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Overview, including Fractal Chaos Blues,…
…Reports & Events, Tricky Tech, Confounded Cassandra's

Overview

Chaos Theory and its major focus on fractals are wonderful things. It has many insights and applications for general businesses and analyses like insurance, meteorology and general business strategy, as well as quite a few market applications. As the name suggests, it can be especially useful to anticipate (to some degree) and analyze those phases when the markets become disorderly. While the current markets are moreso only just highly volatile reactions in the wake of the previous extended trends, this naturally raises the question of where the psychological and technical tipping points might lie.

In classic Chaos Theory terms, there are several factors which indicate the markets have entered a more psychological phase which calls for this sort of analysis. In fact, the equity markets' weakness that is the primary driver for the trends elsewhere (much more on that in the **Tricky Tech, Confounded Cassandra's** sections below) seems to fly in the face of recent general comment and economic data which has on balance been quite strong.

With the notable exceptions of today's belated release of Euro-zone Industrial Production (JAN; as volatile a data set as its US counterpart) and US Retail Sales (FEB) yesterday, the economic data began this week with the surprisingly much stronger than expected Japanese GDP (Q4 Final) revision, and has remained so during the first part of this week. As the US Retail Sales may also have been moreso impacted by weather than the effects of any general consumer retrenchment (nobody can really know), that particularly weak bit of news might be more problematic than definitive.

The question then becomes, what happened to the equities? We are reviewing that this week in our Overview because it is important to address it sooner than not. The confluence of three factors seems to have created more psychological impact than any of them might normally be worth in its own right. Sustained concerns over the subprime mortgage market were reinforced by the degree to which the OECD semi-annual major economic outlook highlighted below trend (albeit still firm) growth in the US, and. lo and behold, what should come along next but the much weaker than expected US Retail Sales numbers.

As an aside, for good reasons that OECD major economic outlook normally follows the normal monthly OECD Composite Leading Indicators (CLI) and they provide a more current view of the economy prior to that major overview. However, due to some statistical problems at the end of last week, OECD delayed the release of the January CLI until Friday of this week, after the major review. In addition to its normal aspects, there always seems to be a bit of this 'random mishap' component in any true 'chaos' landscape factors percolating up to the level of major market impact. If Friday's CLI continues to confirm the strength elsewhere in the world, it will also likely further buffer any near term US weakness.

Are the subprime problems likely to spill over into the economy at large? Possibly; yet that remains only a possibility, and a remote one at that. Was the OECD projection a surprisingly weak outlook for the US? In fact that tendency \was fully articulated in their previous major economic outlook back in September, within the view that it is a normal part of the necessary global rebalancing. The OECD view has also been vindicated by the strength of the European and especially domestic German economies, which have been strong enough to continue growing right through the major German VAT hike from the first of this year. In that regard the OECD view has proved more prescient than our concerns that the Germans might severely curtail their retail spending early this year, as the Japanese did after a similar consumption tax hike in April 1997. We compliment them on their accuracy.

Yet, concerns about housing in the US are not necessarily just a tempest in a teacup. As we have also noted previous, the degree to which Americans were afforded more comfort than usual in living beyond their immediate means was provided by the sustained and extensive rise in home values. This rightfully indicates there is indeed likely to be some sort of economic fallout from the extended housing market weakness. (For more on this please see the *Capital Markets Observer* III-4 discussion "**US Housing Still Issue for Equities**" on the Sample Reports page of our website at http://www.rohrintl.com/sample_reports.php.)

However, that influence is more likely to be evolutionary across many months than have any real impact on the bulk of US homeowners' perceptions of wealth and near term financial well-being. The only thing which might really upset things is an equity market meltdown which sends aftershocks through the general economic psychology. In light of all of the central bankers and key finance officials expressing their confidence in the world economy and specific national growth, it will take that sort of purely psychological failure to turn the current volatile yet still modest reaction into anything on the order of a 'crash.'

That has not prevented financial world Chicken Little's from drawing specious conclusions from this unseemly confluence, and shouting "The Consumer is falling, run to the King." Seemingly (to them) subprime problems will foment a collapse of the housing market into the already below trend growth in the US that can so depress the consumer as to significantly weaken their spending to the point of economic implosion. Interesting perspective, yet that does call for the tail to wag the dog in subprime somehow fomenting massive defaults among more credible borrowers who are in jobs and industries that are doing well.

Which is not to diminish the degree to which anybody losing their home is a tragedy, and one must feel for those who barely qualified and are now seeing their dream evaporate. However, much as was the case for the Hurricane Katrina victims, that is more of a personal than broad economic crisis which will affect the rest of the economy. As today's much better than expected US Current Account Balance (Q4) demonstrated, the US is in the enviable position of the weaker US dollar increasing demand that compliments Trade Balance improvement which also points to stronger US domestic growth.

While there are quite a few factors technical which should be considered in all of the markets, there are drivers for the overall trend psychology which are most telling for the major trend decisions, and the tipping points. The will be critical regarding any potential for sharp reactions becoming disorderly enough to evolve into real chaos. As such, after our review of the important data and news schedule for the balance of the week, we will be concentrating on those, and following up on the other markets' technical considerations later in the week.

Reports & Events

There are two factors which are most telling for the balance of this week, one technical and one psychological. The technical aspect is the degree to which the equity markets can hold on into the lower supports somewhat below the previous lows of the major selloff. That will determine whether last week's recovery was just a very limited weekly bounce prior to the carnage continuing, or whether there can indeed be more for a consolidation phase back up to (or even possibly somewhat above) last week's highs prior to the secondary wave of the overall correction ensuing.

The psychological aspect works hand in glove with that. Except for the FOMC interest rate decision at the end of their two day meeting next Wednesday, the US is into the back half of the typical mid-month reporting vacuum next week. As the FOMC is not likely to move the rates, and likely to attempt calming 'steady as she goes' minimal changes to their statement, extra influence ascribes to the OECD CLI (JAN) and US CPI (FEB) release this Friday, along with other important data and pronouncements beginning tomorrow. That is the last critical US data until the usual important late month data the following week.

The important late week data this week begins with tomorrow's Australian Consumer Inflation Expectation (MAR) and Employment Change (FEB), and Japanese Machine Tool Orders (FEB Final), followed by significant news from Europe. That includes French Non-Farm Payrolls (Q4 Final), the ECB Monthly Report (MAR) as their Garganas testifies in the Greek Parliament with Euro-zone Consumer Price Index (FEB) and Labor Costs (Q4) following close behind. After that it is the US Weekly Jobless Claims (for the week ending March 10), Producer Price Index (FEB), Empire State Manufacturing Index (MAR), Net Treasury International Capital Flows (JAN) and the Philadelphia Fed Index (MAR.)

Yet, as the Cat in the Hat once said to the children, "But that is not all; oh no, that is not all." Into lunchtime tomorrow on the East Coast we still get to hear from former Fed Chairman Greenspan at the Futures Industry Association, which we believe is attempting to deify him in some manner, and he is followed by the Bank of England's Andrew Sentence. It should be a very interesting late session in the US.

As noted above, Friday brings combined impact from OECD CLI (JAN) and US CPI (FEB.) Yet, along the way we will also see the Japanese Tertiary Industry Index (JAN) and Coincident and Leading Indices (JAN Final), Reserve Bank of Australia Assistant Governor Malcolm Edey's speech along with their Preliminary Balance of Payments (FEB), the French Current Account (JAN) and Italian Trade Balance. Even after the US CPI the release of the US Industrial Production and Capacity Utilization (FEB), as well as University of Michigan Consumer Sentiment (MAR Preliminary) will continue to influence the markets. Quite a week leading into next week's virtual US reporting vacuum, and that leaves the weekly Close decision by the equities very critical for the other markets as well.

Tricky Tech,

Why indeed is the technical picture tricky at present? The answer is twofold: In part because some of the major equity indices missed actually reaching critical intermediate term support at the bottom of the initial sharp selloff two weeks ago, and also because the expiration rollovers in various instruments create their usual potential for interesting second month displacements into the more meaningful levels on long term charts as they become lead contracts.

As the psychological driver which has trumped the near term economic news as an influence on the trends of other markets, the equities are the most telling. In that regard, weak sister US markets are likely the most critical into the late part of this week. This is especially true **DJIA** that actually traded as low as somewhere near the 11,900 area in the very weak electronic overnight trade last Monday (March 5th) prior to recovering sharply prior to the official opening, leaving a 12,039 low last week prior to significant recovery. Now that last week's low has been violated, there is a sense that equity markets are indeed headed lower overall once again.

Yet, the more significant underlying support which was not even hit in official trading during the week (albeit seen in overnight trading) is down into the 12,000-11,965 range. That is not just the "big penny" support with a nominal Tolerance. It is also quite a bit of congestion (down into the last early November 2006 pullback low on the general way up through 12,000), the 11,990 Fibonacci 0.382 retracement (of the entire swing from the major July 2006 reaction low to the highs), as well as daily oscillator support (MA 60 minus 500.) If that support fails, the next congestion and Fibonacci 0.50 support is very interesting: right into the old all-time high at 11,750, with an interim weekly channel lower buffer into the 11,640 area.

There is also important gap support at the low end of the **S&P 500** (lead contract) 1,380-65 congestion range and equivalent Fibonacci 0.382 retracement to the DJIA, the low end of which was neared last week and is now under attack today. However, with expiration of the March contract into the end of this week, the 13.00 premium in the June contract reinstitutes the 1,365 area as support, which the June contract must now also violate to confirm further failure of the equities. If it does, the next support is also similar to the DJIA next levels at the Fibonacci 0.50 and weekly oscillator support (MA 41 minus 15.00-20.00) in the 1,340 area.

Of note, all of this is occurring as the strong sister **DAX** is just headed back into the low end of congestion and gap support which it tested last week in the 6,500-6,425 range. However, even if that should fail, there is further congestion, Fibonacci 0.382 and weekly oscillator support into the 6,350 area.

How does all of this relate to similarly tricky technical projections in the fixed income markets? Quite simply, the emotional fixed income rally in the wake of the initial equity market debacle a week ago Tuesday also did not quite reach the full resistances above the markets any more than the equities sunk to the most critical supports. And there as well the expirations add a bit of interest beyond even that factor. Before proceeding any further, it is important to note that the presumption (likely rightful) that the equities have peaked even if they do recover in the near term has left a more buoyant undertone in the fixed income in general, and that is likely going to remain for a while.

Even after the sharp fixed income selloff after the equities kept the bid in the wake of the strongish US Employment numbers last Friday, note how quickly the debt markets began to recover once the equities stopped rallying on Monday. Yet, the June **T-note** (trading in line with the March contract) having held the support back into its own gap, congestion and daily MA support back into the 108-08/-00 range, had still not traded above the 109-02 resistance until the threat of the further equities weakness in the past couple of days. We suspect that the further extension of its rally into or beyond 109-17.5 early December high will depend upon the equities failing the levels noted above on this week's Closes. Otherwise it could quickly revert to weakness.

Similarly, the 50 point discount in the June **Bund** as it took over from the March contract last week was not very troubling for a market which has recovered to a substantial degree from its early-mid February weak sister lows. As the lead contract, March left hefty congestion and UP Breaks back into the 115.65-.40 range, and as we suspected it was not necessary for the June contract to revisit its own lower support into the equivalent patterns in the 115.00-upper 114.00 range, as long as the other long ends held well. However, the tendency for the second month to revisit premium lead contract levels if it holds the lower supports still leaves quite a bit of resistance into the 116.70 area, and even the low 117.00 area (that was not quite reached by the March contract) on both the contract and continuation charts.

The extreme premium in the June **Gilt** is driven by a significant 'cheapest to deliver' change, and is a bit more problematic. It is surely a bit disconcerting to the bears to see the market that had been the significantly weaker sister through the recoveries elsewhere for all of last summer ratchet back above the formidable congestion in the low-mid 108.00 area (which is now support once again.) Yet, the June contract is just back up to near the heavy summer congestion in the 110.00-110.50 range that it failed to violate after the initial May-June lead contract rally carried up to 110.84, which was never violated during all of the subsequent extended recoveries in other long dated fixed income. As we suspected, near term support was down into the area of what will ostensibly become (at formal end of month expiration) the Negated weekly channel DOWN Break at 109.05 (also daily gap and MA support), with a further buffer into the 108.70 congestion. In the buoyant fixed income event, the June contract held the top of that area.

All of this also applies to a lesser degree to the short money. The reason it is lesser is that any extreme short money forward recovery carries with it an implicit assumption of extensive central bank easing which will only become the case if the equity market weakness turns into the fully disorderly chaos which the confluence of weak factors are attempting to become. Significant in the markets' psychological weekly Close into the US news vacuum next week will be the degree to which they believe or reject the Chicken Little view of the confluence of factors noted in the Overview.

Confounded Cassandra's

While we have revisited this major market aspect quite often of late, it is such a focus for so many participants, and such a significant amount of misguided opinion and interpretation of market tendencies has been based on various projections and assessments, we felt a final word on it for now would be useful. In summary, while carry trade worries may have resulted in a certain degree of liquidation of what was likely an overextended Japanese yen borrowing psychology, that has not turned into a 'crisis' in and of itself. Additionally, there are now clear signs that the view we have articulated previous is correct, insofar as carry trade liquidation and attendant yen strength are moreso reacting to asset price deflation than driving it.

It is of course possible that the 'vicious circle' which some fear might still develop if the yen manages to exhibit true secular strength. However, on current form that would take a failure of some of the major currencies through their recent cross rate lows against the yen. It would even require that the weak sister US dollar break not just obvious **USD/JPY** 115.00 support tested last week, but also the more major 113.50 area Inverted Head & Shoulders Bottom UP Break which it last washed out below in May-June of last year.

It is interesting how much better that correlates with the other major currency cross rate supports against the yen noted below than the USD/JPY 115.00 area. In the event, one of the key indications that the potential crisis in the carry trade is not leading the asset deflation is the degree to which the weaker (compared to the UK and Europe) US equity markets have now traded at new lows today, yet even the weak sister US dollar is holding well above last week's 115.00 area low. As such, carry trade liquidation is definitively not leading asset price weakness, and it is moreso vice versa. In fact, if one goes back to subsequent yen weakness even after the recent BoJ rate hike and closely studies the market swings, it is apparent that the carry trade liquidation (i.e. Japanese yen strength) never did 'lead' the trend (albeit it was highly correlated with it at times.)

Obviously, if that is the case, it should be even more pronounced in the stronger economies' foreign exchange activity against the Japanese yen; as indeed it has been. As strongly suggested previous, any weakness of the weak sister US dollar against the Japanese yen was likely quite a bit less important than **EUR/JPY** holding its 151.00-150.00 weekly major channel and MA 41 support, and **GBP/JPY** hitting and holding commensurate 221.00-220.00 range support. And as their respective equity markets fall back today near their lows from last week, it is of note that the low of the EUR/JPY is only down to 152.70, and it is trading back above Tuesday's US Close. Similarly in the GBP/JPY, the low in the mid 222.00 area has also left it back modestly higher on the session.

If the carry trade 'crisis' liquidation were leading the trends elsewhere, it would be reasonable to suspect that the yen should be breaking up to a new high at least in line with that sort of the equity market weakness, if not indeed leading the way. While any future failure of those major cross rate supports by the US dollar, Euro and Sterling may indeed allow the yen to develop the sort of secular strength which cold result in 'vicious circle' liquidation, that has just not been the case to date. The fundamental relative fragility of the Japanese economic recovery, as well as the psychological factors we have covered previous likely continue to keep the unwinding of carry trade excesses 'evolutionary' rather than 'revolutionary.'

For much more analysis of why the carry trade 'crisis' concerns were likely misplaced (and remain so at present), please refer back to *Capital Markets Observer* III-8 (February 21st) for our **Carry 'Tirade' Cassandras' Quixotic Qualms** discussion of those varied fundamental and psychological factors. It is also available on the Sample Reports page of our website at http://www.rohrintl.com/sample_reports.php.)

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

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