Rohr Report

Capital Markets Observer

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Overview, Reports & Events,…

…FOMC, US-China Dialogue, US Housing (again), Geopolitics, Miscellany

Overview

Welcome to the pre-FOMC edition of ***Capital Markets Observer***. There is certainly much to consider when one contemplates not only any adjustments in their statement of influences, yet also that their likely 'no-action' and condensed view may not be anywhere near the most important influence of the week; more on that below.

We are again providing a bit of a different ***CMO*** format this week and probably next, as the Reports & Events section will be abbreviated to include only the key indications. Due to some holiday driven compression in the reporting schedule, there is effectively no mid-month vacuum in the US this month; more of an end of month 'hiatus' because many important reports everywhere are being pushed forward to the end of next week to avoid releasing them into the slack Christmas-New Year holiday markets. While this is sensible, it does create an overflow of economic data this week and next requiring focus on the most important releases.

The market trends are seemingly somewhat clear. Yet, the contradictions in both some of the intermarket influences and their activity in relation to the views of government and central bank officials, as well as portfolio managers are striking. In that regard the seemingly orderly trends are actually part and parcel of a raging debate. At this point that debate manifests itself most clearly as the dichotomy between the upbeat outlook from US government officials regarding the US economy's prospects into next year, and the indications from the US short money forwards and the US dollar. This is also evident to some degree in the differential between the European long dated fixed income and their short money.

As noted previous, while we are adamantly opposed to any presumption of "predictive" value in short money forwards, what is it the market ***thinks*** it sees that the Fed is missing? It was in the early days of the 2001-2002 equity market recoveries that the Eurodollar forwards were heavily mispriced to the downside in their expectation of a major Fed tightening in the wake of the initial equity market recoveries from the post-2000 bear market. However, in those cases time spent near the lows (i.e. higher Fed Funds indications) was very brief prior to heading higher once again. The sheer tenacity of the recent Eurodollar strength speaks of much more ingrained expectations of slowing or stagnancy instead of the recovery the Fed expects.

Again, this may prove wrong in the event, but the significantly lackluster response of the US dollar to a much better than expected Trade Balance (OCT) is another sign that expectations of government officials are not being translated into the market trading and trends. It is of note that better than expected US trade figures were based upon much lower than expected imports, and this comes just as indications of a somewhat weaker than expected US holiday buying season are beginning to surface. To what degree these are indicative of a sustained retrenchment by US consumers is problematic, yet it may be the first salvo in a reaction to the weak housing market continuing for quite a while, even if not degrading any further.

All of which still leaves the markets in quite a quandary, especially this week as they try to sort out whether the hopeful, high decibel pronouncements from the Hank and Ben Road Show are matched by anything more than token responses from the Chinese. This will be further complicated by a full round of inflation numbers that has already seen somewhat hotter than expected indications from the UK, as well as US and UK Retail Sales numbers (both NOV) that will be rightfully viewed as a sign of the relative strength of early holiday sales turnover (and prone to significant adjustment as the more final figures from the retailers emerge into next week.) And whatever transpires in the US, it still leaves quite a bit of influence with the German consumer's reaction to the combined impact of the three percent VAT hike to be instituted from the beginning of January, and any compounding of that from the nominal weight on their export sector from potential further sharp US dollar weakness.

In market terms that relates to any inability of the US dollar to recover back through (as a benchmark for the somewhat divergent others) EUR/USD 1.3100 and 1.2900 areas leaving it very likely to hit at least the 1.3450-1.3550 area. Of course, the broader implication is that it will also knock out the 1.3666 December 2004 EUR/USD high (US dollar low) for a move to the 1.4250 congestion or even the 1.4535 approximate all time high (from the last major US dollar down trend lows into roughly March 1995 on the pre-official Euro launch 'basket.')

The fixed income seemed to over-react a bit to Mr. Paulson's comments last Friday on the degree to which he could succeed in convincing the Chinese to significantly revalue the yuan. While the T-note fell below its 109-04/108-28 support to around the 108-20 Tolerance, it has recovered back into that area after yesterday's ballooning of US Wholesale Inventories (OCT) and disappointing Wholesale Sales. This also meant additional weakness in Europe after the predations of Monsieur Trichet's extended 'vigilant' view at the ECB press conference, which is likely why the September 2007 Euribor additional slippage below 96.20-.17 support has left it challenging the further strong congestion support back into the 96.10-.05 range) and the somewhat predictable accompanying weakness in the March Bund has left it down into the 118.30-.10 support. However, the fact remains that the major long end support remains all the way down at the low 117.00-116.80 area, with commensurate T-note support into the mid 107-00 area. Even the weak sister Gilt that slipped badly below its 109.00-108.80 support is down near secondary major support in the 109.00-108.80 area.

Equities seem to still feel the fixed income bid in the long end is nothing more than a glut of global savings that will endlessly find its way into ever buoyant stock markets. Any indication that the strength of the US long ends and short money forwards is a sign that the economy may be more vulnerable into next year has yet to surface. And while initially cautious in the wake of the renewed US dollar weakness, the European and Japanese markets are now getting back into that good old US "never say top" spirit. The fact is that without some sort of significant selloff into the end of this week below at least DJIA 12,200 and the March S&P future 1,405 area (yep, quite along way down), US equities which rescued themselves last week to remain above weekly oscillator resistances will only be encouraged in their strength by the *de facto* gain from the switch to the premium priced March S&P 500 future when the December contract expires.

And the always erratic energy markets have seen their renewed strength chilled by the major northern tier warm-up this week. As that is due to continue for now (almost all the snow has melted), the potential for the January Crude Oil to escape the 62.00-.50 resistance is likely marginal for now unless the geopolitical situation takes an unexpected turn for the violent worse (which may not be a totally ridiculous issue to watch; more below.)

Reports & Events

We've already seen some reasonable degree of news this week, and that seems to point toward the 'stagflationary' situation that we've been anticipating for some time. Weaker than predicted economic production (except for the expectations in the ZEW) have been met with slightly hotter than expected UK inflation numbers. The latter have had little impact on the fixed income markets. Perhaps this is just because the debt markets were already down from the end of last week. However, it might also be a sign that our expectations for the markets to react first to weaker economic influences, and only then respond to inflationary pressures remaining higher than expected. Ergo, the strength of fixed income at present accompanying a weaker US dollar while setting up a potential problem for the equities. Only time will tell.

Yet, the response to both the FOMC and the inflation reports this week may be a bit more subdued if the markets focus on the economic turnover numbers. Of course, that presumes turnover numbers may well be a bit weaker than expected, as has been the case of late. While we were a bit late in coming to the view that there could be some further weakness into next year based on more psychological spillover from US housing (as opposed a major further crunch), now that we see more potential weakness ahead, our view is actually more consistent with Mr. Bernanke's previous indications of the potential for housing to represent a restraining influence than he and the rest of the US government officials seem to now predict. A bit of irony there.

As such, while the really important news begins from this afternoon, it only intensifies into tomorrow with the French and German CPI (NOV), UK Unemployment numbers, Average Earnings, and Manufacturing Unit Wage Costs (annualized 3 month into OCT), followed by US Advance Retail Sales (NOV.)

As of anytime Thursday the markets will be prone to any ad hoc pronouncements from the American delegation to the US-China Strategic Economic Dialogue. Also on Thursday will be the Australian Consumer Inflation Expectation (DEC), a likely rate hike from 1.75% to 2.00% by the Swiss National Bank, the ECB Monthly Report (DEC) with a presentation by Mr. Liikanen, Italian CPI (NOV), UK Retail Sales (NOV), and Euro-zone Employment and Labor Costs (Q3), followed by the US Import Price Index (NOV.)

Friday sees more important inflation input, with Euro-zone and US CPI numbers (both NOV.) While the Japanese Tankan Survey (Q4) and Tertiary Industry Index (OCT) are also released along with Euro-zone Industrial Production (OCT), US Empire State Manufacturing Index (DEC) and Industrial Production and Capacity Utilization (NOV), the real telling impact might be moreso from the OPEC meeting, and whatever Mr. Bernanke has to say in Beijing on the Chinese economy. Not only will this be a more literal bit of tea leaf reading, it will occur prior to the opening of both the European and US markets. It looks like a very good time to have all risk management considerations in order from Thursday's Close.

FOMC

In a nutshell, we see no reason for the FOMC to vary much from the text of the October 25th statement, other than to reflect that they will maintain their inflation vigilance in the face of what could be improvement from current slowing economic growth. However, that is already well acknowledged, and any marked response from the markets would be a bit of a surprise, other than the tendency to react to the actual release. The real issue is whether the Fed really believes that, or is just politicking a bit of insurance against further housing weakness.

US-China Dialogue

The crosscurrents here are too entangled to provide full review in such a limited forum, except to note that most of our readers have extensive other resources for the broad range of issues. Most important to us are those which impact market psychology, such as Mr. Paulson's overt description of his goals for the meeting last Friday which had a distinct, if seemingly temporary market impact. And that is the key question; how much of what transpires this week is wheat, and how much chaff? The lack of any sustained strength in the US dollar from the good Treasury Secretary's explicit comments leave us wondering both just what the Chinese will do, as opposed to what they will say, and why Mr. Paulson who is known for accomplishing much with a quiet, non-confrontational style has switched to the megaphone.

The answer on both sides is actually quite apparent: US and Chinese domestic politics. (Quite a bit more on the former below in Miscellany.) Much of the strong public posture is likely for the benefit of the incoming Democratic US Congress that takes trade issues as its personal brief, and will likely only become more intensely protectionist if it does not see any constructive (in its view) movement on international trade issues. Of course, there is actually very little that can be done about this in light of a rightful Chinese penchant for 'over saving' (what a concept) in deference to their lack of a significantly effective pension and social security network. This is only among the most evident for Asian cultures which still consider thrift a virtue that underpins the often distorting effects of their governments' mercantilist policies. As Wolfgang Munchau recently noted in an excellent Financial Times opinion on why *Europe will not escape the impact of dollar depreciation*, "The idea that the Asian consumer would come to the rescue of the world economy is wishful thinking."

As such, any overt move on the currency front is unlikely in the first instance, and in any event will be taken as a move within the context of the average pace at which they are going to adjust across time in any event by the inscrutable Chinese. That said, any announcement has the ability to bring another bout of strength into the US dollar on expectations that the full further downward adjustment in the US currency (which now seems in progress) will not need to be quite as exclusively hedged into Europe and the UK due to the normal lack of effective floating relationships with Asia. Of course, in practice this is also true for the trend against the currency of the equally opaque Japanese, who are especially interested in maintaining the weakness of the yen this early in their economic recovery cycle.

US Housing (again)

It is now of note that we began our comments last week by asking what more can we say about the US housing slump that has not already been said? Obvious weakness which brought about a full one third drop in new construction that is the overt effort by builders to clean up what were burdensome inventories is well known. And then on Friday along came one of our favorite analysts and consolidators of other excellent analysis: John Mauldin's latest *Thoughts from the Frontline Weekly Newsletter*. As is often the case, he questions some dicey received wisdom, even though it is the ostensible position of the US Federal Reserve and Treasury Department. Major topic "When Will the Housing Market Bottom?" plays right into our theme from last week's ***CMO*** (II-48) that US housing may have quite a way to go prior to significant recovery. Even if indications from the sources which John cites do not further depress the market to the implied degree (which he also allows at the end of his analysis might be the case), continued lack of upside may still affect consumer attitudes.

While we have taken the liberty of attaching that as a PDF file (TFFWN061208-Mauldin), beyond my usual encouragement for anyone who is interested to contact John regarding getting on the distribution list for his analysis (John@FrontLineThoughts.com), he also makes a case this week for his previous book being a great holiday present for anyone with an even passingly sophisticated approach to the markets. Individual chapters which include insights from some very interesting and estimable folks on the primary focus they suggest as a key to the markets and investing leaves us with "Just One Thing" (© 2006, John Wiley & Sons, Inc. ISBN-10: 0-471-73873-5.) I have owned it for a while, and found it a good resource for the "outside of the box" thinking that is John's specialty.

The US paperback price works out to approximately $1.25 per *de facto* intimate chat with some of the world's best thinkers and advisors on their most important insights. These are on topics as diverse as bond market investment, contrarian market views, market psychology and natural biases, and a revisit to some basic (yet sometimes not as closely adhered to as we would hope) rules of trading. From the last bit noted here, Dennis Gartman included the wonderful reminder that is so relevant in current markets which are grappling such obvious inconsistencies:

"Rule #8: Markets can remain illogical far longer than you or I can remain solvent." While it is not much more than a classical call for aggressive risk management, this is excellent advice for a happier trading and investment community in light of both recent trends, and especially the potentially unsettled future looking forward into next year. The bottom line is the potential for US housing to remain a drag without eroding any further (i.e. remaining only as weak as exhibited to date) means the potential for a gloomier outlook by US consumers could leave a much less robust economy into next year. That's what the US short money forwards are telling us, even if the Fed disagrees for now. This is added to the potential for the presumed European engine of growth that will take over from the US being at risk from the German (and as we failed to mention previous, also Italian) consumption tax hikes, the recovery necessary to keep the equities proceeding apace may be at risk. Once again, only time will tell.

Geopolitics

What more can we add to our previous indications that this is a rapidly degrading area which may still impact anything from energy markets all the way to equities and foreign exchange. The Iranians convene a conference on the Holocaust that is substantially meant to prove it is either a fiction or substantially overstated. When exactly did putting even a single innocent person into a gas chamber, and then extracting the gold from their teeth and using their skin to manufacture lampshades become less than a crime against humanity?

That does not even begin to address the well-established body of evidence which indeed substantiates a significant portion of this horror, if not every single bit. And that does not do justice to the too often overlooked suffering of the millions of non-Jewish objectors sent to these houses of horror for their political beliefs or overt activity against the most despicable bout of mass hysteria of the often hysterical twentieth century. It is unfortunate that Iran chose to go through with this just at the time that it was being elevated in the position of a possible credible negotiating partner in the attempt to find a constructive path in Iraq. What the Iranians conveniently forget is the dictum that those who fail to learn the lessons of history are doomed to repeat its failures.

It is with no hubris whatsoever, and in fact a significant degree of dread that we recall the US response to the last set of fanatical followers of a state religion (of sorts) that it deemed too expensive in blood and treasure to defeat by standard military means. That the US has been woefully misguided in to dismissing diplomatic imperatives that should have complemented its military efforts in Iraq is now very plain to most observers. (Unfortunately that may not include the current resident of 1600 Pennsylvania Avenue.) However, to believe for a moment that means it has been 'defeated' in a way that leaves it unwilling to exercise its most extreme alternatives if it feels that modern, liberal (such as it is), capitalist democracy is threatened with extinction, unfortunately its opponents would be making as grave an error as George Bush himself made with his silly "mission accomplished" statement in 2003.

And speaking of silly pronouncements from US Presidents, Mr. Carter is back on the scene. Let us begin by saying that Jimmy Carter is undoubtedly among the most moral, intellectually adept and sincere people to ever inhabit the White House. However, those qualities in and of themselves do not a sharp political mind or great president make. He was then, and remains now, a sanctimonious dilettante. All of the pining by the left in America for a return to his era is substantially based on him being the last president prior to the evils of the Reagan Era.

However, upon further questioning they can not really justify that attempting to reestablish what they recall fondly (and hazily) as a gentler time would be worth the twenty percent interest rates, labor strife, military and political embarrassment and Mr. Carter's self admitted US state of "malaise." While his humanitarian efforts are to be lauded, he reminds us of the unattributed quote from French fabulist Jean de La Fontaine, "Nothing is as dangerous as an ignorant friend; a wise enemy is to be preferred." And none can feel that is moreso the case than the Israeli's.

It is likely just deserts for Mr. Carter that his latest book, "Palestine: Peace Not Apartheid" has caused the resignation of one well-regarded advisor, and has so far only contributed to his own diminished standing for allowing such an overtly incendiary title to impugn whatever benefit the book's insights might have provided. There are likely good grounds in the eyes of the Palestinians to believe the security wall which the Israelis are erecting is indeed the institution of a form of apartheid. However, that should be addressed through reinvigoration of a sincere peace effort led by the US and its allies as part of the overall approach to the Middle East issues noted by the Iraq Study Group. All the more the pity that Iran has put itself into a position of looking too radical to be a fair participant.

As to the Carter book itself, I must admit to not having read it. Yet, the informed reviews are that it is full of wishful thinking and outright misinformation. Not the least of these criticisms is from the very well-regarded and highly sophisticated former Clinton administration peace negotiator, Dr. Dennis Ross. Ross immediately refuted the book's claim that maps on page 148 (of the hard cover US edition) are the Palestinian and Israeli interpretations of the then evolving Clinton-Arafat-Barak peace plan.

He is very adamant that these were variations of the maps that the Americans put forward as discussion points, and he should know as he was one of the prime movers in drafting them. He says it is a mischaracterization to say they were somebody else's interpretation of a plan, and only asks that former President Carter and his publisher insert a statement to that effect in the future editions of the book. It will be interesting to see if in such a lopsided, polarizing volume the former President is willing to allow this, as that would be viewed breaking a point of faith with the American left that does not tolerate any compromise.

Beyond that, the most recent escalation between the PLO and Hamas over the attempted assassination which ended in the tragic death of three children would seem to lead inexorably to a civil war in the Palestinian Territories. That is the last thing that will facilitate any moves toward reinvigorated Israeli-Palestinian peace talks that might have been reinstituted by the US Iraq Study Group allowing that the failures of the US Iraq War call for a more active regional diplomatic effort. With whom?

Miscellany

It's true: American Government IS Even More Demented Than When We Last Inquired

This lack of ability to come to any reasonable basis for a meaningful negotiation to cool the Middle East is even moreso the case due to the lack of consensus in the US Congress that may be incapable of demonstrating the sort of leadership necessary from a crippled executive branch that continues to cling to outmoded approaches. And that's not to take a partisan view, as the lack of consensus is even within the Democratic Party (as we feared might be the case.)

Congress is quickly slipping into the sort of demented partisanship that the American people had been promised would not be the case if they would just let those nice Democrats take over from the corrupt, biased Republicans. Yeah, right. As just a bit of the most backward and pointless posturing, which is both internecine and between the Parties, consider…

…New Speaker of the House (congratulations again to the first woman to hold that post) Nancy Pelosi finally decided to pass over the very radical and legally challenged Alcee Hastings for the Chair of the House Select Committee on Intelligence. Yet she also passed over the highly qualified longtime senior minority member of that panel (i.e. from her own party, now in the majority) Jane Harman, ostensibly because she's not quite liberal enough for Ms. Pelosi. Her substitute is Representative Silvestre Reyes, who had trouble at a press conference identifying the sect of Islam which dominates the leadership of Al Qaeda, or who and where exactly the organization Hezbollah might be;

…The Don Rumsfeld resignation as Secretary of Defense not only came too late to help the electoral fortunes of the Republican Party, the guy had evidently penned a memo long prior to the election as well that mentioned possible changes to Iraq War strategy and tactics which included quite a few of the very suggestions that the Iraq Study Group has now put forward (albeit in a much different order of prioritization);

…Ms. Pelosi has backed another effort on behalf of a fellow Democratic Representative who is ethically challenged. As the subject of an FBI corruption probe revolving around payoffs allegedly accepted by Representative William Jefferson to ensure other parties were going to be awarded certain franchises, investigators found $90,000 in the freezer in his home at least loosely linked to previous conversations regarding "motivating factors." The House decided that in the absence of an actual conviction they could not impeach and expel him, albeit they'd demure from confirming committee appointments. The criminal probe continues;

…The committee investigating if there had been any official misconduct other than that by the now disgraced former Representative Mark Foley attendant to alleged long-time awareness of Foley's improper homosexual advances to House pages found that while not a very active enforcement of standards, no specific House rules in force at that time had been violated;

…And in a most bizarre turn of events for Speaker Nancy Pelosi (D – San Francisco), who is being dragged kicking and screaming in from her left wing ledge to less radical positions by House and Senate colleagues hoping for a chance to be the "Party of Effective Government" into the 2008 election opportunity to recapture the White House, on November 14th, exactly one week after the midterm elections, The People's Republic of San Francisco's Board of Supervisors passed a law that essentially says when it comes to marijuana, the city doesn't much care. The measure provides some exceptions: allowing crackdowns on those caught driving under the influence, selling pot on public property, if it poses a threat to public safety, and the use and sale involving minors.

And this is the country everyone hopes can focus its energies on solving the rest of the world's problems through clear vision and determined effort. Good luck.

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

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