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Overview, Reports & Events,…
…The Good, The Bad, The Ugly, Miscellany

Overview

Today's overview is a brief once again. The rather convoluted factors affecting the markets in both the short term and across the cycle are reviewed in extensive additional topics below. One sign of that is in spite of a significant amount of economic and inflation data so far this week the markets seem a bit stuck near critical decision levels. That we have already seen so much early week news means we will also summarize that in this section's market review, which will also rightfully shorten the Reports and Events section. Rightfully because our instincts are that the nature of the US reporting cycle and other events make Thursday the key to any trend decision. This is exacerbated by the degree to which Thursday is more or less the last important US news prior to the return to the back half of the mid-month reporting vacuum into what is essentially a three day Thanksgiving holiday week in the US next week. Unless there is a clear constructive signal from the US T-note into the end of this week, that will leave the more bearish European fixed income back in control.

No doubt there is quite a bit of important news prior to then, as tomorrow's Bank of England Quarterly Inflation Report and minutes of the last FOMC meeting. While there are also a goodly number of pronouncements from central bankers both from earlier this week and tomorrow, the topics and nature of the news dictates that Thursday will be the final arbiter of any decisions taken prior to then. It is extremely interesting that with the notable exceptions of the UK PPI (OCT) yesterday and German and Euro-zone ZEW Surveys (NOV) today, economic and inflation news has been weaker than expected so far this week. Yet, so much of that is due to the weaker energy prices which are a stimulative economic factor that it leaves a question over their intermediate term impact on fixed income markets, which have not rallied through key resistances in their wake.

All of which promises the convoluted market continues unless there is a decision from the trend setting US T-note. While we will review specific technical aspects of that below, to date the fixed income markets and the US dollar remain more contentiously range bound than anyone might have suspected after the return from the late summer bank holidays all the way through the major political shift from the US mid-term election.

On recent form the markets bring to mind the film *The Good, The Bad and The Ugly*[1], as there are strong elements of each in the current situation. The Good is represented by a refreshing element of realism in, of all things, French politics. The Bad is the intra-party and pan-government gridlock which might plague the US at a critical moment. The Ugly is the investment and trading alternatives facing portfolio managers as we move from a fairly good year into the more challenging part of the cycle.

[1] The Good, The Bad and The Ugly. ©1966 Alberto Grimaldi Productions SA, released by United Artists, directed by Sergio Leone

Yet, whatever transpires in the news and reports, the fact remains of US fixed income upside leadership of improvements in the other markets. Since the **T-note** first recovered back above the 107-00/106-24 range three week's ago the failures from the 108-11/-16 resistance are a key delimiter of the rallies, with interim support at 107-16/-12. That remains a critical weekly oscillator resistance, above which it might see 110-00/-16, or even higher resistances. Similarly as telling at this point, the still falling weekly MA 41 in the **Bund** (due to the continued influence of the sharp early year break) means that the 118.10-.20 resistance there is as important as the mid 118.00s were in late August and late September; essentially, the weekly oscillator decision by the T-note and Bund is closely calibrated. Lower support in the Bund remains 117.40 and the 117.00-116.80 area.

Weak sister **Gilt** remains in a different world, yet with the 110.10 and 110.50 areas remaining critical there as well. Support also remains at 108.80 and the 108.50-.31 range. The still weak European short money forwards have only benefited slightly from the September 2007 **Eurodollar** rally back to its 95.15 resistance, and will also only do that much worse if it ever fails more convincingly below 94.94-.92 support.

The equities also held up very well at the end of last week, which is another anomaly associated with the fixed income also doing quite so well. Even with any uncertainty over maintaining the accommodative tax regime, especially the capital gains portion of it, the market performance seems impressive (more on this below.) In the event, we do not wish to draw any major conclusions until the markets reflect on the specific legislation put forth by the Democratic majority, and that may take some time. Yet, the **DJIA** still holding around the 12,100 oscillator resistance, and the December **S&P 500** challenging the rising weekly oscillator levels in the 1,380 and 1,390 areas is encouraging. Of course, maintaining that strength into the weekly Close is the more important factor yet to be seen.

After a bit of a fright on the **US Dollar Index** failure below the .8513 trendline support late last week, and **EUR/USD** pushing above congestion as 1.2830, the buck seems to have stabilized yet again in the wake of the EUR/USD failing to carry on for a push above the 1.2900 equivalent down trendline. **USD/JPY** would also still need to break 116.00 support to signal any secular weakness of the US dollar, as **AUD/USD** also did not fare very well at all in its attempt to remain above the .7700 area, and **USD/CAD** is downright friendly up into its 1.1400 resistance once again. As such, the temporary weakness of the US Dollar Index below the .8500 area notwithstanding, unfortunately we do not see any significant overall trend here either, in spite of longer term misgivings about the US currency.

The energy markets remain weak in their own right as the **Crude Oil** continues to have trouble sustaining any strength back above the 60.00-59.00 area in spite of Closing above the 60.75 gap last Thursday. However, as noted previous, Closing above that gap does lend a bit of stability, and whatever the ultimate fate of the trend in these markets that could mean the attempted formation of a broader bottom with near term support back into 58.00-57.50. The next major supports remain in the 55.00 and 53.00 areas.

Reports & Events

As noted above, while there have been a significant number of reports as well as more than a few pronouncements from financial luminaries, these are less trend decisive than the market information for the balance of the week. That recommences with tomorrow's Australian

Westpac Consumer Confidence (NOV), Wage Price Index and House Price Index (both Q3), along with along with the Japanese Tertiary Industry Index (SEP.) That is followed by UK Employment figures (OCT), including the important Average Earnings and Manufacturing Unit Wage Cost (SEP annualized rolling quarterly), with Italian CPI (OCT), Euro-zone Industrial Production (SEP) and previously noted Bank of England Quarterly Inflation Report to follow. The US only sees the Empire State Manufacturing Index (NOV) prior to the afternoon release of the minutes of the October 24-25 FOMC meeting.

With little trend decisive news out on Friday or next week in the US, Thursday is the pivotal late week influence, beginning with Australian Consumer Inflation Expectations (NOV), the RBA Foreign Exchange Transaction Report (OCT), and Average Weekly Wages (Q3), along with the UK RICS House Price Balance (OCT.) The BOJ Target Rate decision is not likely to show any change from 0.25 percent, yet is accompanied by their Leading and Coincident Economic Indices (SEP Final), the BOJ Monthly Financial and Economic Report, Machine Tool Orders (OCT Final) and Governor Fukui's regular press conference. This is followed by UK Retail Sales, the Euro-zone CPI, and the US Consumer Price Index (all OCT.) In addition to the US Industrial Production and Capacity Utilization (OCT), Philadelphia Fed and NAHB Housing Market Index (both NOV), the central bankers' input becomes more critical as well, with the Fed's Kroszner at the Cato Institute Monetary Conference, Poole speaking on the Fed's role in responding to crisis, and Dr. Moskow speaking on the U.S. economic outlook.

Friday sees some interesting, yet likely less than trend decisive input in the form of French Non-Farm Payrolls and Wages (Q3) and the Euro-zone Trade Balance (SEP.) Given the emphasis placed on the US housing market of late, possibly the US Housing Starts and Building Permits (OCT) will be more influential, along with any impact from the Fed's Pianalto's remarks.

The Good

Last week's frank (pardon the pun) remarks from Nicolas Sarkozy were the most refreshing thing in the European political sphere since Mr. Blair informed the UK Labor party that holding the rest of the country hostage with threats of industrial action was not a party platform; it was simple highway robbery that would stand neither in the global marketplace nor the domestic electoral marketplace of ideas.

While he had been moving toward it for a while in previous brief expositions, right wing French presidential contender Sarkozy finally laid out his major platform for France moving beyond its parochial interests and tackling the challenge of globalization. As opposed to the often mindless assertions of free trade's unmitigated benefits from that portion of the US political class which supports it, he was very balanced in laying out the macro and micro risks it entailed, along with the potential benefits.

Yet, the key line which carried the day was his quip, "The state must protect without being protectionist." If he is prepared to back up his emphasis on the importance of education with a solid plan, it would represent the most progressive move anywhere in Europe. It would also be a good lesson for the US, where the political class of both left and right talk a good game, yet rarely provide the support needed to accomplish the requisite improvement what is a feeble mass education effort by global standards.

The Bad

What a wonderful counterpoint from an unexpected source to The Bad: the very convoluted situation in the US after the political shift of the mid-term election, which leaves a very high likelihood that protectionist forces will indeed have quite a bit more influence. Why would the US possibly consider improving the education system to the degree that might allow it to once again compete in the world, when it can just roll up the commercial welcome mat? That the return to better funding of the education system has been a hallmark of the Democratic Party after the normal cutbacks from the Republicans (much to do with the natural personal political affiliations of teachers and their unions) does not seem to suffice for the party's populist wing.

While it is hard to imagine an erosion of the US government fiscal picture from its current dismal state, the Democrats will be constrained to honor election promises of adjusting the tax regime to favor the middle class, and will not really want to be the party in power which dictates too hasty a withdrawal from Iraq that foments chaos. The most dovish views of their old line leadership notwithstanding, as noted previous their freshman members are an unusually conservative lot (hand picked to win in conservative districts), and may be less inclined than usual to just play 'Follow the (Pacifist) Leader.'

This particular batch of newbie legislative members will need to get re-elected in two years by acting on conservative campaign rhetoric, and that means gridlock may not just be between the Republican administration and the Democratic legislature; there may be no small amount of inertia within the Democratic bloc in Congress. Not a formula for a lot getting done, unless it is centrist, and the Democrats keep Mr. Bush on side by dropping impeachment motions. The President can't really be expected to cooperate with them on a legislative program if they are in the process of trying to get him fired; no moreso than Bill Clinton was inclined to do so while his impeachment proceedings were in progress.

Hopefully that keeps the worst instincts of the Old Left in check. Of course, all of that means that the fiscal weakness will evolve from being obviously due to expenditures on the War in Iraq to more entrenched social spending once again. If the markets get the sense that the US government deficit will not shrink when defense spending comes back down, that will likely be a real shock to system for the fixed income and the US dollar. It will not be quite as big a problem for equities which do not do too badly with a bit of inflation; at least until the yields get high enough to be a real burden. At that point the market goes into the long delayed intermediate term bear trend which foreshadows economic contraction.

The irony is that the higher inflation into what is a lower economic turnover means that no matter how high the Dems push the high earner tax rates, it cannot compensate for the modest breaks extended to the much larger middle class: hello permanent big deficits. All of which gets *Back to the Future* (see below) with the same sort of "soak the rich" mentality that created disincentives to investment which plagued the mid-to-late 1970's. The *coup de grâce* is that guns-n-butter will once again be the key element of problems for a Democrat president who won the election without serious challenge. Compounding the problem is another factor that those without long memories fail to factor into the fiscal equation: the ability of the high earners to afford to park the money in tax sheltered investments that current interest in alternative energy and the like will undoubtedly afford them.

The Ugly

Entry into the most contentious part of the investment cycle has begun, and it creates unusually risky challenges for investors in all classes of assets. After the seemingly clear indications of late, 2007 is likely to be a year of change; some of which may strike quickly.

The initial reason we say this is that there are no easy investment alternatives from a clear yield standpoint. With the equities entering the fifth year of a bull market, the inverted yield curve will still cause a certain degree of forced flows into the stock markets. Managers with a broad brief have two choices, neither of them very appealing. Given that all investment performance measures (Sharpe Ratio and the like) are benchmarked against the risk-free return from short term government securities, managers must either selectively place money into the stocks of companies they believe will continue to provide solid earnings, or lock in a not insubstantial loss in an inverted yield curve.

On balance that means they are going to be forced to buy equities instead of locking in a sure under performance on the fixed income. Of course, the defensive move is to keep duration short on any fixed income investments, and use proceeds from cashing out (at only nominal losses once the yields push up) to invest in premium yields restored in long term instruments. Yet, that still forces a short term loss onto the portfolio, and presumes some timely return to higher yields and a much steeper yield curve than has been the case across the cycle so far. As such, the greater fool theory has no small amount of appeal for managers who feel that taking more risk in the late phase of the equities cycle is the only way to maintain premium performance which justifies their fees and bonuses.

In that regard one of the lessons from *The Good, The Bad and The Ugly*[1] should be revisited by senior risk managers, and kept in mind by active traders. In an early movie segment, the good/bad guy 'Man With No Name' (Clint Eastwood) is running a bit of a scam on the local communities by turning in confederate Tuco, the wanted felon (Eli Wallach), only to expertly place a rifle shot which cuts the hangman's rope after he has collected a handsome reward. In the subsequent scene where they are splitting the reward, Tuco says, "I'm the one with the risk; it's my neck in the noose." With a wry smile the 'Man With No Name' replies, "I do the cutting (of the rope.) If you cut down my percentage, it's liable to interfere with my aim."

And as we move into this phase of the markets, that is the deal with the devil which all investors and capital backers of investment and trading organizations face. As it is their money, it is ultimately their neck in the noose. Frustration is already running high from stagnant markets engendered variously by convoluted political influences, and cross currents from the unusually strong differences of opinion between major central banks. As such, there is an incentive for traders and investment managers to consider taking additional risks as the only way to achieve the sort of returns which support an attractive bonus structure; and that's the mistake a lot of people (classically) make at this point in the cycle.

A bit more patience will likely yield enough clarity on both inflation and the foreign exchange trends to encourage active, directional activity once again. Our instincts remain that inflation is not lapsing as the Fed would hope; yet it is taking more time to accelerate than in the intermediate term cycles of the 1980's and 1990's. The reasons for this are revisited below, with the influence from real yield driving the broader trend, and still leaving the long dated fixed income a bear across the cycle. This is not likely good for the US dollar, considering the potential for more social spending (albeit possibly necessary in the longer run) with the Democrats back in power, and looking to capture the White House in 2008.

Miscellany

Inflation Is Not Dead; The Cycles Are Just Longer In This Phase

In our previous reviews of the nature of the shift from the intermediate term cycles of the 1980's and 1990's we noted that everything takes longer to develop in the wake of the major cycle high exhaustion (i.e. 2000.) While yields spiked up markedly in the late 1970's, that was as much a political displacement due to the profligacy of the Carter administration as anything having to do with natural cycle tendencies. Yet, it was that much more telling that the short term yields also pushed sooner than the long term yields back then. This is due to a natural tendency for a psychological lag in the markets that depresses long term yields until there is an obvious threat to the real yield from higher than expected inflation.

While we were not actually watching the financial markets and monitoring sentiment that closely back in the early 1970's (we were moreso still involved in agriculturals and metals at that time), we can only imagine there were just as many frustrated long dated fixed income bears back then. Once the US left the gold standard and the Bretton Woods currency regime collapsed into floating exchange rates, there must have been quite a few folks who saw the potential for destabilization of the US dollar leading to higher inflation. This was exacerbated by the guns-n-butter program which the various US administrations had to run to fund both the war in Vietnam, and enough domestic social spending to keep things under control back at home (sound familiar?)

With the Fed's policies admittedly still accommodative unless there is indeed a recession, and the equity markets shaking off the housing influence to signal a better chance that there will not be one, a day of reckoning will likely soon be at hand for inflation influences. While today's PPI was a constructive influence, the crux is likely Thursday's US CPI. Yet, even if the fixed income rallies further for now under the influence of any weak near term economic data, the influence of high energy prices will continue to be a corrosive influence. Their fall from the highs so far still leaves them at historically high levels.

For the same reason that it took so long for the Bund to turn bearish after the T-note topped in the summer of 2003 (two-and-a-half years versus a norm of three months during the intermediate term cycles), it seems to be taking longer than during the 1980's and 1990's for the long dated fixed income to respond to strong economic factors and high core inflation. This is likely pure psychology, which nonetheless must be respected in the near term. If we look back to the late 1960's and 1970's, note how long it took for the non-energy inflation to become a problem even though high energy prices provided the basis for the accelerated wage demands which are a critical part of the overall inflation psychology returning to a perniciously high and ingrained state.

In that regard, we refer you to two additional resources, the first of which is another revisit to our previous (March 2005) major report 1970's Redux: Back to the Future on the **Sample Reports** page of our website. The main page link is www.rohrintl.com (or the much easier to remember www.rohrinternational.com), which is where the CFTC requires you enter the site to afford you the option of clicking down to our Extensive Risk Disclosure/Disclaimer (by design a wholly draconian affair.) While it may seem a bit dated (and we are considering a major follow up sometime soon), the historic information and graphs on how things actually unfolded in the 1970's remains instructive.

The second resource is another excellent review of the current situation from John Mauldin. His *View from the Frontline* and *Outside the Box* commentaries and excerpts from other analysts are always very interesting. In the past week these have highlighted some of the remaining inflation risks, and are better accessed directly from him than any paraphrase we might attempt. His most recent *Outside the Box* includes those adroit analyses from Rob Arnott and John Hussman, Ph.D. While this includes quite a bit of insightful, well-balanced analysis, it is Dr. Hussman's perspective, "As for the universally-known fact that slower economic growth means slower inflation, I would submit that it's not a fact at all" …which is of most interest at this critical time in the fixed income market. It is substantiated by both textual and graphical analysis of the historic tendencies.

As they both require it, and we encourage anyone who is interested to get on his email distribution list, the contact address is JohnMauldin@InvestorsInsight.com. The date of the *Outside the Box* issue noted above is November 13, 2006 (Volume 3 - Issue 8.)

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

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