

Rohr Report

CAPITAL MARKETS OBSERVER

Volume III Number 14

Wednesday, April 4, 2007

Overview, Reports & Events, Markets,... ...Misguided, The Fed's Real Challenge

Overview

What a wild week. It's fair to inquire whether we mean last week or this week. In fact, both; and very possibly next week as well. And the truly wild part is not so much the ostensible volatile influences which have impacted the markets, or even the very interesting responses. It goes much further than that, into realms of **Misguided** overall perceptions of the true factors and contingencies which are driving the markets' various psychologies.

Prior to reviewing what may happen later this week and the very interesting wake left by last week's news and the attendant price swings, consider for a moment that next Wednesday is the release of the minutes from the last FOMC meeting. After the mixed messages from their statement, subsequent JEC testimony of Chairman Bernanke, and the wildly disparate views expressed by members of the Fed system, it will undoubtedly be one of the most closely scrutinized and potentially influential set of minutes ever.

Other than those, the US enters its typical mid-month reporting vacuum next week. It is also typical to shift to more influence from European data and inflation numbers, reinforced next week by the ECB rate decision and press conference which is being deferred from this week's normal first week of the month schedule. As such, central bank influences, either direct or inferred, will continue to be a major focal point for the markets; especially whether they are perceived to be fully focused on the reality of the economic and inflation situation.

Whatever might come next week, this one still promises to be fraught with radical influences from the geopolitically influenced crude oil market, to major early month economic statistics, to the equity market indications for the forward looking economic responses which are still a significant influence on the fixed income markets. Please note that in addition to the regular discussions of trends and levels in the **Markets** section, there is further important background in **Reports & Events** on both the schedule and historic tendencies for the markets in what will be a very unusual session structure this Friday in US derivatives markets while the rest of the world is out for the Good Friday holiday.

Our basic view remains that equities trending higher in a global high growth environment with sustained inflation pressures is not good for fixed income, yet still may not assist the US dollar with US growth lagging the balance of the world, and potentially weakening further. While sustained growth in the US is viewed as being below trend, it will still maintain enough strength to encourage upbeat expectations elsewhere. That is one of the key aspects which makes the Fed's job harder, as the fear of crippling an already weak US housing market does not allow for a unified inflation focus, as the recent public food fights among various members of the Fed system has shown. For now, unless weak sister DJIA fails the 12,350-00 support, look for further erosion of fixed income, especially in Europe where critical lows are already modestly violated (June Gilt 107.42), or very close at hand (June Bund 114.55-.46.)

Reports & Events

While it is actually the last important influence on Friday, we felt it best to get to the bottom line on the US trading hours and potential implications for a day that most major reporting calendars have mistakenly specified the US is closed like the rest of the world. As noted yesterday, the reason for the US authorities consistently releasing data on the first Friday in April even when it is a Good Friday is anybody's guess. The classic answer gets back to the US paranoia about mixing anything that smacks of church and state, as Good Friday is a religious holiday. Yet, possibly the fact that across time this holiday has become heavily secularized should inform their view.

Whatever the reason, US Employment (MAR) and Wholesale Sales and Inventories (FEB) will be released Friday morning, as will the OECD Composite Leading Indicator (FEB), which we have now confirmed through direct contact with them. Along with all of Europe and the UK, there will be no trading on any of the US stock exchanges (including a rare NYSE full closing holiday), nor in any metals, agricultural or exotic commodity derivatives.

The one exception to the total blackout on equities trading will be the Chicago Mercantile Exchange Globex equity index products trading overnight from Thursday until 8:15 AM (CDT) Friday morning. That will give all of the world's equity traders a 45 minute window to take any hedging activity they feel is warranted after the Employment report. The Chicago Board of Trade's e-cbot trading will not open Thursday evening, so CME Globex electronic trading will be the only equity contracts open anywhere; a formula for a radical reaction to any radical deviation in the employment figures.

As much as this has been the case at times for equities during these occasional abnormal holiday abbreviated trading sessions, the potential for radical reactions has been even more prevalent for fixed income markets and the to a lesser degree foreign exchange. The reason for this is fairly straightforward, and especially telling when the fixed income is already a bear market struggling to hold support. If there is a major failure from stronger than expected numbers during a session when the rest of the world is out and there is only a limited time to react, who is going to risk grabbing the proverbial 'falling knife'?

While it is not necessarily a given that bear markets must fail support on Good Friday, historic examples from 1994 and 1996 are compelling. Stronger than expected US Employment data on those two occasions significantly knocked fixed income markets. Weaker than expected numbers in 1999 left the fixed income markets in a mild temporary recovery along the way in their intermediate term bear trend. Yet, this week's report is moreso fraught with risk due to the sustained strength of the equities, and resilience of inflation indications which have not been as fully reflected of late in the US markets as for the UK and Europe.

Especially as the US has the least robust economy and equities bull trend, along with the commensurate (relatively) strong sister fixed income, any overt failure would be especially devastating to already weak fixed income elsewhere. While it would admittedly be a bit of a self-fulfilling prophesy, any initial sharp June T-note failure below the 107-24 Tolerance of the 108-08/00 support would not only be bad for the T-note; it would also foment selling pressure to hedge exposures or attempt to capitalize on the very high likelihood of further weakness in Europe early next week. It should not be lost on anyone that the UK Easter Monday holiday means weak sister Gilt (as well as Short Sterling) does not trade again until next Tuesday!

Yet, that remains a long two days from now. In the interim, the most recent releases have been mixed, yet still confirming growth and some inflation are the main influences into the various markets. And at this point in the cycle it is important to remember that the equity markets do not mind a bit of inflation which speaks of enhanced pricing power.

The first of the recent economic releases late yesterday evening was the UK Nationwide Consumer Confidence (MAR), which was higher on the month. The Reserve Bank of Australia's no action was expected, and seemingly reinforced by the weaker than expected AiG Performance of Service Index (MAR.) While today is void of any Japanese economic releases, Bank of Japan Deputy Governor Muto gave a fairly hawkish speech in Tokyo that was based on the economic outlook, and not on any carry trade influences. The UK and Euro-zone Purchasing Managers Indexes of Services (MAR) were mixed, yet with Germany and France still coming in a bit stronger than expected. The UK BRC Shop Price Index (MAR) was a bit weaker than expected.

However, in spite of Euro-zone Retail Sales (FEB) coming in mixed (with an upward revision to last month's figures), German Factory Orders (FEB) were very strong. Of note, the ECB's Liebscher all of the hawkish views on excess liquidity and strong growth just as the OECD monthly Consumer Price Index inflation report showed a fairly significant uptick. While this was based significantly on energy prices, that is still part of the inflation inputs which will not likely cool down unless and until there is some slowing in the global economy. And that will likely need to be led by the Fed further cooling of the US economy, even if it risks a recession in the process. US reports proved mixed-to-weak as much lower than expected Challenger Job Cuts were offset by weaker ADP Employment Change (both MAR), Factory Orders and Inventories (both FEB), ISM Services (MAR.) We still await EIA Crude Oil Stocks that are substantially moot in the wake of the UK hostage release, along with the Fed's Fisher speaking in Austin on the US Economy (should be interesting.)

Thursday begins with the Australian CashCard Retail Index (MAR), followed by the UK Industrial and Manufacturing Production and German Industrial Production (all FEB), and the US Monster Employment Index (MAR) prior to the Bank of England rate decision. The US sees the typical Weekly Jobless Claims (for the week ending MAR 31), and the release of UK NIESR GDP Estimate (MAR) late Thursday evening.

In addition to the other possibly critical economic news released into the abbreviated US trading session, Friday morning also sees Japanese Leading and Coincident Economic Indices (FEB Preliminary), as well as French Construction Costs (Q4.) After that it's the OECD Composite Leading Indicator (FEB), as well as all of the US reports noted previous. And in a week which has seen a relatively light speaking schedule by central bankers, they actually do not get the last word for a change; this week that's left to the markets.

Markets **EQUITIES**

Whatever transpires next in other markets, US equities have now put themselves in a position to once again require further upside follow through to confirm that the previous post-FOMC statement surge is fully back on track. If so, that would leave them open to a push back to higher resistances; if not, they 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 the key resistances in other equities here. June **S&P 500** (remaining very well calibrated to the DJIA) has daily gap and congestion resistances at 1,450-54 and 1,460-62.

Strong sister **DAX** back above both the 6,845-60 range and the 7,000-40 range from the February high has extended resistance in the 7,085 area (November 2000 reaction high), and not again until near 7,500. **FTSE** is back above 6,315-30 and challenging 6,355-80. Next resistance above that is the trading resistance in the mid 7,400s reached in February, which did not quite reach extended historic congestion resistance in the low-mid 6,500 area.

NIKKEI has been burdened by the return to somewhat weaker news in Japan, and is still struggling with the 17,500-600 area, with next resistance as nearby as the 17,750-850 range. It is likely that only a significant push up through resistance in the DJIA will assist Japan in Negating those resistances.

The specific near term test of the equities success in maintaining the strong resurgence will once again be the ability of the **DJIA** to post a weekly 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 three weeks ago, so too would the current rally (which we expected) above the mid-March 12,350 previous recovery high not actually represent a trend turn back into a bull, and any drop back below 12,350-00 would still 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

As noted yesterday, the more critical trend support tests are coming in Europe due to the relatively stronger state of the European economies and equity markets which has once again been demonstrated on the most recent price swings. All of which keeps the pressure on already weak fixed income. As noted in yesterday morning's **TrendView MARKET ALERT**, downside leader **Gilt** was already below support into the 108.00 area (now resistance, and yesterday put in an initial daily Close below the 107.62 contract lows, as well as mid-March continuation chart trading congestion at 107.42. That lower level is the last ditch prior to a potential collapse back into the mid-low 106.00 historic support; that was last seen by the March contract back in February (prior to the sharp equity market selloff.)

Similarly, the **Bund** has slipped below its low 115.00-upper 114.00 area support (now resistance) on the contract (discounted to premium continuation levels set up by the March contract prior to expiration) from its Inverse Head & Shoulders Bottom UP Break. Of note, 114.46 is the Tolerance of that UP Break at the low of the right shoulder of the June contract pattern. That is also the last continuation chart pullback low from September 2004 (during the return to a bull trend out of the sharp selloff from the 2003 highs), which the lead contract just missed hitting during the May and July 2006 intermediate term bottom, and again on the tests earlier this year. Next major lower support below that is not until the 113.35-20 range.

As the short money is also either dipping or remaining below key supports in the wake of the various developments today (September **Short Sterling** 94.24-.22 range, **Euribor** 95.85-.80 area, **Eurodollar** 94.95-.92) with next supports approximately ten points below those violated supports, the last shoe to fall (how typical of late) is whether the June **T-note** breaches the 107-24 Tolerance of the 108-08/-00 support on a weekly Close. While its holding action has not been of much assistance to the others, a failure would represent a full capitulation.

However, if the T-note can Close back above violated near term congestion support in the 108-08/-12 area, it may be ready for a recovery back into the upper 108-00s, which could be a saving grace for the balance of the fixed income markets. Which is precisely why all of the near term gyrations this week prior to the OECD Composite Leading indicator (FEB) and US Employment report (MAR) on Friday are so much noise, unless the Bank of England stuns the markets with a surprise rate hike tomorrow. That, however, is a remote possibility.

FOREIGN EXCHANGE

The foreign exchange view remains very much (in fact tediously so) the same weakening US dollar anticipation in spite of a weaker yen that continues to refute previous 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, last week the **US dollar Index** has also sold off into another test of the 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 MACDs to finally exhibit a more convincing turn to the DOWN side is very apparent; and even moreso against the upside leaders. That said, the recent holding action of the buck has put daily MACDs back into balance, and the bears need to reassert the pressure on the US dollar soon to prevent any further strength that might impact the down trend.

However, as noted previous, 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 still respecting its 1.1900-1.1880 UP CPR reversal bottom from December, which also reinforces the basing action from May 2006. Near term resistance is in the 1.2250 area, with the more important trend resistance remaining 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 the past two weeks, and it is now also beginning to challenge extended resistance at 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 1.1500-1430 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.) That also made it a more than six year high going back to the December 1996 .8212 high, which the market is now approaching on its extended rally. Next resistance above that is not until the previous major August 1990 .8493 high.

And the poor co-weak sister Japanese yen remains under pressure, as the previous **USD/JPY** trading range has been violated on a push above 118.00-.50 prior to any sign that major support in the 115.00 and 113.50 could be 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 reinvigorate 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, it is already up to next resistance in the 159.00 area, with the old high as nearby as 159.63. While the next extended historic resistance is as nearby as the 1998 summer-fall highs in the 162.00-.40 range, the further historic levels above that are not until the 170 and 175 areas. Similarly, albeit a bit less so in spite of the recent return of the bid to the British pound, **GBP/JPY** is also back above its previous 229.00-228.00 weekly channel DOWN Break and congestion, which it held on a retest last week. While it is also through interim resistance in the 232.00 area, quite a bit of resistance remains in the 235.00 area currently being tested, as well as the upper 2.3000s.

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 had 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 spikes to unseasonably hot temperatures in the US, further assistance for the technical picture came from a premium of the May **Crude Oil** (now lead contract) to the recently expired April contract.

That 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 (now support), with even closer support into the violated congestion resistance in the upper 63.00-low 64.00 area. Extended resistances remain up at 67.50-68.00, and not again until the 71.00 area.

Misguided

VOLATILE SHORT TERM INFLUENCES

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. While there are several factors which have pointed toward a very tumultuous situation, the one factor which has maintained through all of that is the equity markets sustaining their up trends in spite of what could have been very pernicious influences. While due respect must be given to the potential for negative factors building up in these markets that might suddenly impact them all at once, the performance to date has been impressive. And none more so than US equities which are the harbingers of what to look for next in what seems to be the weakest of the developed world economies.

In fact, some of those factors which might not only have weakened equities at times, but also had strengthened the fixed income seem not to be performing as usual. To review just a couple of those, the US announcement of import duties on specialty Chinese paper imports was greeted last Friday by a vicious short term selloff. Yet, it seems the market decided that short of that turning into *cassus belli* for a trade war, it would have a very limited impact; they all recovered by last week's Close. Of course, the more upsetting and fully critical should have been the major escalation crude oil prices which were already recovering in anticipation of the return to the US home cooling and driving season.

The extreme exacerbation of that recovery due to the geopolitical distress from the UK-Iran hostage standoff fomented a ten percent increase in crude oil prices in a week. While the other markets are within their rights to view that as so purely geopolitical to discount it as a long term (or even intermediate term) influence, the lack of any impact was striking. While the neo-classical economic view of higher oil prices always appeared a bit specious to old time inflation hawks, there has been some merit to that theory in practice. During previous parts of this cycle the markets have indeed acted like the higher oil prices were indeed worse for equities and assisted the fixed income under the auspices of being an invisible tax on the developed economies.

Even inflation hawks came to agree with Mr. Greenspan's admittedly sanguine view during the early part of the energy price rises, yet even he was very clear that those price increases were not inflationary only so long as they were temporary. As we noted awhile back, energy prices have been beyond any reasonable assessment that sustained increase are temporary for some time now. Yet, it is impossible to know whether last week's lack of a trend reversal in the bullish equity markets, or complete absence of any recovery of the fixed income was just acknowledgement of this (hopefully temporary) geopolitical influence, or a move to a new phase which is moreso concerned about the seeming lack of urgency in the Fed's inflation mitigation efforts (in spite of Mr. Bernanke's ostensibly clarified risk assessment.)

CONTENTION AT THE FED SPREADS

The bottom line is that either the Fed or the markets appear misguided. Our sentiments are well known: the Fed has actually been misguided since their lack of understanding on the degree to which the new high in the DJIA last summer into the fall could ignite too much exuberance (which they allowed in spite of Mr. Greenspan's ever more explicit explanations of the failures of the mid-late 1990's since September 2005.) While this seems to have been the view of the hawks at the Fed for some time now, there seems little actual movement toward implementing tighter policy to offset domestic US confidence or the impact which that has on global economies and markets. Thus we see the rather more erratic communication from what should be a fairly unified group, and that is causing its own form of concern in the debt markets.

While it is reasonable to object that neither the Fed nor any central bank should explicitly target equity markets, this had more to do with whether the general economic sentiment was about to (as Mr. Greenspan later characterized the equity market of 1996) "disconnect from its moorings." The extremes of the subprime mortgage mess and excessive comfort with loose credit are the most telling examples of how it doesn't take an extreme over-extension of the equity market trend in its own right to end up with a bubble that is hard to deflate.

This confusion between very weak sectors within a still very strong global economy (if only a passingly strong US one) is reflected in public debate and analysis by not just the usual culprits, but also the normally inscrutable members of the Fed system. That has fomented even more aggressive debate among the rest of the 'street' than usual about future paths of everything from the equities to Fed Funds to long term interest rates to foreign exchange. Yet, due to the degree to which most participants want compact answers from the limited amount of history which they can reasonably digest (readers of the Rohr Report excepted), there remains what is too much of a short term focus in the search for answers which have much more to do with the evolution of a fresh major cycle from the dust of the Dot.Com bust.

POORLY FOCUSED HISTORIC VIEW

The ways in which analysis has been too short sighted from even the more respected quarters of the financial community can be seen in some very insightful coverage in the financial press. And what can this coverage from the financial fourth estate tell us? In the first instance that the Fed is too lax in the signals it is putting out on inflation control, and in the second that the analysis of many astute market participants only looks back to what are recent intermediate term trends to assess the situation, and those are very different from the one which exists at present .

While there has been much said about the Fed seeming a bit sanguine about inflation as measured by their preferred Core PCE reading above their comfort zone, nothing was more telling than the speech by Mr. Mishkin two weeks ago. His observation that the collateral damage which might ensue from any concerted effort to get that reading back below the top of the 1%-2% comfort range might not be worth the effort was a seemingly very misguided defusing of the Fed's credibility. The attached excerpt including charts from the Financial Times LEX column

While we will have more to say on that below, it was no surprise that Mr. Poole's speech to economists on Monday included a strong endorsement of an inflation target back in the middle of that range. The purchasing power parity calculus for the US dollar is just too damaging to allow for perceptions that 2.00% has shifted from an inflation ceiling to the floor (as we noted in the Inflation Expectations section of last week's *CMO* III-13, now available on the Sample Reports page of our website www.rohrintl.com.)

Yet, even the thought that the US dollar might shed almost forty percent of its purchasing power across as little as twenty years is a very long view. And the seeming lack of ability of many otherwise astute participants to put things into a broader cyclical context is burdening both the debate, and (as noted above) many folks' ability to understand near term market reactions to news which brought wholly different intermarket price reactions previous.

While we do not agree with all of his views, recent observations and editorial comment from Financial Times chief US economics correspondent Krishna Guha were instructive. In his Monday report on history providing an imperfect guide to future Fed behavior he notes that market participants are looking back to the 1994/1995 and 2000/2001 shifts to easing for indications of what to look for next.

Yet, neither of those periods represents the sort of strong global growth environment which is encouraging strong equity markets at their highs and strong commodity prices at present. Of course, Mr. Guha is merely reporting what he's been told by his sources, and even observes, "...to predict that the Fed in 2007 will follow the path laid out in 1995 or 2001 is a leap of faith." "The economic situation today is very different..."

Indeed. And that does not begin to address the fact that Mr. Greenspan has made those repeated, and successively more explicit references since his September 2005 speech to the fact that the Fed had not really tightened enough in 1994 to fully quell the exuberance in the economy. Of further interest is Mr. Guha's analysis on the FT comment page the same day. He rightfully observes that, "...the Federal Reserve and the bond market are sharply at odds over the outlook for the US economy and interest rates."

It is apparent from the immediate further comment that he was likely referring to short term yields as opposed to the longer dated end of the bond market. He is right in asserting what anybody looking at the pricing of the Eurodollar interest rate future forwards can plainly see: "The market thinks the Fed will be forced to cut interest rates twice this year, with a close to even chance that the first rate cut will come at or before its August policy meeting." Yet, he proceeds to hypothesize that of the two alternatives the rates rising to where the Fed says they should be is the more benign outcome.

On the other hand, if the rates need to fall to where the market is asserting they will through Fed rate cuts in the face of continued weakness, and that holds the slightly more disconcerting possibility the Fed will move too late and a heavier recession will ensue. Attached please find both his article and analysis for your review.

Yet, as we have noted previous, the potential for any contraction, much less a strong one, seems to be refuted by the sustained up trend in equities that is stronger outside of the US than within. There is always something to be said for the markets ability to reverse markedly at any time. Yet, on balance, as has been the case both historically and definitely across this cycle, the equities' ability to accurately reflect the growth and earnings potential is impressive. As such, it is very hard to see where Mr. Bernanke or any analysts can effectively anticipate a global phenomenon like inflation will abate as long as strong energy and commodity usage can still rely upon at least nominal growth in the US.

What if neither of Mr. Guha's hypotheses is correct? What if a lack of real weakness in the US continues to drive strong expectations elsewhere in a manner which exacerbates inflation in spite of a bit of below trend growth in the US for the next couple of quarters? Rising prices at a time of softer economic growth (albeit growth nonetheless) sounds like the return of that great enemy of central banks: stagflation.

In other words, what if the market reaction is for the long ends to render their own verdict on the Fed's more sanguine than healthy approach to inflation? What if Fed is wrong now and the short term yield markets even more wrong: any Fed hike will be predetermined by long term rate escalation, which the Fed will merely verify with belated adjustment if continued strong global growth re-invigorates the US economy in spite of weaker housing.

Which is why Friday's OECD Composite Leading Indicator is as important for the intermediate term trend tendencies as US Employment is for the short term reaction. Especially as OECD had been roundly weakening for the developed economies of late, and leaving quite a bit of the potential for future growth with the BRIC economies, any reversion to strength in Europe (especially Germany) or a real surprise on bottoming activity in the US will be a significant problem for the fixed income markets.

Of course, both reports may actually come in a bit weak. Yet, the nature of the news as well as the isolated and truncated US trading session on Friday leave quite a few hostages to fortune into next week's release of what might be quite a bit more hawkish set of FOMC minutes than the statement seemed to suggest.

The Fed's Real Challenge

THE WORLD'S CENTRAL BANKER

So where does that leave the Fed? Right where we suggested they were five weeks ago when we suggested they are the World's Central Banker. Mr. Bernanke (with an assist from Mr. Paulson) did a fine job at that time assuaging the markets fears by noting that any equity market meltdown would be very inconsistent with the strong economic environment. Yet he has done less well at moving to weaken those strong tendencies enough to make meaningful progress toward the Fed's stated goal of seeing Core PCE fall back to the top of (much less well into) the 1%-2% comfort zone.

As we noted at that time (and previous), "...if through nothing other than a marginally 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. And in that it also still has the primary influence over the global sense of well being which affects most of the balance of the world's economies and equity markets."

Nothing reinforced that perception quite so much as Mr. Greenspan's mention of even the possibility of a US recession sending the Chinese equity market into the spin that fomented the sharp February selloff elsewhere. However, renewed confidence from Mr. Bernanke's recent JEC testimony clarification that the US will continue to grow has allowed the Chinese market to achieve new highs for the rally, as has the German DAX.

When the tendencies were in the opposite direction into the deflation scare in 2003 the Fed was willing to act because the ECB recalcitrance at the time did not allow for any sense that they were going to cure the global weakness which was flowing out of the German pension reform inspired extended European economic weakness. In the event, it was up to Fed Chairman Greenspan to highlight the danger and take a step which had been almost unimaginable in mid-2002: cut the Federal Funds target rate from an already very low 1.75 percent to the new historic low of 1.00 percent into mid-2003.

The same applies to Mr. Bernanke today. Unless and until the US slows enough to leave consumers retrenching, the rest of the world will maintain its upbeat view that further expansion it worth the risk because the conspicuous consumers will be there to take their goods. In fact, the sense of wealth in the other economies generated by their own prosperity having been enhanced across the recent cycle is feeding on itself without any sign of weakness from the leader. Who would have considered a few years ago that the German economy could have remained strong right through the three percent VAT hike instituted at the beginning of this year?

HISTORIC RISKS

The risks in the Fed not understanding the primary influence which the US economy and equity markets exert elsewhere are tantamount to abrogating their inflation credentials. History has taught us that it is very much more costly to re-establish that hard won respect than even what appears to be hard work of maintaining it.

As trying as times were during the Volcker era at the Fed, that was a necessary counterpoint to the previous regime. Which is of particular interest at present, because the last time any ruminations on the degree to which it would be too hard to bring inflation down because the employment situation and economy would not tolerate it was the G. William Miller Fed during the Carter administration.

While we have mentioned it in passing previous, we feel it is a good time to actually review a couple of excerpts from the excellent study "Choosing the Federal Reserve Chair: Lessons from History", by Professors Christina D. and David H. Romer of the University of California, Berkeley and National Bureau of Economic Research, Cambridge, Massachusetts. A full abstract of that study is available at <http://emlab.berkeley.edu/users/cromer/draftpost.pdf>. The section on the Miller era begins on page 15, and is of special interest in light of the comments in Mr. Mishkin's speech. To wit,...

‘In November 1978, Miller testified: “If inflation is to be gradually slowed, aggregate demand must not be permitted to expand to the point at which it presses excessively on available supplies of labor and industrial resources. This means that real GNP at this juncture probably should not grow at an annualized rate much above 3 percent, in line with the prospective growth of potential output” (Bulletin, November 1978, p. 844).’ As the professors subsequently noted, ‘And certainly, the estimated growth rate of potential output was quite high.’

‘A perhaps even more important feature of beliefs in the Miller era was the reemergence of the view that slack could do little to reduce inflation. Policymakers’ belief that slack would have little impact on inflation reinforced their conviction that they should avoid genuine contraction. This sentiment was expressed in 1979 when Miller testified: “The Federal Reserve does not consider a recession desirable. ‘Stop-go’ patterns of economic growth have ... brought no lasting relief from inflation” (February 1979, p. 120).’

The professors’ conclusion illustrates the current point, ‘To run such modest real interest rates when inflation was already high is clearly out of line with modern practice. It is also exactly what one would expect given the Federal Reserve’s model of the economy at the time.⁵ The effects of Miller’s relatively expansionary policy (as well as the lagged effects of Burns’s last hurrah) are obvious...’ ‘The unemployment rate fell steadily in 1978 and early 1979, and inflation surged even before the oil price shock in the second half of 1979.’

While Mr. Mishkin did seem to understand that slack is what is indeed necessary to restrain inflation, his seeming aversion to creating enough of it to get the inflation rate back into the comfort zone is a bit disconcerting. With the US acting as the modulator or sentiment elsewhere in the world, the lack of enough ‘slack’ here to impact the expectations elsewhere risks a re-invigoration of the US economy from the influence of the very strong tendencies elsewhere. As already noted on several occasions, as long as global growth remains strong, it is the wrong part of the cycle to expect that inflation will remain subdued, and long dated fixed income markets can exhibit any strength along with the equities.

What seems to be happening is that in spite of benign inflation to date, the long ends are signally that there is too much liquidity in the global financial system, and they feel that the central banks are doing far too little to counter these incipient pressures. Once inflation shows up in the headline numbers, it is almost impossible to restrain wage demands that workers feel have not kept pace with the real cost of living in any event. The Fed’s real challenge is to weaken the US economy enough (even at the risk of fomenting a contraction) to leave workers everywhere once again more concerned about keeping their jobs than keeping up with inflation. Unless something changes soon, core inflation above 2.00% may soon come to be viewed as an intractable global phenomenon so long as the US consumer keeps everyone else feeling good.

Due to the Fed’s lack of action to stem budding exuberance last summer into the fall, there is a helping of opprobrium waiting at some point. A bit of a large helping now, or a potential full buffet of multi-year higher rates later seems the choice. It will be interesting to see which menu selection a Chairman who has been a bit too timid up to this point chooses. It will also determine whether he gets to be the World’s Central Banker, or cedes that mantle to the combined efforts of his more aggressive cohorts in London and Frankfurt. Of course, based on the present performance of the UK and European long dated fixed income, they appear a bit behind the curve as well; and that is also part of the problem.

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

-Rohr

www.rohrintl.com

This analysis is confidential. It may also be legally privileged. If you are not the intended recipient you may not copy, forward, disclose or use any part of it. If you have received this analysis in error, please delete it and all copies from your system and notify sender immediately by e-mail to info@rohrintl.com. Internet access cannot be guaranteed to be timely, secure, or error and virus-free.

While based upon price data and market information from sources believed reliable, the analyst(s) do(es) not accept liability for any errors or omissions, and (do)es not guarantee any profitability or avoidance of loss based upon the content of the foregoing analysis.