

ROHR REPORT

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Overview, Reports & Events,... ...Of Bankers and Busts, Miscellany

Overview

While it has been a very interesting week to date, the truly decisive phase is just beginning with the further news and events from this afternoon. The spillover of the weak US equities Close last week into the top of this week was eminently predictable, as was the volatile basing activity of the past several sessions once the equity markets did not violate key supports during the sharp swings early this week.

To address the immediate technical contingencies prior to our broader views, those technical parameters remain the same as Monday's **TRENDVIEW GENERAL UPDATE**. Which means the critical equity supports into late this week are still DJIA 12,000-11,965 (the overnight electronic trade below it prior to Monday's official opening notwithstanding), very important gap support at the low end of the S&P 500 (lead contract) 1,380-65 range and the congestion and gap support into DAX 6,500-6,425 range (especially after gapping below 6,500 initially Monday morning.) This works hand in glove with the counter trend activity in the fixed income markets having neared or tested their higher resistances at the highs of the week.

Of note is the degree to which the carry trade concerns have only seemed to surface in the wake of equity and other asset price deflation, as opposed to having become a driver of the recent trends in their own right. It is also very interesting that the equities slipping to very near some significant intermediate-major trend support has been accompanied by the movement in a suddenly firmer US dollar not seeing the USD/JPY challenge its major support at 113.50. However, as noted previous, that is likely a bit less important than EUR/JPY testing the top of its 151.00-150.00 weekly major channel and MA 41 support, and GBP/JPY hitting commensurate 221.00-220.00 range support. While there are no doubt many important indications elsewhere, that's about it for the truly critical macro-trend levels, and we refer you back to Monday's **TRENDVIEW GENERAL UPDATE** for any additional trend views and technical projections.

What is also very important to appreciate at present is that there has been enough damage to the equity market up trends along with specific DOWN Breaks and weak trend signals that they are highly unlikely to head straight back to the old highs even if they survive their near term test of lower support. Similarly, the fixed income and Japanese yen are not likely to head straight back to their lows. While it has not been an ideal way to infuse more active turnover and volatility to markets which had become suspiciously moribund at their extended trend levels, if the equities survive the test we are more likely back into bi-directional trading markets rather than a reinstatement of the previous directional trends.

On a technical level this is reinforced by the DJIA fall below the 12,650-00 support and next lower support in the 12,500-12,450 area leaving an intermediate term up channel DOWN Break from 12,460, which will now likely be formidable resistance on any rally. Similar resistance gets very heavy on any extended recovery of the **S&P 500** future (lead contract) back up into congestion and near term trend DOWN Breaks in the 1,410, especially 1,420 and 1,435 areas. While the strong sister DAX may actually get back above the near term failure below 6,700-6,650, there is formidable resistance into the daily Island Top gaps in the 6,805-20 range; even if a trade up to 6,820 should close off those gaps, there is still significant congestion into the mid 6,800-low 6,900 area. While there will quite a bit more discussion below, those resistances in the equities should also mean that supports in the fixed income and Japanese yen will also be respected.

That said, the pivotal development into the end of this week will be whether equities indeed hold critical intermediate term supports slightly below the current trading lows of this week. While those will also remain important for the next several weeks as well, there is a critical aspect which is more telling this week than if the markets stabilize in the near term prior to possibly knocking out that lower support after a further recovery.

That factor is the degree to which equity markets will feel moreso like a true 'crash' is in progress if they trade back down and Close this week at even more significant new lows for the selloff than already experienced. While it only occurs rarely due to the sustained escalation of markets necessary to provide the necessary technical structure for the sharp serial violation of support, the degree to which markets markedly extend any single week's selloff in the immediate subsequent week is a potent psychological and technical influence.

While applied more strictly to the downward Closing Price Reversals (CPR) that actually did occur in the DAX, FTSE and NIKKEI last week, it is also psychologically relevant for any sharp corrections from a sustained trend extension to an overbought condition (or vice versa for oversold markets such as the Japanese yen.) Especially as the equities are now subject to the extended news which will impact them later this week which is far more trend critical than anything seen so far, the next couple of sessions from this afternoon are the truly critical phase of the near term market dynamics.

Is it stabilization, with less radical responses elsewhere even if they do violate the supports after a several week modest recovery? Or do the equities experience such a substantial secondary failure later this week that it encourages hypervolatility elsewhere? We have been very pointed in our view that the carry trade upside correction in the Japanese yen has been driven by extended equity weakness (fostering other asset price deflation elsewhere), as indicated by yen strength not extending until the equities remained weak into the end of last week. Yet, any further sharp weakness in the equities could put the other currencies under pressure below the yen cross rate supports noted above, and encourage the carry trade liquidation to take on a pernicious 'vicious circle' dimension avoided to date.

Of course, those yen cross rate levels should be watched in any event, as there is no guarantee that will not become a more telling aspect in their own right. However, at least until some different driving force becomes apparent, the further news and events this week are going to enter a more critical phase from this afternoon's release of the Federal Reserve Beige Book readings on the US economy. More important than any of the nominal indications on that or other reports will be the very crucial psychological market reactions.

Reports & Events

In spite of having seen many reports so far this week, the real decisions are now moreso about the ability of the most critical reports and expositions by financial figures to lend a bit of stability to the equity markets; or their lack of ability to do so. As such, we will only point toward the most important economic releases, and dwell a bit more on how the markets were allowed to enter their current hypercritical phase in the extended discussions below.

After mixed news early this week in both the US and Europe, as well as pronouncements which have been very mixed from the upbeat US Treasury Secretary and Fed Chairman and Mr. Bernanke's rather more pessimistic predecessor, we will now see the more critical central bank activity and statements and economic reports. This afternoon brings the Fed's Moskow speaking on the economic outlook one hour prior to the release of the Beige Book. While we presume these insights will be very consistent, it should be interesting if they are not.

Equity bulls and fixed income bears hope that these reflect Messrs. Bernanke and Paulson's more upbeat view. While it is not normally a major global economic influence, due to the intense speculation on the rate spreads which at least partially affect the yen carry trade psychology, the Reserve Bank of New Zealand rate decision looms a bit larger than usual. Adding extra influence to the mix is the fact that the Kiwi's early Thursday morning decision is right into the US fixed income Close, which is one hour after this afternoon's Beige Book release and one hour prior to the equity market Close. That does not include consideration of this being a bit of a contentious decision on whether to hold at 7.25%, or hike to 7.50%.

The two edged sword is while the hike might increase the ostensible attraction of the New Zealand dollar over the still low yielding yen, if the hike is not taken well by the equity markets then further asset price deflation potential noted above may trigger more upward pressure on the yen. This same consideration pervades the ECB decision. While it is a huge week for central bank decisions, with Canada and Australia already out of the way on fully anticipated 'no action' meetings yesterday and today (respectively), the balance hangs with New Zealand and the broadly anticipated ECB hike tomorrow.

Along the way tomorrow morning we also see Treasury Secretary Paulson speaking again on financial markets, Japanese Machine Tool Orders (FEB Preliminary) and their Economy Watcher's Survey (FEB), the UK BRC Shop Price Index (FEB), German Industrial Production (JAN) and the Bank of England rate decision. However, as the latter is expected to be no change from the previous 'no action' at 5.25% in spite of the hawkish views of some MPC members, that leaves the field to the ECB. Their post rate decision press conference will also be very telling as to just how hawkish the über-hawks remain. Hopefully they will make much of maintaining their flexible data driven approach. As that would seem to respect somewhat weaker German economic releases of late, as well as possible subliminal appreciation of the need to respect equity market conditions, it might be a stabilizing factor. Any overly stubborn hawkish 'vigilance' expressions will not be as soothing.

With not much out Thursday in the US the focus will revolve around to Friday's critical reports. While early day indications on French and UK Industrial Production (both JAN), as well as Italian Labor Costs and their GDP with the typical associated indications (Q4 Final) will be interesting, any trend decisive influence is more likely from the OECD Composite Leading Indicator (JAN) and US Employment report's (FEB) various components.

Additional influences from US Trade Balance, and Wholesale Inventories and Sales (all JAN) releases will hit on Friday as well. Yet, once again the final word literally belongs to central bankers in the form of the Fed's Bies speaking at a risk management conference, and Messrs. Kohn and Kroszner speaking at a Washington inflation conference. We hope all of them have some prepared remarks which will be nominally upbeat. Notwithstanding the remarks of the previous Chairman possibly being more prescient in the intermediate term, the proper stance for a Fed that should be acting as not just the US central bank yet moreso 'The World's Central Banker' (see *CMO* III-9, Wednesday, February 28th) in the current unsettled atmosphere is to circle the wagons and speak well of the economy.

Of Bankers and Busts

Why do equity markets crash? And what can central bankers do to prevent these very disruptive and economically damaging events?

For the most part markets can only 'crash' if they have been allowed to outperform some meaningful underlying intermediate and longer term trends to a degree which leaves them vulnerable to sharp, 'vicious circle' liquidation phases. However, 'overbought' conditions are not enough to foment a sharp selloff in and of themselves. It also requires a trigger which signals that previous assumptions underlying the sustained extension of the trend are no longer tenable. What experienced dealers and portfolios manager know is that seemingly over extended market trends can become even more 'overbought' prior to events fomenting the nominally overdue (and thereby sometimes dramatic) correction.

What can central bankers do about it? There is an old wheeze about how to play better golf which applies here. The advice is to go back, and take the game up at a much younger age. Similarly, the time for central bankers to get concerned about the highly vulnerable state of overbought equity markets is well before they become over extended relative to either underlying trends, or when they seem about to achieve the sort of positive reinforcement that allows for further self-sustaining extension of trends which are already quite advanced.

There are some variations over which central bankers can not exert meaningful influence. Yet, this is less often the case than their lack of desire to foment negative reactions in the markets and economy. This is likely due a distinct aversion to criticism for possibly having fomented the very cooling off periods it is their ostensible job to create as a counterpoint to unrestrained growth and associated inflation, or economic and market bubbles.

However, there has been a pernicious tendency of late for the central banks to feel they can indeed let more exuberance (sometimes to an 'irrational' degree, as Mr. Greenspan so aptly noted) infect the financial markets and deal with the fallout later. This is the corollary to the "It's different this time" mentality which attempts to assert that in some miraculous way the business cycle has been repealed. Of course, that would mean human nature as it relates to the markets has also been superseded by some new, highly enlightened perspective which has replaced fear and greed. You'll pardon our enduring skepticism.

In the most telling recent historic examples (we presume familiarity with Dutch Tulipomania and the South Sea Bubble nullify any need for our views on those) the "Crash of '87" and the very recent "Dot.Com Bust" offer good examples of market situations which precluded proper address by the Federal Reserve. Both involved fallacious positive feedback loops.

The case of the mid 1980's US equity markets run up into the summer 1987 highs had more to do with the rampant marketing of "put sales" options strategies to naïve public investors (by what may well have been equally naïve retail stock brokers) than anything over which the Fed had real control. This allowed savvy fund managers to keep buying the underlying equities that drove the up trend. The public was not long of the market in that case; just continuing to put up nominal margins to capitalize on the collection of 'put' options premiums they were convinced were never going to be exercised in a market which was going up forever.

Greed won out over fear in a manner which could have only been stemmed by the central bank taking overly draconian action on the economy. However, once the last retail customer bought the last option prior to nerves winning out in the wake of the typical foreign exchange and 'global imbalance' concerns, there was nobody left to buy what an obviously overvalued (on a P/E basis) stock market on the way down. The market continuing up had been its own fallacious positive feedback loop.

Similarly in the late 1990's, the expansion of general economic activity due to large amounts of money being thrown at the internet e-commerce function through highly profitable venture capital investments being sold out into full equity market IPO's created its own very powerful fallacious positive feedback loop. There was real money made during that period; by those who either got in early and at least partially cashed out, and among the support services which tended to the needs of the burgeoning Dot.Com companies. Yet, the received wisdom that "It's different this time" once again did not repeal the business cycle.

In fact, anyone paying close attention to the business plans of successive companies which were going to spend their huge IPO capital infusions on 'classic' advertising to achieve a level of market penetration that would also require discounted prices to establish their corporate presence would quickly realize these were pretty dated, and ultimately disproven notions. Except for the fact that they had some new product access 'function' that was going to dominate their sector, there was not much new here at all.

The most troubling part was the degree to which successive startup companies thought that their newer (i.e. by about six months) model was going to marginalize the 'process' of the other four Dot.Com companies which came just before them. They were also sure that they were each going to grab sixty percent of the 'space.' Maybe Outer Space. Possibly there is some black hole somewhere in which six different companies can each achieve sixty percent of market share in their 'space.' While all of the support companies from securities firms to shippers to even the lowly packaging business all did very well from this wanton speculation in startups with catchy ideas, the investors' money went down the black hole instead.

Ironically that occurred just as markets got past the dreaded Y2K computer problem fears, peace seemed achievable in the Middle East, and there were pretty much nothing but blue skies ahead. The year 2000 will thus stand out as the number one example of being careful in an equity market which is "priced for perfection", much as the recent markets were sure that the age of defaults and the potential for the still low yield Japanese yen to rally at all had become historic relics. However, the difference between 2006 and the equity markets of the later 1990's is the lack of any external crises such as the Asian Contagion or Russian Crisis to prevent the Fed from acting timely in an equity market which was developing another fallacious positive feedback loop. This time it was also influencing markets elsewhere, as well as encouraging credit creation that was flowing to ever more marginal investments.

The bottom line is that while the US equities were only extended to the lower echelons of what can be considered the sort of overbought conditions reached during the late 1990's into 2000, they were still over extended. This was by enough of a degree to provide the instability which has come home to roost in the past couple of weeks. Of course, this was not just through the sheer weight of US market conditions, yet rather through that pernicious recent tendency for central bankers to believe their own plaudits (much like an actor would believe their best reviews) that they could indeed repeal the business cycle through balanced activity which circumvented the need for a recession to ever occur again.

The other aspect of this is the lesson which could have been veritably gleaned from the most recent example. This was cited in various ways that ultimately took a highly specific form from the estimable Mr. Greenspan long before Mr. Bernanke took over as Fed Chairman. Because we have alluded extensively on previous occasions to Mr. Greenspan's September 2005 *Economic Flexibility* speech, we will be brief. He confessed at that time that he and the rest of the Fed came to understand by as timely as early 1996 that the equity was exhibiting clear tendencies to "disconnect from its moorings."

Along with our definitive view on this, other interest rate hawks also encouraged the Fed to act while the DJIA was still only on the approach to the old 2000 high back in the summer and fall of 2006. The general psychology was the DJIA being allowed to establish a substantial and sustained move above that old high would encourage the sort of 'irrational' exuberance, or at least abiding confidence that could create yet another fallacious positive feedback loop.

Some might note the strength of corporate earnings and economic growth since mid 2006 reinforce the degree to which the Fed would have needed to target the equities markets to justify tightening. Yet, there are several mitigating considerations. Not the least of these is factoring in how much the domestic and international confidence in the US economy and consumer encouraged activity elsewhere. If for nothing other than a nominally pernicious tendency toward conspicuous consumption (and the attendant trade deficits), the US remains one of the primary demand drivers for the rest of the world economy. By allowing perceptions to develop elsewhere that we would continue to grow unabated, Bernanke & Company were at least partially responsible for the extent of the bubble in China that became a trigger for the recent drop.

While allowing there was not an extreme bubble in the US equities, that same confidence in the US consumer and economy continued to underwrite the rabid combined quest for both funding and yield that fed the fixed income derivatives market and carry trade excesses. Those now make unwinding the current imbalances that much thornier; hopefully it all still occurs in an orderly manner. While hindsight is 20/20 even as we were clear in hoping the Fed would firm further last summer, we can not help but wonder what would have transpired.

If the Fed had not so much targeted the strong equities psychology contributing to the current global bubble, yet rather enforced their classic role of pulling the proverbial punchbowl when things threatened to get too strong, they may have triggered a mild (dare we say it) recession. Yet, in that case they'd be in a better position to ease now if the global situation warranted. And that is our issue with the Fed: insofar as perceptions of the American economy remain a very significant driver for the rest of the world, the Fed is not just the US central bank. While its influence may soon (in historic terms) be surpassed by rapidly developing economies, the Fed remains the 'Central Banker to the World', at least on a psychological level.

Mr. Greenspan's forbearance for the over extension of the US equity market and economy in the context of the problematic Dot.Com boom was in deference to a potential US slowdown exacerbating crises elsewhere into a full blown global economic meltdown. With the extreme strength of the past several years in the Chinese and Indian economies, as well as the significant resurgence of Europe from a very low (Euro currency and reform extended) cycle bottom, Mr. Bernanke had the luxury of cooling the US economy while the rest of the world was substantially counter cyclical. Instead he chose to "not rock the boat."

He and his fellow central bankers now need to stem what otherwise may become a crisis. Classic central bank activity is meant to keep things on an even keel. Mr. Bernanke's desire to not reap criticism for erring on the side of caution and possibly fomenting a recession have shown that he has yet to make the full transition from 'professor' to 'prime mover.' That was never going to be easy. Yet, it will only be that much harder to establish that sort of *gravitas* if he is thrust into a crisis after not demonstrating the proactive credentials which might have avoided quite a bit of the excess leading to the current risk of instability.

We are reminded yet again of La Fontaine's observation "*On recontre sa destinée souvent par des chemins qu'on prend pour l'éviter.*" (Our destiny is frequently met in the very paths we take to avoid it. -Jean de La Fontaine, *Fables, Book VII, fable 16, The Horoscope, 1679.*)

Miscellany

Yet, what we view as Mr. Bernanke's lax approach to equity markets which were (in our humble opinion) becoming over extended is wholly exceeded by an individual to whom we present our 'Central Banker Who's Not Ready for Prime Time' Award for last week. That is none other than Bank of Japan policy board member Atisushi Mizuno.

Even after what could readily be seen as the start of a possible crisis in the equity markets last Tuesday, on Wednesday he chose to be very candid that at least part of the BoJ interest rate hike the previous week had been to offset the "side effects" (i.e. carry trade) encouraged by the sustained low Japanese interest rate. While we respect his desire to dissuade undue negative speculation against the yen, he should consider that being blamed for a major global equity market crash might be the price to pay for espousing his consistently hawkish view at this particular moment. Well, at least he'll be in good company; if things go really wrong, it is very likely that Mr. Greenspan will get tarred with part of the blame as well.

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

-Rohr

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