. Plosser's sense that "…growth is likely to accelerate in 2007…" are not consistent with lower inflation rates, and (by extension) weaker yields.

In that regard some recent studies are instructive. If the weakening OECD Composite Leading Indicator (AUG) released last Friday is considered in light of their most recent CPI study (also AUG) from last Tuesday, the picture is less clear cut. While the headline inflation indication is consistent with the comforting falls in country inflation fomented by weaker energy prices into late August, the core rate continues to rise. The other aspect to consider in light of massive changes in global energy usage due to the demands from China, India and other rapidly industrializing states is just how much more energy price relief is possible?

Technical studies are always subject to failure. That said, sustained Crude Oil weakness much below the $55.00-$50.00 technical support range seems unlikely in light of geopolitical and seasonal factors; especially now that the Natural Gas speculative liquidation debacle seems to have run its course. For more on this we recommend review of the OECD reports at http://www.oecd.org/dataoecd/4/59/37499069.pdf for the Composite Leading Indicator, and at http://www.oecd.org/dataoecd/48/46/37481295.pdf for the CPI abstract.

With next release of the ECB Monthly Bulletin (OCT) due Thursday, review of the September issue http://www.ecb.int/pub/pdf/mobu/mb200609en.pdf might also be of interest, at least as a point of comparison. The full analysis in this lengthy, in-depth overview is not necessarily pertinent to the topics at hand. Yet, of interest in their own right, as well as how the ECB view evolves in this Thursday's release, might be the opening editorial and external environment observations on pages 6-14, as well as the prices and costs analysis (including a separate section on inflation expectations) on pages 47-53. While it is no surprise that consumer inflation expectations have continued to rise even as actual HICP inflation seems to have stalled in the low 2.0% area, given the ECB's commitment to restrain any second round inflation effects, it does seem to justify their continued hawkish stance.

The one other indication which might be telling for the US economy is the degree to which the recent drop in long yields might be just as self-limiting as any significant further push up in the equities market. Last week the highest levels of home mortgage refinance activity that has occurred in some time was reported. People are always reluctant to chase the rates higher, as they feel like they've missed out on the bargains. However, once there is as sharp a fall as the one which fifteen and thirty year rates have experienced recently, they are happy to jump in and reset their monthly payments to lower levels.

One of the key questions for which we do not yet have an answer is the degree to which this recent refinancing surge included folks switching out of what had become (and we suspect will be even moreso) onerous ARM's (adjustable rate mortgages) on this recent round of aggressive refinancing. To the degree that was (and/or remains) the case during what are still amenable rates on the current yield break (i.e. long end rally), it could mitigate quite a bit of any economic drag from higher US short term rates. This is one way in which housing market weakness might fail to spill over into the economy at large.

US Data Discrepancy

The BLS Current Employment Statistics dilemma is only symptomatic of something broader which now affects much of US government and economic management. It is interesting to us that so many of the estimates for European economic releases are very much on target. While this is not as prevalent for releases from various institutes and NGO's (German Ifo and ZEW for example), government figures are almost always very consistent with the estimates.

This is in marked contrast to the US, and the reason is glaringly apparent. In the wake of the BLS failure, there was a hue and cry from many corners; most pronounced from the political class crying we had better get more accurate statistics if we expect to manage our economy. Intent on avoiding any focus in front of mid term elections (only a month away) on whatever modest success the Bush administration has achieved in job creation, the wails from the Democrats were especially shrill. Yet, these are the same folks who voted for the budget cuts that eviscerated the statistical departments at the agencies from whom they now demand better data.

While Europe may struggle under a burden of ostensibly bloated government bureaucracy, which many criticize as a primary reason for its sluggish economic performance, at least they get their figures right. It seems this is more than the 'streamlined' US agencies can deliver without hiring additional staff. Of course, politicians will turn this into good reason to spend more money once again; in this case it actually makes sense, and likely suits them better in any event.

Miscellany

The Foley Affair: Further Devolution of the Already Bizarre US Political Culture

The bottom line on the Foley imbroglio is that man gives alcohol a bad name. What's with all of these crooks and perverts who run off to alcohol abuse rehabilitation after being busted for their particular form of criminal recklessness?

Alcohol has many pernicious short term effects. It might cause one to engage in a tryst with someone they would not normally consider worthy of their attention, will definitely impair operation of a motor vehicle, cause communication skills to slip into slurring irrelevancies

(when indeed still comprehensible at all), and will leave one with a nasty hangover if abused. However, it is not a primary cause for industrial or institutional espionage, embezzlement, pedophilia, or other long term criminal behavior. That's just who these folks are.

Yet, Mark Foley goes off to rehab, claiming he was under the influence when he engaged in the most lurid sort of homosexual enticement to young people who were ostensibly under his guidance and protection. As offensively incredible as it is that he should claim some sort of drink induced compulsion for such long term behavior, the permutations of this situation are almost too bizarre to know how or why it evolved as it did, or what's coming next.

In the first instance, he was the head of the 'Missing and Exploited Children's Caucus', and introduced legislation in July to protect children from exploitation by adults over the internet. He also sponsored other legislation designed to help protect minors from abuse and neglect. Talk about the fox guarding the hen house!

Beyond that, the misguided views and activity of legislators on both sides has led the entire electorate through the looking glass, as things get "curiouser and curiouser" indeed. Now the various committees and departments are involved in the typical "who knew what, when, how, why, where and what did they attempt to do about it?" Of course all of that will only yield more distraction from really pressing issues made that much worse by the paltry legislative output from a highly partisan Congress, which most Americans believe incapable of tackling any of the really substantive issues which face the nation.

Yet, in this instance, the Republicans are instituting what is an even more egregious twist on the continual Washington game of political "gotcha." A junior Republican legislator is calling for the submission to lie detector tests by *all* of the key Congressional ***Democrats***. And his rationale for this phenomenally fantastic request? That Foley's obvious (to those who were paying attention) lack of libido control went on for so long that the Dems likely also knew of it, and the affair being brought to light so near the election was possibly part of a conspiracy to discredit his party right before the poll.

Breathtaking. The self-righteous right getting righteously outraged over what? The other side playing dirty politics into an election? What a concept; who woulda thought?

Of course, the lack of willingness to make the ethical call, and assume the risk to Foley's (until now) 'safe' Congressional seat, is what really galls the ultra-conservative base. If even only a limited number of their leaders turned a blind eye to this activity, it means someone with tendencies they abhor was given standing in their midst and political cover; an obvious case of (in their world view) an ultra-liberal pervert in conservative's clothing (even though one of their own legislators has been brave enough to disclose his homosexuality.) In that regard, the real Republican risk is that the premium placed on political expedience over moral rectitude might have demotivated the (literally) faithful into the election.

Then again, as long as we are on the subject of the totally bizarre potential permutations of the US political landscape, what if the conspiracy was actually on the part of a select group of ultra-conservative Republicans? To what end might they have acted? With the Republicans suffering the usual bout of second term blues, they might have viewed the benefits of this sort of scandal as several fold. Instead of limping along under the continued ire of an unhappy electorate into what is likely a recession by 2008, why not lose some perniciously weird baggage (Foley), and saddle the country with a Democratic Congressional majority?

They might have reasoned that if there is anything which could hopefully reinvigorate their base into the 2008 general election, a couple of years of ultra-liberals like Nancy Pelosi (who would become Speaker of the House), Harry Reed, Al Sharpton and Barney Frank controlling the legislative agenda should just about do it. Who knows?

Maybe it's actually a case of "more Byzantine and more Byzantine." And then they actually pay consultants to try and figure out what's behind progressively lower voter turnouts.

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

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