Rohr Report

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…Further Fed Food Fight, Choppy Cycle Phase, Correction

Overview

While things have quieted down a bit since the Good Friday frolics, trends remain stubbornly intact in their way. Which is to say that the US seems to incongruously both set the trend for the other markets, yet lag in trend performance, except in the weakness of its currency. However, as we have covered the reasons for that have already in *Capital Markets Observer* for the past two weeks (III-13 & 14), we are only going to revisit that briefly. So long as the Fed avoids any extreme fallout from the subprime lending fiasco by talking up the balance of the economy outside of housing, it foments a lot of exuberance elsewhere in the world.

That growth elsewhere is stimulated in part by confidence that the American consumer will remain in good enough shape to buy the imports. That is a source of the inflation pressure which the Fed would rather see wane, yet is not likely to do so while the rest of the world remains so strong. However, as Mr. Mishkin has noted repeatedly of late, the amount of economic weakness necessary to put the US into an inflation busting contraction likely carries with it more risk than the Fed wants to shoulder. While concerns about extended US housing sector risk and sustained below trend growth is buffering both US equity market strength and fixed income weakness, the rest of the world markets' trends are more pronounced.

The US would seem to be the rising tide that carries all ships; except its own, or at least not very well. All of this is exacerbated by the continuing dissension in the various opinions at the Fed, with Mr. Bernanke left to arbitrate the middle ground, or possibly the muddle ground. There's certainly something to be said for muddling along when the picture is one of balance between strong forces that are offsetting each other. Yet, the current situation is one of eroding forces creating more uncertainty and risk. Mr. Bernanke's transparency campaign has degenerated into articulating nothing less than the uncertainties on both sides of the inflation/growth factors are becoming more unpredictable, as he noted in so many words.

At least that hopefully means the aggressive shift toward making transparency sound like a good idea under all circumstances may have finally lapsed. It was a good idea when countering post cycle high deflation risk into 2003, and offsetting obvious over-stimulation during 2004-2006. Yet, at times there are contentious, transitional economic phases when it is best avoided. One of our favorite writers last week noted that the Bank of England's more cryptic approach meant they reserved the right to shock the market; to send a message through action (which can be reversed later) instead of trying to explain their every act.

The Fed might also be in better shape now if it did not appear so wholly reactive in the face of significantly conflicting forces. As uncertainties have indeed grown, their need to explain it all may preclude acting to eventually ease or (especially) tighten rates. It would be better for as important a participant as a central bank to appear the prime mover that can shape outcomes instead waiting around to see the proof in what may be a very murky pudding.

As the market fallout from Mr. Greenspan's passing comment on the mere possibility that the US might go into recession amply illustrated, the Fed has the ability to cool down the world economy any time it wants to live up to its *de facto* role (noted extensively previous) as the World's Central Banker. Yet, the fortitude to risk marginal possibilities that the very strong global economy would implode without the US demand (instead of just slowing to a less torrid pace) seems to elude the Fed. And so long as that is the case, the cooling of inflation which it repeatedly assures everyone will occur likely eludes it as well.

As such, until some tangible confirmation of a US equity market trend reversal occurs in the form of the DJIA at least slipping back below the 12,350-00 support for starters, it is more likely that the US punchbowl will continue to fuel the party elsewhere. With the US lagging to some degree, the US T-note will also likely hold up better than the other fixed income, albeit still in a bear trend as long as it does not Close back above the recently violated 108-08/-00 support or higher resistances. Yet, there may yet be a delimiter on just how well US fixed income holds up: the US dollar. If it should remain under sustained pressure that carries through the EUR/USD 1.3666 December 2004 high, then its recent orderly downward trend may accelerate into disarray. And at some point, on grounds of pricing in a pariah currency as well as implicit inflation expectations, that may weaken the US fixed income as well.

While tightening into a weak housing sector may seem a bit of overkill, the one way to reduce inflation is weaker global growth through lower expectations for US consumers absorbing the usual level everyone else's output. While many may attribute any subsequent strengthening of the US dollar to a surprise improvement in comparative short term interest rates, the reality would be the benefit of lower growth elsewhere. It is in fact the only way to possibly lower global inflation encouraged by upbeat expectations for the US economy and consumer. Prices for everything from energy to metals to agricultural products will only soften in a meaningful way once the US equities and economy lead the way.

Otherwise the Fed may be forced to tighten later, when the decision is dictated by the verdict from extremely weak long dated fixed income. Yet, historically when that has been the case, it takes much longer to force the beast back into the cage. Which is why it is so disconcerting to watch the Fed allow the continuing food fight between its committed hawks and doves, as well as waiting for the data to dictate policy that leaves a sense it is caught in the headlights.

Reports & Events

While there have been a few interesting reports early this week, nothing particularly trend decisive was scheduled. In fact, the speeches have been far more interesting than the somewhat mixed data. Earlier yesterday Mr. Mishkin was reiterating his view that that while inflation must indeed be tamed at some point, the cost of lowering it back into the acceptable target range of 1-2% may be more than the Fed is willing to shoulder in the near term.

Then Dr. Plosser comes along yesterday evening with what were predictably hawkish yet very interesting views the need to maintain inflation credibility. The actual start of economic releases this morning was Japanese Machine Orders (FEB), Money Supply (MAR) and Trade Balance (FEB.) That was followed by Australian Home Loans and Investment Lending (both FEB), which yielded to the BoJ's new board members Kamezaki and Nakamura holding their first press conference. All with very little market impact.

Then it was onto German Wholesale Price Index (MAR), the French Trade Balance (FEB), US MBA Mortgage Applications (for the week ending APR 6), to be followed by UK Leading and Coincident Indicator Indices (FEB), and the US EIA Crude Oil Stocks (also for the week ending APR 6.) Then, even prior to the release of the FOMC minutes, the Fed's Lacker speaks to economists in North Carolina, and Chairman Bernanke expounds on 'Market Discipline and Regulation' at the Global Economic Policy Forum in New York.

What a wonderful backdrop for the release of the minutes. Then it's on to the FOMC minutes (March 20-21) and simultaneous US Monthly Treasury Budget Statement (MAR) release. Any larger than estimated deficit could exacerbate any fixed income weakness encouraged by minutes which are inconsistent with the seemingly dovish statement. While Mr. Bernanke has already significantly accomplished that with his recent testimony, the actual details of the minutes, as well as how that interacts with the budget statement, should be very interesting.

Thursday sees the UK RICS House Price Balance (MAR), Japanese Domestic Capital Goods Price Index (MAR), and UK BCC (British Chamber of Commerce) Economic Survey (Q1.) Once again what still qualifies as the previous day's influence arises, as the Fed's Moskow speaks on the Economic Outlook Wednesday evening in Illinois. That is followed by the Australian Employment Change, Unemployment Rate and Labor Force Participation (MAR), Italian Industrial Production (FEB), and UK Trade Balance (MAR), as a prelude to the final Euro-Zone Growth Domestic Product figures (Q4) and all attendant figures, including any revisions to the European Commission's Q1-Q3 2007 GDP estimates.

Which itself is a prelude to the European Central Bank rate decision, and exposition with Q&A by President Trichet at the monthly news conference. That is followed by US Weekly Jobless Claims (for the week ending APR 7) and Import Price Index (MAR), followed by BoC Deputy Governor Kennedy speaking on 'Uncertainty and Monetary Policy.' Sounds like the Fed Chairman has found a supporter for ambivalence in the face of less than compelling data.

Friday's complete absence of Japanese data means the day begins with French and Italian Consumer Price Indices (MAR), Euro-Zone Industrial Production (FEB), US Trade Balance (FEB), along with the US Producer Price Index (MAR) and University of Michigan Consumer Confidence (APR Preliminary.) Yet, we are also back to central bankers having the last word, as the Fed's Fisher speaks in Houston on Globalization, and the European Central Bank's Trichet, Almunia and Juncker hold a briefing in Washington.

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 confirming that post-Employment report strength is bona fide push that can lead back to the old highs. 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) pushed through its daily gap and congestion resistances at 1,450-54 in the wake of the strong Employment report. While that appears to have been in part an over reaction which left the door open to some correction earlier this week now that the market has held on slippage back into that range it is likely okay unless some heavy shock weighs on it. As such, the next test is likely whether it can get through higher resistance in the 1,460-62 range.

Strong sister **DAX** was already back above both the 6,845-60 range and the 7,000-40 range from the February high, and is already above the next extended resistance in the 7,085 area (November 2000 reaction high); next major resistance is not until near 7,500. **FTSE** back above 6,315-30 and 6,355-80 is up to the next interim trading resistance in the mid 6,400s reached in February, which did not quite reach extended historic congestion resistance in the low-mid 6,500 area. **NIKKEI** seemed burdened by the return to somewhat weaker news in Japan, and was still struggling with the 17,500-600 area. As we noted last week, only a push up through resistance in the DJIA would assist Japan in Negating that resistance, and it has now pushed up to the next nearby resistance in the 17,750-850 range. The extended interim resistance is at the 18,315 February high, with major resistance up into the 19,000 area historic congestion it missed reaching back at that time.

Even though Europe and Japan were higher initially in part to equalize for the US gains on Friday, equities are likely to remain firm if the DJIA does no worse than retest support back around the 12,500-12,450 violated resistance. The other markets now seem to maintain strength in their own right, which is not really much of a surprise with the US actually being the weaker sister. In fact, it will take quite a break from the US to weigh heavily on the others, as lower support in the DJIA now ranges down to as low as the DJIA 12,400 area UP Break (actually 12,385) from the daily down channel (from the February all-time high.)

FIXED INCOME

As noted previous, the more critical trend support tests are unfolding 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. Downside leader **Gilt** was already below support into the 108.00 area (now resistance) and below the 107.62 contract lows, as well as mid-March continuation chart trading congestion at 107.42. Lower interim and major supports are respectively 107.00-106.80 and in the 106.40-.00 range.

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, the failure below 114.46 violates the Tolerance of that UP Break at the low of the right shoulder of the June contract pattern. That is also the last interim 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 interim support at the January-February low end June contract congestion was held yesterday on the test of 114.20-.14, with major support not until more major Fibonacci, congestion and weekly oscillator support in the 113.35-.20 range. lower support below that is not until the 113.35-20 range.

All the while the more resilient (not exactly ‘strong’) sister June **T-note** drop exhibits what was a very orderly, modest selloff below intermediate term 108-08/-00 support (now resistance) Tolerance at 107-22 (congestion and identical contract and continuation gaps.) As we expected, that was the reason that the scope of weakness in Europe yesterday was fairly problematic. While next interim support in the T-note is 107-00/106-24, major support is not until the 106-08/-00 range, and all trend indications remain DOWN.

The short money had also been dropping below key supports in the wake of the various developments last week prior to the US Employment report was a less than auspicious sign. September **Short Sterling** had failed the 94.24-.22 range, **Euribor** had similarly dropped below the long held 95.85-.80 area, and most tellingly the effective strong sister September **Eurodollar** which had maintained the hope of central bank easing was not only below its 94.95-.92 range support, it also obliterated next support in the 94.85.-.82 range after the US jobs number. That leaves it vulnerable to revisit the low end congestion support in the 94.70 area, which essentially reflects the market actualizing the reality of a very low percentage potential for an FOMC rate cut by as early as their early August meeting.

Next supports elsewhere are September **Short Sterling** in the recent historic congestion at 94.10-.08 (contract low), with extended support at daily oscillator levels in the 93.85-.80 area. September **Euribor** next interim historic congestion is in the 95.70 area, yet with the major 95.60-.57 historic (May-June 2004) congestion and daily oscillator support.

FOREIGN EXCHANGE

The foreign exchange view remains the same weakening US dollar trend in spite of a weaker yen that continues to buffer the support levels on the US Dollar Index. Yet, not surprisingly, immediate reaction to Friday's strong US Employment report was **US Dollar Index** recovery to the .8300 area from the test of previous near term .8250 area basing action (still critical support, with a Tolerance to the .8224 December trading low.) . As we had noted that was a fairly tepid response, and are not surprised that the market could not even muster a more impressive test of the resistance remaining at previously violated .8350 congestion support, with even more critical trend resistance back up into the .8400 area.

The more active response to Friday's news was the **EUR/USD** drop back from the low 1.3400 area to the violated 1.3350-67 resistance (from back in December.) That was a test of whether the market would back below that previous resistance (reinstating it), or turn it into a test of that area as support which holds and foments further weakness in the buck, as ended up being the case. While the currency trends against the US dollar are somewhat disjointed, if the Euro leads the way up, the rest are likely to follow in some form. Notable exceptions are the weakest of the weak sisters Japanese yen, and the Australian Dollar actually leading the way up against the buck.

That is especially so as even though 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; while even USD/JPY MACD remains nominally DOWN, the tendency is naturally even more pronounced against the upside leaders.

The critical levels against the other currencies are **EUR/USD** remain 1.3350-67, 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. It has even recovered to back up near the near term resistance 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 several weeks, and it is also continuing to challenge extended resistance at 1.9750, with the more major recent resistance at the 1.9850-1.9915 congestion and previous (post BoE January rate hike) high area. However, above that the 2.0050 and 2.0100 early 1991 and September 1992 (respective) highs are still close at hand. All of which is reinforced by the relatively firm performance of **EUR/GBP** holding the retest of its .6760 UP Break (out of its weekly down channel from the major April 2006 high.) Based upon heavy congestion, and weekly MACD and MA 13, it would actually take a weekly Close below the .6700 area to fully reverse the upside leadership of the Euro. Higher resistances remain in the .6900 and .6960-80 areas.

USD/CAD has reinvigorated its sustained weakness in the past several days as well. After failing badly on the last test from its previous recovery to repeated tests of the 1.1800 area congestion resistance, the market was hovering below recent trading congestion support at 1.1600-1.1566 (now short term resistance) for the past couple of weeks. Yet, that was still only approaching its major congestion, weekly up channel and MA 41 in the 1.1500-1430 range, which is now back under pressure. It will still need to break it 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.) It has now 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 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. Next resistances are the recent and historic congestion area at 120 (heavy), 121 (interim) and 122 (heavy), with next resistance into the 123.25 DOWN Break form the June 2002 major weekly channel.

Of course, that also means the cross rate strength of the other currencies against the yen continues to lead the way up, and 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, 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
Sitting in snowy Chicago (not a 'lake effect' flurry; it's a blizzard out there today), it is hard to imagine why energy prices have dropped at all, given the much higher than normal seasonal usage for heating into what is record breaking April cold throughout the US. Yet, we suppose (in fact fervently hope) this is the last bit prior to a return to the normal northern tier spring weather next week, even if that is only 45 degrees Fahrenheit rain.

As noted previous, energy market weakness to mid-March had been seasonal weakness, and the shift to a focus on summer cooling (at least we hope so) 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. Yet the real surprise has been the extreme shift back into significantly wintry weather throughout all of the US after such enjoyable temporary sharp spikes to unseasonably hot temperatures.

That has assisted the May **Crude Oil** in holding the bid well above its initial trading as lead contract back in the 60.00 area (now reinstated support extending down to congestion in the 59.00 area.) Higher congestion areas in the upper 63.00-low 64.00 area as well as 62.50 have been violated, and must be considered reinstated resistance. Extended resistances remain up at 67.50-68.00, and not again until the 71.00 area.

Further Fed Food Fight
Our sentiments on the degree to which the Fed is falling behind the (actual or the equally important psychological) inflation curve have been extensively revisited over the past couple of weeks. Yet, one of the key factors which lend credibility if not respect to a central bank is leadership at the top that gives the impression it knows where it is headed. Insofar as we vehemently disagreed with continued ECB parsimony into the Schroeder regime's brave implementation of fiscally sound pension reforms into the weak German economy of the 2003-2004 period, we also respect that they remained on message that the structural reforms would take longer yet provide the desired effect.

Whether they were right in that, or the US economic recovery and French shift to a more laissez faire view of their economy and the Euro-Zone Growth and Stability Pact strictures strengthened the world economy enough to overcome the extended German drag on Europe is debatable. We happen to still believe the latter is the case: without strong growth elsewhere, the world might still be mired in weakness, and the ECB was certainly not any help in avoiding the deflation risk which had become apparent to Mr. Greenspan into 2003.

Yet, they have now been the clear voice of concern about risks remaining in strong economic growth and inflation rather than any real chance inflation will wane in its own right if the major economies and rapidly developing ones continue their solid-to-strong growth. And that is in spite of the drop to lower sustained growth in the US. Yet, there is now net ambivalence at the Fed which stems from the hawks' and doves' arguments neutered by Mr. Bernanke's desire to be more of a fair witness to whatever the economy requires than a prime mover in shaping the economic and (more important) inflation trends. And that has been apparent of late in both his remarks that uncertainties surrounding the forecast are expanding, as well as the extremely polarized views from Fed members.

As noted previous, the most extensively fresh dovish positions have come from Mr. Mishkin lending some academic and analytic support to the notion that the desire of the Fed to see inflation back well into its 1-2% ostensible 'comfort zone' may be more damaging to the economy than any extended benefit from achieving that target.

Mr. Mishkin's revisited his extensive discussion of practical considerations of implementation of Federal Reserve policy, and added a bit of analysis on the uncertainties surrounding what represents full employment in yesterday morning's speech. In our view it all remains 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. For further background on that which includes more excerpts from a scholarly history of the Fed, please see last week's ***Capital Markets Observer*** III-14 (now available along with additional comment on those topics in ***CMO*** III-13 on the Sample Reports page of our website www.rohrintl.com.)

All of that said, there are actually more inflation hawks at the Fed, with some previous fairly balanced views now leaning moreso toward inflation concern. One of the most articulate and ardent recent hawkish additions is Philadelphia Fed President Dr. Charles Plosser. He has both been a clear hawk since joining, and gave a most impressive metaphorical and analytic rebuttal (as it seemed to almost be very specifically aimed at Mr. Mishkin's recent attempt to justify a more relaxed approach) in what can only be regarded as long distance debating style. The full text is available via a link to his 'Credibility and Commitment' speech on the Philadelphia Fed Newsroom page at http://www.phil.frb.org/newsroom/speech-calendar.cfm.

In addition to a metaphorical section excerpting certain ideas on rationale expectations for whether a government is going to fulfill certain commitments (from an article published in the Richmond Fed's *Economic Quarterly*, in the speech section 'Living in the Desert), he also is the first we have seen at the Fed to cover something we have discussed extensively: how the gradual slippage into higher inflation expectations left the Miller Fed of the late 1970's with an untenable situation that needed to be ultimately sorted out by draconian action on the part of successor Paul Volcker. To wit (from the 'Real world policymaking' section)…

"In the late 1960s, after a decade or more of fairly benign inflation, accommodative monetary policy began to drive up inflation. By early 1970 the inflation rate had reached 6 percent. In mid-1971, with the inflation rate still in excess of 4 percent, President Nixon imposed wage and price controls.

"By that point, the public was not sure what the Fed's plans for inflation were. To put it another way, inflationary expectations were not well anchored. Then, in late 1973, the first Arab oil embargo hit, and the price of oil quadrupled. Higher oil prices ratcheted up the public's expectations of inflation.

"The Fed then had, in effect, two choices: either ease monetary policy, ratifying the public's expectation of higher inflation thus ensuring inflation would rise—hoping that this would ease the economic dislocations of the oil embargo, or tighten monetary policy to keep inflation down with the attendant risk that this policy might lead to increased economic disruption. Policymakers chose to ratify the higher inflation expectations and we saw rising inflation—reaching nearly 15 percent by 1980. And it turned out that there were few if any benefits to the economy on the output side. The 1970s were and still are viewed as the decade of stagflation."

Dr. Plosser finishes with some views on 'Communication and Transparency' that are very reasonable and clear. Most telling is his assertion, "In addition, this improved transparency increases the accountability of policymakers. By stating their objectives clearly, policymakers make it much easier for the public to judge whether they are achieving their stated goals."

Very sensible. Yet, as we have noted, the Fed's problem now is not too little transparency. Rather moreso it is with too much transparency exposing ambivalence at the top. What *are* the current goals of the Fed as filtered out by the Chairman balancing sincere influence from his broad array of ardent hawks and doves? To wait until the conflicting cross currents from the weak housing and auto sectors versus the significant strength in the balance of the economy work themselves out to provide a clear picture. With prices on everything from commodities (more on that next week) to energy to healthcare expense all ratcheting higher, we would think that a bit more leadership on inflation mitigation would be in order if inflation expectations are indeed to be kept under control.

Choppy Cycle Phase

Just a brief note on a phenomenon quite a few friends and clients have commented upon of late, and which we have cautioned on previous. The June Bund finally slipping below its own Inverse Head & Shoulders Bottom UP Break Tolerance at 114.46 that was also the interim continuation chart pullback low from September 2004 (i.e. also a new four-and-a-half year low) confirms its entry into the second phase of the bear trend which saw the primary wave unfold between November 2005 and May 2006.

This adds the last long end standing to the violation of previous critical lows in the Gilt and the T-note. Even though the T-note has not slipped anywhere back near the June 2006 low in the 104-00 area, it has been the leading bear market since the summer of 2003 (i.e. a full two years prior to the Bund and Gilt), and its early 2006 violation of previous 108-00/107-16 support (now isn't that interesting in the current context) can be considered its entry to the second phase of its bear trend (regardless of its trend still exhibiting extensive divergence from the European instruments.) Of course, US short money forwards are also attempting to look more like stabilized bottoms as well compared to the Euribor, or event Short Sterling.

Yet, the tendency which is somewhat disconcerting is the extensive choppiness of the current trends, as markets look very good at the top of relatively short term recoveries prior to failing, and just awful at the bottom of breaks prior to squeezing the bears. As we have sardonically noted previous, there is good news and bad news. The good news is that we know that second phase bear markets in fixed income just happen to act that way, with the occasional sharp drop when pressures build. That we know what kind of market we are in is the good news; unfortunately, it's also the bad news that will likely maintain throughout 2007. Ugh!

Correction

In last week's ***Capital Markets Observer*** III-14 we noted how the perceptions of even the informed financial press seemed to be possibly not allowing for the dislocation that might occur if either the rates rise to meet current Fed expectations, with the potential for any problem if the Fed waits too long to cut if the economy turns out to be a lot weaker than expected the decidedly less radical and risky path.

We included both the article on the street's attempt at (what we consider short term) cyclical analysis and the editorial page comment (i.e. analysis) from Financial Times chief US economics correspondent Krishna Guha. Our stated intent in providing those was to allow our readers to see them first hand in case we had misinterpreted Mr. Guha's comments.

In fact, amidst our agreement with many of his report's observations on the 'street' analysis and perspective of his own analysis, we had indeed misconstrued part of his point on the most unsettling outcomes to the Fed's current mixed signals. Upon review, we may have been viewing this through the prism of our own bias that the street sees the Fed (and even possibly other central banks) as near the end of the tightening cycle, and that too much risk was being placed on the potential for the Fed not easing soon enough, as Mr. Guha mentioned in his analysis.

That said, we now see that his assessment of the major risk was the 'street' not properly assessing the Fed's 'reaction function' under any circumstance. And that would seem to fall more heavily on the potential for the Fed to be forced back into more of an inflation mitigation role (i.e. into unexpected rate hikes) if the economy or just the inflation pressures independent of the US economy accelerate. Of course, this also gets back to confusion in good measure being part of the Fed seeming like it does not have a unified view of likely future actions.

As noted repeatedly, a sanguine, reactive central bank which also allows disagreements on conditions and policy belies the efficacy of transparency during contentious transition periods, and sows the seeds of public distrust on its real goals, and confusion about its future actions.

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

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