Rohr Report

Capital Markets Observer

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Overview, Reports & Events, Markets,…
…Differential Psychology, Inflation Expectations, Targeting

Overview

Yes? No? Maybe? Is the Federal Reserve actually still committed to inflation fighting and price stability as its primary mandate? That's a good question, and one which we hope the esteemed members of the US Congressional Joint Economic Committee choose to ask Chairman Bernanke today. While there will be many additional important reports and central bank pronouncements this week, none will likely be quite as telling as whether the Chairman allows that the Fed is even temporarily letting inflation seek its own level, or remains committed to the previous comfort zone in the 1.00%-2.00% range. The answer may make quite a bit of difference not only to equity and fixed income markets, but very critically for a US dollar already under pressure due to a perception of weaker US growth.

As the headings indicate, quite a few related matters will be explored in our extended topics. Yet, whatever transpires in Mr. Bernanke's testimony the likely implications remain as discussed previous. Given the lags and differentials in the fixed income response to the overall tone of the equities, if the DJIA manages to see something hawkish (ergo likely bearish) enough in Mr. Bernanke's testimony to Close back below the 12,350-00 support (violated interim congestion resistance around the previous recovery high) that will be the overt manifestation of a rejection of the notion that last week's FOMC statement shifted the Fed's bias to easing. That will also be an indication that the recent burden on the fixed income from the renewed strength of equities in the wake of the FOMC statement might be lifted; most critically in the weak sister Gilt, which is down slightly below low end support in the low 108.00 area, as well as assisting strong sister T-note to rebound from the top of the 108-08/-00 range once again.

As noted in last Thursday morning's discussion of **The Cycle (*Capital Markets Observer*** III-12), the positive fixed income activity in the face of the euphoric equity market response to the FOMC statement was misguided as… "it is just the wrong phase for continued equity market strength to co-exist with rising fixed income markets." That came home to roost in the form of significantly weaker fixed income activity once those markets woke up to the implications of the sustained equities strength. This is also especially bad for the US dollar if the Fed is indeed allowing for more inflation across this phase of the cycle than their previous comfort range would suggest. As also noted last week,… "In fact, that sounds moreso like classic 'stagflation' (which we began warning of… …two years ago) is still a likely outcome."

And lo and behold, in spite of even more active recent pronouncements from the Fed's (as well as other central banks') inflation hawks of late, along comes Friday's 'Inflation Dynamics' inaugural speech as a Federal Reserve Governor from Frederic Mishkin. And what does the new Governor tell us? That it may be very hard to get inflation back down below 2.00% in the short-to-intermediate term without extensive collateral damage to the economy. No kidding! That seems to carry with it an implication that the Fed should not be too concerned about it.

The scary ‘stagflation’ component is that Mr. Mishkin seemed very sanguine about a return to essentially monetizing US deficits behind a shift in acceptable inflation levels. That will also ostensibly assist US consumers inflate their way out of debt. Yet, after any near term benefit, we all know that historically that has ended very badly; the near term manifestation will be the return to sustained significant US dollar weakness. We have quite a bit more to say about the **Inflation Expectations** and **Targeting** sections below, along with key US dollar technical implications in the foreign exchange analysis in the **Markets**.

Reports & Events

While there have been quite a few important reports and especially events so far this week, with the exception of Monday’s US Hew Home Sales (FEB) those have been quite a bit stronger than not. When a hawkish BoE Inflation Report is combined with various economic data that especially reinforce the ECB instincts through a very strong German IFO (MAR) yesterday and double digit annualized Euro-zone M3 (FEB) growth today, it all looks very good for the equity markets and negative for the fixed income. Yet, the further success of the equities and weakness in fixed income rests with the expression of economic sentiment and inflation credibility which Mr. Bernanke provides (or fails to provide) later this morning.

Even prior to pronouncements and responses to Congressional Joint Economic Committee Q&A, we see the US Durable Goods Orders (FEB.) Yet, that is such an erratic data set, its market influence will likely be quite limited in front of whatever Mr. Bernanke has to say. The balance of the very robust final week of the month includes today’s US EIA Crude Oil Stocks (for the week ending March 23), which will be even more influential than usual due to the unfortunate geopolitical situation evolving in the wake of Iran seizing British sailors. While markets other than energy have more or less discounted the trend implication of that confrontation so far, it certainly bears close watching, along with our hopes for the sailors’ timely release.

Tomorrow brings Japanese Retail Trade (FEB) news, along with Australian Job Vacancies (FEB), which segues into news in Europe that is supposed to include German Consumer Price Index (MAR Preliminary) data at some point this week (love those elective release times.) The additional news from Europe includes German Unemployment data (MAR), Italian Producer Prices (FEB), as well as the UK Lending figures (FEB Final), Mortgage Approvals (FEB) and CBI Distributive Trades Survey (Realized MAR and Expected APR.)

Early in the US the European Central Bank's Trichet and Ordonez speak in Madrid, while the Fed's Lacker gives opening remarks at a Financing Community Development conference which may not be very critical (but we never know when the hawks have their dander up.) Later US information includes Gross Domestic Product (Q4 Final) and associated indications, Weekly Jobless Claims (for the week ending MAR 24.)

That is followed by what are likely to be very interesting speeches that include the Federal Reserve's Kohn, the Fed's Stern speaking on the Federal Reserve, and the Bank of Canada's Dodge speaking in New York City on Sound Economic Policies. That is followed by the very late (in European terms) of the French Unemployment Change (FEB) after the US markets are Closed.

Friday begins with quite a bit of news out of Japan that includes the Jobless Rate (FEB), the usual mix of Household Spending (FEB) indications, as well as Tokyo (MAR) and National (FEB) Consumer Price Indices, the Nomura/JMMA Manufacturing Purchasing Managers' Index (MAR), Industrial Production (FEB Preliminary), Labor Cash and Overtime Earnings (FEB), Vehicle Production (FEB), and Housing as well as other Construction Starts (FEB.) Along the way the Fed's Lacker speaks on Inflation and Unemployment in Richmond (Thursday evening), prior to Australian Private Sector Credit (FEB.)

Europe sees German Retail Sales (FEB), and French Consumer Confidence Indicator (MAR), French Gross Domestic Product (4Q Final), and French Producer Prices (FEB.) After that it's Italian Hourly Wages (FEB), the Euro-zone Consumer Price Index (MAR) and various Consumer and Industrial Confidence indicators (MAR) along with the Unemployment Rate (MAR.) That is followed by the Italian Consumer Price Index (MAR Preliminary) and UK GFK Consumer Confidence (MAR.) All of which is prior to the Fed's Plosser speaking at that Financing Community Development Conference right into classic US final monthly statistics. Those include Personal Income and Consumption Expenditure (FEB), with its PCE Price Index, Chicago Purchasing Managers' Index (MAR), Construction Spending (FEB), and Michigan Consumer Sentiment (MAR Final), all prior to Fed Chairman Bernanke also speaking at that Financing Community Development Conference into lunchtime.

Markets

EQUITIES

Whatever transpires next in other markets, the equities have now put themselves in a position to require further upside follow through confirming that the post-FOMC statement surge more than just a highly energetic return to the initial failure levels. If so, that would leave them topped out, and headed back down to the recent lows, or even more likely below them to complete overall corrections.

As we will concentrate on the contingencies for trend setter (albeit not the most volatile on the upside) **DJIA** below, we note here that key resistances in other equities are June **S&P 500** (now lead contract) 1,450-54 and 1,460-62; strong sister **DAX** in the 6,845-60 range (even though that was marginally exceeded on last week's Closing late rally); **FTSE** 6,315-30 and 6,355-80; **NIKKEI** 17,500-600 and 17,750-850.

The specific near term test of the equities success in maintaining the strong resurgence will be the ability of the **DJIA** to Close above the 12,450-12,500 range resistance Tolerance at 12,560, with commensurate levels in the other equity markets as already noted. If so, the only DOWN Break on the charts (below the aggressive weekly intermediate term up channel from the June-July 2006 lows) will be Negated, and a push to, or through, the February 12,796 all-time high will be in order.

However, if the DJIA can not knock out the higher resistance it already tested at the top of the recent surge, it will still look moreso like a typical sharp upward correction in a bear market. Just as the drop to a new trading low for the break into more formidable support in the 12,000-11,965 area (in fact just below it) was not sustainable two weeks ago, so too would the current rally (which we expected) above the mid-March 12,350 previous recovery high <u>not</u> actually represent a trend turn back into a bull, and any drop back below 12,350-00 would represent a near term failure.

In fact, turnover remaining much heavier on the way down on previous recent major selloffs reinforces the notion that if higher resistance is not broken, the recent recovery (including the post-FOMC violent surge) will have only been a full recovery that leaves equities topped out. In that case, they are likely headed back below recent lows to complete the overall correction. Along the way back down to the 12,000 area, the 12,350-00 (as noted) and 12,100-12,050 areas remain interim support.

FIXED INCOME

The good news for the fixed income bulls in the lack of a sharp selloff in the face of the equities surge after the FOMC statement was short-lived. While the strong sister US fixed income held support at June **T-note** 108-08/-00, the **Bund** has dropped below the 115.65-.40 range, albeit not quite to the 115.00-upper 114.00 area as yet. Weak sister June **Gilt** has failed below the 109.00-108.70 support (now resistance) in the wake of various hawkish indications and fiscal burdens, and is now even slipping marginally below the congestion back into the summer trading range lows and end of year gap in the 108.40-.13 range.

While there is some residual **Gilt** support into the 108.00 area and congestion around 107.62 contract lows, due to the (new cheapest-to-deliver inspired) major upside transposition of prices, any 're-failure' of the lead contract (which is June from today's Close) below the upper 107.00s could lead to a collapse back into the low 106.00 historic support last seen by the March contract back in February (prior to the sharp equity market selloff.) This is the most critical illustration of why the equity market response to Mr. Bernanke and the balance of the news this week likely remains a critical, if erratic input for the fixed income.

The other weak sisters are of course UK September **Short Sterling**, and September **Euribor**. While the former had more of a recovery in the wake of previous weaker UK news, seemingly dovish discussions at the Bank of England MPC meetings have now been reversed. It has now stalled in any event on repeated tests of its obvious 94.40-.42 resistance, and remains down into interim congestion support in the 94.24-.22 range, with far more major support remaining at the historic congestion and previous trading lows in the 94.10-.05 range last seen in late January-early February.

The September Euribor is a different matter altogether, as it remained under the influence of Über-hawk ECB. While the initial sharp drop in the equities back on February 27th brought a spike up to secondary resistance is in the 96.15-.20 range, the following week's rally attempt could not even foment a daily Close above the 96.02-.05 resistance, and market has actually spent the last week back below the early February 95.93 high of the trading range. That is all very consistent with consideration of the ECB still remaining hawkish in the face of the strong European and especially German economy, and without some further global equity market weakness back below the pre-FOMC statement highs it will be hard to motivate any sort of recovery. Even if the equity markets do selloff back below the near term supports, the rallies here should likely be viewed as temporary. Yet, with the market holding support well in the 95.85-.80 area, it remains problematic how much further down this market might fall.

FOREIGN EXCHANGE

The foreign exchange view remains very much the same weakening US dollar anticipation in spite of a weaker yen that refutes the extensive carry trade 'crisis' concerns, and is the one place where the US dollar can seem to keep the bid.

In addition to all of that, the **US dollar Index** has also sold off into yet another new low below previous holding action at the .8350 congestion support (which it failed again on a retest in the past couple of sessions) after failing the last rally to the mid .8400 previous failed support. However, it is still holding lower support (likely due to the weighting of the USD/JPY) down into the December lows and basing action in the mid .8200 area, which is only marginally the case against the strong sister Euro, and not the case at all against the Australian dollar.

However, even as the index holds slightly above the critical support, that tendency for the weekly MACD to finally exhibit a more convincing turn to the DOWN side is very apparent; and even moreso against the upside leaders. In fact, due to the very lengthy sideways trading range consolidation which the buck experienced against the other currencies for most of 2006, and the somewhat substantial recovery reaction early this year (after the late 2006 drop), the US dollar is also not very oversold against any of the other currencies in its long term technical structure. It is certainly a major trend consideration that the inauspicious fundamental outlook for the greenback is not offset by any technical conditions.

The critical levels against the other currencies are **EUR/USD** 1.3350-67 reinstated resistance from back in December, extended support back in the upper 1.3200 area and mid-low 1.3100 area, with extended resistance at the (late 2004-early 2005) 1.3460-1.3520 congestion, and 1.3666 (devilish) eleven year high. **USD/CHF** is till respecting its 1.1900-1.1880 UP CPR reversal bottom from December, which also reinforces the basing action from May 2006, resistance remains in the low-mid 1.2300 area.

Previous weak sister **GBP/USD** has sustained its rally above the 1.9500-50 resistance (now reinstated support) on the back of dollar weakness and pound strength in that past several sessions, and has extended resistance in the 1.9750 and 1.9850-1.9915 congestion and previous (post BoE rate hike) January high areas; however, above that the 2.0050 and 2.0100 early 1991 and September 1992 (respective) highs are still close at hand.

USD/CAD failed badly last week from its previous recovery to repeated tests of the 1.1800 area congestion resistance, yet below recent trading congestion support at 1.1600-1.1566 (now short term resistance) it is still only approaching its major congestion, weekly up channel and MA 41 in the 1.1475-25 range, which it will need to break in order to return to the more aggressive bear trend which bottomed out back in May. Meanwhile, the strong sister **AUD/USD** is well above its previous .7980-.8000 resistance (now near term support), which was much more than just some sort of “big penny” level: it was also the major February 2004 and March 2005 Double Top (with a break to .6776 in between), which also made it a more than six year high going back to the December 1996 .8212 high. Yet, that is now also the next resistance, with the previous major high above that not until the August 1990 .8493 high.

And the poor co-weak sister Japanese yen remains stuck in a trading affair against the buck, with recent **USD/JPY** retests of 118.00-.50 failing, yet no sign that more major support in the 115.00 and 113.50 can even be significantly challenged, much less violated. Of course, that also means the cross rate strength of the other currencies against the yen continue to refute any sense that the carry trade ‘crisis’ is anywhere to be seen. While that may re-invigorate itself if the equities lapse back into weakness, it is now glaringly apparent that the carry trade liquidation had been moreso in response to the equity market (and other asset class) weakness that the cause of it.

As the **EUR/JPY** pushes well back above its 155.00-154.50 previous weekly channel DOWN Break and congestion, next resistance is not until up near the 159.00 area, with the old high as nearby as 159.63. Similarly, albeit a bit less so in spite of the recent British pound resurgence, **GBP/JPY** is also just back above its previous 229.00-228.00 weekly channel DOWN Break and congestion, yet with quite a bit of resistance remaining in the 232.00, 235.00 and upper 2.3000 areas.

ENERGY

As noted previous, energy market weakness to mid-March had been seasonal weakness, and the shift to a focus on summer cooling and driving needs would begin to favor the bulls, as has the geopolitical impact of the Iran-UK standoff over the return of the UK sailors. Along with an early (pardon the pun) jump start due to the temporary sharp spike to unseasonably hot temperatures in the US southwest, further assistance for the technical picture came from the premium of the May **Crude Oil** (now lead contract) to the recently expired April contract which transposed prices (likely very rightfully) back above the 60.00 area (now reinstated support extending down to congestion in the 59.00 area.) The geopolitical influences have now encouraged a recovery back above the lead contract and May congestion in the 62.50 area. The real test will be whether the market can sustain activity above upper 63.00-low 64.00 areas, with extended resistances up at 67.50-68.00, and not again until the 71.00 area.

Differential Psychology

We have been very strong in our view that recent activity in a broad range of other markets from commodities to metals to energy dictated that it is the wrong point in the cycle for the equities and fixed income to trend together. In consideration of the potential for either a more sustained equities correction evolving if they have topped, or a return to the old highs or beyond on the upside if they have not, counterpoint between equities and fixed income is as likely a theme now as it was back in early 2006.

Yet, those extreme contrarian views of the likely equity market trend after the early February sharp selloff have also generated a differential between various near term phases of equity market activity and the fixed income responses instead of any consistent proportional inverse debt market activity. This is further exacerbated by the differential between core expectations for the different economies, with Europe and the UK still presumed to be much stronger even if the US does continue to grow overall; all of which is also reinforced by macro-economic views from sources such as the OECD.

In the first instance the sharp initial equity market selloffs in late February left a view that there could be a crash (thankfully avoided) or at least a reversion to some extreme weakness (i.e. new low for the break) at any time. This meant that the initial recoveries in the equities that were sort of impressive on a sheer percentage basis were not taken very seriously by the fixed income markets (with the notable exception of a Euribor still under the influence of Über-hawk ECB.) This meant that the initial equity market bounces of early- and mid-March were met with only minor setbacks in the debt markets; why bother to weaken too much when the next equities selloffs into new lows are likely at any time?

While the shift to a seemingly more dovish FOMC stance last Wednesday encouraged a degree of fixed income strength along with the equities explosion, the implication of the equities recovery above the mid-March highs was soon a burden on the fixed income.

And one that could not be easily shed now that equities are ‘good’ again in the wake of the ‘obvious’ signal from the Fed that its tightening bias has been reversed, and the next move in rates will be down. Even though the return of very hawkish pronouncements from almost all other Fed Governors or regional Presidents has once again brought that into question, the degree to which equities remain above those interim highs has reinforced the stronger global economic sentiment which the central bankers all (rightfully) trotted out initially to counter the potential for an equity market meltdown after the initial late February weakness.

Along with the stronger than expected news from most quarters other that the crazy-quilt of alternating very strong and very weak US housing data, that is why the fixed income needs the equity markets to exhibit more weakness in the near term to recover. In spite of the fact that might be due in part to a less accommodative stance from the Fed than the inferences from the FOMC statement might have signaled, the equity and credit market bubbles were at least partially responsible for the previous excesses, and some sign from the equities that they are indeed still (possibly) topped out and headed lower will be the critical counter trend influence it takes to put a bottom into the fixed income.

The other glaringly apparent result of stronger growth outside of the US is the degree to which other fixed income markets have been more damaged by far during the recent equity market resurgence. While part of it is that they all held up better than would have been the case if presumptions of equity market weakness had not been in place prior to last week, the stronger economies elsewhere have generated more extensive fixed income weakness below the interim pullback lows from earlier this month than in the T-note, which is supported by that abiding sense the US will only grow at a below trend rate for the balance of the year. That is opposed to Europe that has above trend growth apparent in Germany, and a UK economy which may be much stronger and have much more telling inflation pressures than presumed recently. All of which can be readily observed in the degree of recovery in the DAX and FTSE compared to the DJIA.

That is also why whatever Mr. Bernanke has to say today, and how it is interpreted by the trend setting (albeit not necessarily trade leading) DJIA is most important. Beyond that, whatever the Chairman says about the conflict between Mr. Mishkin’s remarks and the seeming conflict between those and the communication from many others in the Federal Reserve system will be telling for overall credibility: both the institutions’ and his own.

Inflation Expectations

As noted previous, Mr. Mishkin’s extensive discussion of the practical considerations of implementation of Federal Reserve policy was quite radical and in its way very alarming. While still ostensibly committed to inflation fighting and price stability as its primary mandate, if the Fed is willing to accept even temporarily letting inflation remain no lower than the top end of its previous comfort zone in the 1.00%-2.00% range, it speaks of a return to tendencies which we have not seen for quite some time.

As we noted awhile back, the last time the Fed took the stance that interest rate actions were not going to make a meaningful difference in the overall inflation picture becoming any better was back in the Carter era G. William Miller Fed. We can not speak for others, yet are fairly sure that the return to regime which gradually allowed the inflation expectations to remain at levels which ballooned into double digits is not very high on anyone’s wish list.

While this may or may not have immediate implications for the debt markets, intermediate term implications for an already weak US dollar that is at risk of dropping below critical supports just as trend indications have eroded once again is stunning. The Purchasing Power Parity calculus is compelling. If 2.00% is the floor for inflation, the US dollar loses more than 30% of its purchasing power over a 20 year horizon; if that's the floor, it will soon be easy to hypothesize a 2.50% average: a loss of close to 40% across the same time frame.

And that is the (historically) very recent lesson in how attempting to monetize the high cost basis for energy and excessive consumer debt eventually seeps back into being a major inflationary factor. While the central banks don't want the opprobrium for foisting a recession onto already burdened consumers when energy prices are high, historically that is the only way to make the point to the oil producers through lower demand.

This is a classic Catch-22, especially as Mr. Mishkin may have a point. While appropriate action may have been possible earlier in the cycle (i.e. before the economic excesses, and inflation expectations becoming so ingrained at present levels), it can not now be addressed due to the extreme over-extension of US housing sector euphoria (a direct result of the Fed allowing credit and equity market exuberance), and its subsequent fragility.

While it will be an important indication for near term market reactions, whether Mr. Bernanke creates a sense today that the Fed is still in proactively in charge or simply reacting to the economic winds will also be an important influence on whether the US Congress will trust the Fed with another mandate which Mr. Bernanke seems to desire: an overt inflation target. However the markets react today and through the balance of this week, the professor will need to demonstrate he has not lost control of the classroom to encourage enough confidence that he (and future Fed Chairmen) can be trusted to manage that mandate.

Targeting

There was an interesting editorial in the Financial Times yesterday (attached) on the benefits attendant to the Fed adopting an explicit inflation target. Whatever your views on this, their focus is of interest not only for its restatement of their consistent stance, yet also for a very insightful *real politik* acknowledgement that it will only occur if the political environment and promotion of Congress is effective in bringing about this constructive change. While it seems to be a key desire of Mr. Bernanke as well, recent Fed wavering in its need for anticipatory action to head off inflation and over-exuberant markets has been counter productive.

Experienced shooters know effective action means aiming well ahead of a moving target. The dilemma for the Fed is Mr. Bernanke’s desire for transparency arrived just as economic cross currents became more muddled. With mixed data from various sectors the ostensible ‘transparent’ situation, the FOMC is left in more of a reactive than proactive state.

The FT’s consistent position on the benefits of an inflation target includes the critical factor that it should be ‘medium-term.’ A system similar to the Bank of England’s requirement to provide formal explanation if inflation exceeds certain bands occurs in practice through various forms of communication. Yet, that mandate requires a forward view of policy implementation in spite of criticism of actions not consistent with current economic data.

Regarding this cycle (as we aggressively noted last summer into the fall), various indications should have left the Fed more hawkish previous, pulling credit and equity market punchbowls. That might have avoided the excesses which have now back-lashed into concerns about avoiding a US housing crash. More hawkish action previous would have allowed a more dovish stance now, while likely enhancing their inflation credentials.

While not explicitly stated, Mr. Mishkin's tacit indication that it might take a recession to get inflation down to something resembling price stability is right. I am glad someone at the Fed has finally said it; less glad they are now stuck in a phase where otherwise normal cyclical tendencies would risk a hard landing that might have been avoided last year. Viewing price movements as communication, I do not envy the Fed or other central banks their constant and often trying negotiation with economies and inflation. Yet, there is a hard and fast rule in successful negotiation: never lose control of the conversation.

Success relies on maintaining the ability to set the frame of reference; even if that means taking aggressive positions at times. In not risking a cool down sooner, the Fed has become the proverbial deer caught in the headlights; captive to the current extreme cross currents in the US economy. As opposed to transparency, those cross currents have now fomented vehement debate inside (and beyond) the Fed, as the professor seems in jeopardy of losing control of the classroom. And as the FT aptly noted, the key element is whether Congress can be seduced into approving an inflation target.

That would be far easier if a previous tightening which had headed off the worst excesses of the equity and credit market excesses allowed for a current transparent easing. It would most certainly go a long way toward instilling Congressional confidence in the Fed's commitment to the second half of their mandate: encouraging sustainable employment. Their previous lack of anticipation in the face of excessive capital markets exuberance and price pressures has deprived the Fed of that luxury.

Mr. Mishkin's speech has now put a lot of pressure on the other ostensible dove at the head of the Fed, and we do not envy Mr. Bernanke the balancing act he will need to perform at his JEC testimony today. Especially as any further vacillation will not only impact the credibility of the Fed; there is also little chance that a deer caught in the headlights will inspire enough confidence to create any chance Congress will trust its ability to effectively implement even a flexible form of the inflation target Mr. Bernanke's desires.

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

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