

ROHR REPORT

CAPITAL MARKETS OBSERVER

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Overview, Reports & Events, Markets,... ...France-III, China and the Fed, Analytic Balance

Overview

While this week sees fewer formal economic data releases and major central bank activity than the previous two weeks, it has nonetheless been a very interesting time. That is in part due to this morning's release of the Bank of England May 9-10 MPC meeting minutes, as well as the high level Sino-American economic meetings in Washington D.C. Yet, there overall equity market and fixed income background leading out of last week into this week has also left the markets in a much more active state, and the reasons behind the markets' direction and trend volatility will be explored further in a general way in the topical discussions.

With due respect for the anti-climactic influence of the Chinese visit to Washington D.C. after their rather extensive policy adjustments last week and Richmond Federal Reserve President Jeffrey Lacker's observations on inflation yesterday evening, this week is much moreso about Europe during the back half of the typical mid-month US reporting vacuum. That always includes a certain amount of housing data, which was less critical last year, and has become seemingly moreso this year. Yet, Mr. Bernanke's confirmation last Thursday of that sector's weakness not representing any real threat to the otherwise improving US economy likely leaves those reports later this week as less than trend decisive.

The reason that this week is about Europe is the important data releases which have already seen very firm indications of further strong growth. Along with Asia (ex-Japan), that growth is driving the strength of equity markets and the weakness of fixed income, and as long as their figures continue to exhibit strength, expect those trends to continue in spite of the stock markets seeming to become over extended. The 'whys' and 'wherefores' of that shift to an extremely vigorous bullish frame of reference will also be reviewed below.

The area which has become quite a bit more problematic is foreign exchange, where feelings the US economy might well improve also still leave reasons to feel that will not match expansions in place elsewhere. That has put the US dollar into a very divergent and choppy near term recovery. To revisit the levels we noted briefly last Thursday, **US Dollar Index** has been having a problem grinding above .8225, **EUR/USD** 1.3525-00, **GBP/USD** 1.9750, **AUD/USD** .8230, **USD/CHF** 1.2300, and **USD/CAD** has dropped precipitously from last week's test of 1.1050. Yet, overall, the short term momentum seems to be coming out of the US dollar bear, even if that is just for a more extensive correction.

On the other hand, the extensive counterpoint we have anticipated for quite some time would plague the fixed income if the equities continued their bull trends has finally come home to roost in the past week's June **T-note** failure below 107-25/-22 which confirmed the already extensive bearish indications from Europe. Whether it also breaks next support at 106-24 very possibly remains contingent on whether **DJIA** continues to exceed the 13,500 resistance by pushing up through 13,585 on this week's Close for a move to 14,000, already encouraged by upside leader **DAX** pushing above its equivalent 7,620 area by a goodly margin.

Reports & Events

As we have noted previous, the economic news has consistently supported the view that the US and UK economic turnover is somewhat weak and especially US inflation is abating in the near term. Yet, their fixed income markets refused to exhibit any sort of strength, and have now even violated important interim supports. In the BoE deliberations at the May 9-10 MPC meeting they seemed to join the sentiment we noted last week from the Reserve Bank of Australia Inflation and Monetary Policy reports that while there is currently some weakening of inflationary tendencies that will not be sustained later this year. And as forward looking markets the equities seem to like that to some degree, along with it being obviously pernicious for the fixed income.

To wit (from the MPC minutes discussion of the international economy),... “euro area data... continued to be consistent with robust growth.” On the US... “...Institute for Supply Management (ISM) indices for April had risen strongly for both manufacturing and services, consistent with the possibility of somewhat firmer GDP growth in the second quarter. But downside risks to consumption were signaled by subdued housing activity, rising petrol prices and slowing employment growth.” Of course, Mr. Bernanke has now refuted the degree to which housing will be a drag on the balance of the economy, while employment weakness is also a questionable indication, as noted in the attached article from today’s Financial Times. On the broader world economy,... “Slower growth in the US did not seem to have spilled over into the rest of the world. ...Asian countries such as China and India continued to have high growth rates.” “With signs of higher inflation in a number of emerging market economies there was, perhaps, rather less sign of disinflationary pressure than hitherto.”

All of which has been reinforced by the above estimate results on every Euro-zone economic release from the German and Euro-zone ZEW’s and Italian Consumer Confidence (all MAY) yesterday, as well as the Australian Westpac Leading Index (MAR) and back to Euro-zone for Italian Retail Sales and Euro-zone Industrial New Orders (both MAR) this morning, which all came in above estimate. So while there is an impression that the equities are over extended, and the view that they can maintain their rally is now a troubling (if grudging in some quarters) consensus, until there is some weaker news to trigger a reversal of current stock market strength and fixed income weakness, those tendencies likely remain intact.

The balance of the day today’s mid-month reporting vacuum in the US brings only the wrap-up of US Treasury Secretary Paulson’s meetings with Chinese officials in Washington D.C. Thursday’s early news includes the Japanese Merchandise Trade Balance Total (APR) and Australian Conference Board Leading Index (MAR.) After which it’s back to Europe for a less than critical final adjustment to German Gross Domestic Product (Q1 Final) and associated figures which include Private Consumption, Government Spending, Equipment and Construction Investment, Domestic Demand and Imports and Exports. This is followed by the French Business Confidence Indicator, Production Outlook Indicator, and Own-Company Production Outlook, Italian Business Confidence, and the more influential German IFO indications (all MAY) that might tell the tale for the week in the influential Euro-zone equity markets and Bund. That is followed by UK Total Business Investment (Q1 Preliminary) and the CBI Industrial Trends Survey (MAY.) The US sees the wonderfully erratic Durable Goods Orders (APR), what have been very weak Weekly Initial Jobless Claims (for the week ending MAY 19) and housing indications from New Home Sales (APR.)

Friday begins with Japanese inflation figures that include the Tokyo Consumer Price Index (MAY) and National Consumer Price Index (APR), that segue into more important European data which includes the German GfK Consumer Confidence Survey (JUN), French Consumer Spending (APR), Italian Hourly Wages (APR), and some real punctuation from a first look at UK Gross Domestic Product (Q1 Preliminary), and associated Private Consumption, Government Spending and Gross Fixed Capital Formation (some of which is estimated to have slipped in the quarter), along with their Index of Services (rolling three month quarterly indication into MAR.) That is followed by the Italian Trade Balance (APR) prior to the coda for the US housing numbers this week in the form of NAR Existing Home Sales (APR.)

Markets

EQUITIES

As the **DJIA** had already exceeded the near term over-extended conditions on classical oscillator indications that restrained it during November-February on its various tests of (gradually rising) oscillator resistance at 1,000 points above weekly MA 41 by Closing above 13,150 two weeks ago, that signaled a move to more extended overbought levels. The next of those is 1,250 above MA 41, and it has been achieved very quickly, which is not much of a surprise for a market which has developed an accelerated trend consistent with overrunning that previous oscillator resistance.

That equated to the 13,520 area on a weekly Close last week, 13,585 this week and projects to 13,650 next week. All of which creates what may seem a bit of a perverse burden of proof on the bulls at the top of a very strong rally. Yet, the degree to which accelerated trends must continue to reinforce their accelerated nature or risk slipping into some sort of correction is actually quite typical. Any weekly Close well above those levels will signal the potential for a move to the 14,000 area to test the next major oscillator extension (MA 41 plus 1,500) over a time horizon as nearby as the next several weeks.

While that may seem at least as outrageous as the move to date to those maintaining a more negative view due to the obvious weakness in US housing and autos, as we noted recently until an overbought up trend demonstrates a definitive sign of reversal by violating lower technical support (or some other marked sign of reversal), it is likely to continue the up trend into more overbought territory. It all gets back to the old axiom (for which we will explore more background in **Analytic Balance**) that due to evolving circumstances (in this case the global economy), price trends tend to last longer and proceed further than anyone (even the strongest proponents of the trend) can possibly imagine at the commencement of the move.

We are among the best examples of that, as even though we were very friendly to equities on the last selloff into early 2003, there was not even a minor hint of any indication on our radar screens that this would mean a major new high in the DJIA above 11,750 achieved in 2000. Yet, here we are, bullish above there, due in part to the Mr. Bernanke's lack of desire to pull the punchbowl as the market recovered to near that old high last summer-fall. Near term DJIA support has now moved up from around the late February 12,800 area highs (which remains interim support) to the recent 13,210 reaction lows, as that is also now aggressive up channel support from the mid-March reaction low. That area is also intermediate term trend UP Acceleration (out of the top of the up channel from the 10,683 major July 2006 reaction low), which typically works well with previously noted violation of weekly oscillator resistance. Of note in that regard, the top of the major up channel from the 7,197.50 October 2002 major cycle low is at 13,935 this month and just above 14,000 into June. Hmmm.

The **S&P 500** future short term support is similar to the DJIA insofar as it is also into the 1,496 reaction low from two weeks ago. It has in fact played a bit of upside catch-up with the DJIA, as its oscillator resistance is 1,535 this week and 1,542 next, based on a more accelerated upward slope to the MA 41 in the past couple of weeks. Think about it; by the time a market is exhibiting a further increase in the upward slope of an indicator as long term as a 41 week moving average, do we need to ask if the price trend has become accelerated?

As to any extended lower support, the interesting aspect of the S&P future is its weekly continuation chart Runaway Gap higher a month ago above the previous late February high. That was a leap above the previous high of the aggressive rally since the mid-March significant low. Due to the premium in the June contract to previous lead contract March, while it only 'traded' through the February previous high on the contract after that gap higher, on the continuation chart it gapped the old late February 1,464.50 high; a very telling sign.

That was a signal that unless the bears could get the proverbial genie back into the bottle by forcing the market back below the bottom of that 1,466.90-1,461.50 Runaway Gap, the potential for sustained acceleration to occur was significantly enhanced; and that is indeed what we have witnessed since that time. In fact the Objective projection attendant to the Runaway Gap is a lead contract target of 1,565.40; interesting in light of the extended oscillator resistance above DJIA 13,520-75 not coming in until the 14,000 area.

Similar conditions are evident in the other equities. Viewing it through the prism of developed economies' upside leader, the **DAX** was recently just getting up to its own resistance at 1,000-1,100 over weekly MA 41 for the first time in this cycle that allowed for the extension of the current trend to the 7,500 area (Tolerance at 7,572) mid-2000 congestion we noted was possible once 7,085 was exceeded. That was consistent with the MA 41 plus 1,000 oscillator resistance moving up to the 7,560 level that was exceeded last week, and which moves up to 7,620 this week and 7,670 next. All of which reinforces the DAX upside leadership, as it is already trading above levels which demonstrate it is continuing to accelerate unless the bears can get the genie back into the bottle.

Of note, these are the same sort of 'overbought' conditions exhibited on late 1990's into 2000 extensions that project to 1,250 or even 1,400-1,500 better than weekly MA 41. That is the equivalent of the 7,900 area, or even the 8,100-8,200 range on a weekly Close; another good example of what can happen once a market remains strong enough to accelerate momentum of an indicator as long term as the 41 week moving average. However, unlike its co-strong sister DJIA, the DAX lagging for so long back in 2003-2004 means that those resistances are just getting it back to its 8,136 March 2000 all-time high (as opposed to the DJIA already achieving a test of the top of its major up channel return line across the cycle. It will also be interesting to see how well the DAX holds if there is any near term dip back into the lower support at the violated 7,400-7,370 resistance area (congestion, daily MA and Negated aggressive daily trend channel DOWN Break.)

FTSE maintaining the bid above 6,315-30 and 6,355-80 was destined to eventually Negate the next interim trading resistance in the mid 6,400-6,500 range and historic congestion resistance in the low-mid 6,500 area until last month. Yet, due to it lagging the DAX, it is still not really overbought at present levels. Extended resistances above mid-6,600-low 6,700 areas is not until the mid 6,800s, and the 6,950.60 all-time high.

The **NIKKEI** still seemed burdened by the return to somewhat weaker news in Japan, and had struggled previous with the 17,500-600 area from which it ground slowly back toward lower supports in 17,050-16,880 area, yet never broke weekly trend channel support in the 17,250 area. As we suspected would be the requirement, it still seems like the further push through resistance in the DJIA assisted Japan in Negating the 17,500-600 area resistance yet again (the fourth recent trip above it, and it likely takes further strength in the US and Europe to assist with Negation of 17,750-850 resistance which the market stalled into once again on the current rally. Extended resistance remains at the 18,315 February continuation high.

FIXED INCOME

As noted previous, more critical trend support tests unfolded 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 its already weak fixed income. Downside leader **Gilt** was already well below support in the 108.00 area and below the 107.62 previous contract lows, as well as mid-March continuation chart trading congestion at 107.42, which are now the key current resistances. Lower interim and major supports at 106.40 has now been violated, with slippage even below the 105.95 trading low back in January earlier today prior to having to respect the inability of the June T-note to break its 106-24 support. Below the current support the Gilt is into a major new continuation low with next support not until the June-July 2004 105.14-104.86 congestion, the bottom of which is a major 15 year trading low.

Similarly, downside leader **Bund** was in trouble slipping below its low 115.00-upper 114.00 area support 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 was . Of note, the failure below 114.46 violated the Tolerance of that UP Break at the low of the right shoulder of the June contract pattern. That was also the last interim continuation chart pullback low from September 2004, which the lead contract missed hitting during summer 2006 intermediate term bottoms, and again on the tests earlier this year. It was also a major Fibonacci 0.50 retracement (of the swing from the 104.50 March 2002 low to the highs.)

That is why the weekly gap in the 114.44-.57 range is so critical. All of which was also very critical for whether the daily MACD in the long ends could turn UP more convincingly, and especially whether the weekly MACD in the upside leaders T-note and even the T-bond could turn UP after coming back into balance from DOWN; they have reverted back to clear DOWN signals in the wake of their recent failures.

Yet, in spite of that failure below the mid 114.00 area, the much more critical Bund support was always going to be the major Fibonacci, congestion and weekly oscillator support in the 113.35-.20 range. This is likely why it was able to stabilize into that range for almost a month in spite of the destructive trend influence of the gap below the mid 114.00 area. Yet, that is why future activity from here is so critical regarding whether the Bund now maintains the most recent failure below 113.35-.20; with a Tolerance to the recent 113.45 congestion, above which it would seem to be Negating the near term Triangle pattern DOWN Break. If it does remain weak by respecting that near term resistance, it is also likely ready to enter a more accelerated down trend (the mirror image of the equity markets' accelerated strength), with interim support in the 112.20-111.80 area, and major weekly congestion and oscillator levels not until the low 111.00-110.50 range.

All the while the more resilient (not exactly 'strong') sister June **T-note** drop exhibited what was a very orderly, modest selloff below intermediate term 108-08/00 support, with the support Tolerance at 107-22 remaining critical for the short term trend decision (congestion and identical contract and continuation gaps.) As we expected, the T-note's previous inability to violate that Tolerance was the reason that the scope of weakness in Europe was fairly problematic as the Gilt and the Bund initially hit their more major lower supports. Now that it has been violated, the next T-note support in the 107-00/106-24 range has come under pressure, with lower major support not until the 106-08/00 range as all trend indications remain DOWN.

All of which points out the degree to which these massively disparate trends since the last major cycle turn in early 2000 come back into synchronization at times. Any chance for a more general bottom in the long dated fixed income seems to still be heavily contingent on whether the T-note can post daily (and ultimately weekly) Closes back above the 108-08/10 fine line resistance. That will very likely be a strong influence on all of the other fixed income markets, and short money as well.

Speaking of the short money, it had also been dropping below key supports in the wake of the various developments last week into this week, with September **Short Sterling** previously failing the 94.24-.22 range, and **Euribor** dropping below the long held 95.85-.80 area.

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 94.86-.82 range, which has been resistance on recent rallies. That left it vulnerable to revisit the low end congestion support in the 94.70 area that has now occurred, 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 under pressure as well, with September **Short Sterling** still grinding its way below the recent historic congestion at 94.10-.08 (contract low), vulnerable to an extension to support at daily oscillator levels in the 93.85-.80 area. September **Euribor** interim historic congestion in the 95.70 area has also been violated, with the major 95.60-.57 historic (May-June 2004) congestion and daily oscillator support the next level.

FOREIGN EXCHANGE

Until late last week the foreign exchange view remained the same weakening US dollar trend in spite of softness in the co-weak sister yen modestly buffering the US Dollar Index support levels and the recent sustained (albeit quite modest) US dollar recovery. However, as noted in the Overview above, the continued overall global economic strength that we expect to also reinvigorate the US economy in spite of its continued housing and auto woes means that at some point the US will move back up toward trend growth from current weaker performance. That will encourage some degree of intrinsic US dollar strength, along with expectations for the further Fed tightening which is still not envisioned by most market participants.

However, the buck has been more erratic than clear cut around short term resistances noted previous in the **US Dollar Index** at .8225, **EUR/USD** 1.3525-00, the **GBP/USD** 1.9750, the **AUD/USD** .8230, **USD/CHF** 1.2300, and the massive capitulation into a new low from the **USD/CAD** test of 1.1050 that has left it below the 1.0900 area December 1977 low.

Yet, other than USD/CAD all of the divergences in the US dollar down trend against the other currencies still seem to have come back into synchronization around current resistances, with a bit of extra slack in the USD/CHF. It will still be interesting to see whether the buck can succeed in churning its way through them, or revert to the previous more bearish activity. Along the way, we prefer a bit of a more neutral view, as the choppy nature of the recovery in the buck still speaks of this being a rally in a bear trend, even if it manages to extend to higher levels in the near term.

To address one other matter, there is not really any particular level against the Japanese yen that would signal any additional trend influence on the US dollar, even allowing that the next major resistance above **USD/JPY** 120.00 is not until the 123.00 area (albeit with 122.00 interim resistance.) As the weaker of the weak sisters of late, the yen would be totally adrift if the buck should succeed in breaking the noted resistances. With the recent return to weaker Japanese economic indications of late, it is no surprise the BoJ left their base rate at 0.50 percent last week, which also still underpins the carry trade for now.

If the US dollar Index does manage to sustain the recovery back above the .8225 area in the **US Dollar Index**, the first full correction in some time may lead to an initial recovery to the upper .8300 interim congestion, yet also hold the potential for a fuller recovery to retest important .8500-40 congestion and the weekly Triangle DOWN Break after the last test failed from there as far back as mid January. This is especially possible after the recent DOWN Acceleration on the drop below .8180 last month was not successful in maintaining the attempt to re-accelerate this week after the upside reaction above; often a sign of the bear trend losing momentum which is being reinforced by activity elsewhere.

The more active trend in **EUR/USD** had only seemed temporarily interrupted by the recent selloff. Yet, the shift from US growth expectations remaining weaker than Europe and Asia into the global growth possibly assisting the US to recover back near trend growth leaves the buck stronger in the near term. This is evidenced by the EUR/USD quick drop back below the interim support at 1.3525-00 which seemed to be reinstated on the recovery last Friday into early this week. While extended interim support is 1.3450, a sustained correction in the buck would point to a likely retest of the mid 1.3300 support, and a full correction to the trend channel support (from the major November 2005 low) would indicate a retest of the very low 1.3000 area is possible. Overall resistance remains around the 1.3666 December 2004 high, with extended resistances above that previous 1.3666 'official' all-time high up into 1.4000, 1.4200-50, and 1.4500-35 (the all-time high of the pre-1999 official launch synthetic 'basket.')

USD/CHF was, interestingly enough, holding well above its 1.1900-1.1880 UP CPR reversal bottom from December, with support at 1.2000 holding all year. While recently failing at the resistance in the low-mid 1.2300 area, weekly MACD had also turned UP. However, that tends to be a preliminary indication which still requires further US dollar strength to confirm it is anything more than a minor aberration.

Previous weak sister **GBP/USD** regained the bid in the recent stronger than estimated UK inflation numbers, yet lapsed back fairly quickly in the wake of weaker UK economic reports and the somewhat sanguine (if possibly misguided) BoE Quarterly Inflation Report this week. While its rally above the 1.9500-50 also carries above the extended resistances at 1.9750 (reinstated support), resistance also remains in the upper 1.9800 top of the current rally.

Of note, any further break will still need to occur in conjunction with EUR/USD weakness, as the **EUR/GBP** holding the retests of its .6760 UP Break (out of its weekly down channel from the major April 2006 high) still leaves that as lower support 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. EUR/GBP never came close to higher resistances in the .6900 and .6960-80 areas, and that reinforces the degree to which the pound is still more or less in line on their mutual trends against other currencies, and they will likely need to break their supports against the buck together in order to confirm that return to any sustained near term US dollar strength.

USD/CAD trend indications remained heavily DOWN after the recent violation of 1.1250 and its 1.1180 Tolerance left hefty weekly congestion above the market, which duly proceeded down to and even somewhat below 1.1050 interim support (now resistance.) Subsequent sharp failure from that resistance last week also quickly violated major support at 1.0931 (major May 2006 trend low) and its Tolerance to the 1.0900 area December 1977 low. In spite of that not leaving much historic congestion beneath there until the 1.0400 area, the market is holding against major weekly oscillator support (MA 41 minus 0.0600) that has held the bottom of every break since the US dollar stabilized into early 2005. That might make the fortunes of the buck against the other currencies more interesting and critical than usual against the Canadian dollar that is often an outlying trend.

Meanwhile, the strong sister **AUD/USD** remains well above previous .7980-.8000 resistance (now intermediate 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 also made it through the .8212 major December 1996 high, and that has been loosely held as short term trend support on the selloffs of the past two week. While it had violated .8230 area interim support as part of a vigorous retest of .8212, there has been no weekly Close below those levels, and they remain important to the near term complexion of the US dollar trend. Any bad failure below there will be significant confirmation that the US dollar is likely in some sort of sustained recovery that can indeed foment a correction to the .8000 area, with a Tolerance to the mid .7900 previous historic congestion that is also weekly intermediate term up channel trend support into next month.

On the Japanese yen cross rates, the recovery of the US dollar will only be of assistance to the yen if the USD/JPY also heads back down in the near term. Otherwise, the weakness of the other currencies against the buck will only be a modulator of continued secular weakness in the yen. **EUR/JPY** had already pushed well back above its 155.00-154.50 previous weekly channel DOWN Break and congestion, and up through next resistance in the 159.00 area and old high at 159.63 last month. Yet, even this tower of strength must continue to maintain the recent up trend back above extended historic resistance at the 1998 summer-fall highs in the 162.00-.40 range (also historic weekly oscillator resistance); that is also now a Negated near term 162.70 DOWN Break from the selloff early last week. However, there is sufficient recent congestion in the mid-low 161.00 area to buffer any initial weakness back below that area, and unless those levels fail the market will maintain the potential to maintain the push back above the mid 162.00 area, with extended historic resistance levels above that not until the 170 and 175 areas.

Similarly, and a bit more critically due to the recent resurgence of the British pound, the **GBP/JPY** back above its 229.00-228.00 weekly channel DOWN Break and congestion, also pushed through interim resistance in the 232.00 and 235.00 areas, and is now (finally) also convincingly above its remaining resistance in the upper 2.3000s. Having accomplished all of that, it is possible it might achieve a weekly Close above the previous major 240.88 August 1988 high, as it is currently attacking the 241.51 late January trading high. Above that the historic congestion and weekly oscillator projections allow for a rise to 247.00-248.00, which would be very consistent with a EUR/JPY extension to the 170 or 175 area.

ENERGY

Geopolitical concerns continue to bolster short supply issues, as worries over the situation in Nigeria, various terror plots and continued confrontation with Iran over various issues impact the energy markets add to the problems of US refiners in supplying gasoline to regional markets in the US. While the latter is not necessarily an overt bullish indication for the July **Crude Oil**, the rollover to that contract also still supports more strength in the energy markets, as its recent recovery still puts it back above 65.00. If it holds short term setbacks to the higher congestion in the low 64.00-upper 63.00 area (the lower congestion remains at 62.50), it is likely to extend the rally to the continuation and contract resistances up at 67.50-68.00, with extended resistance remaining in the 71.00 area.

France-III

While this is the third consecutive week for comments on France, after correcting our mistake (along with many others) in concentrating on political implications of Mr. Sarkozy's electoral success two weeks ago, we noted last week that the markets had been more forward looking. As such, they wasted no time in communicating to everyone what they thought about it all, as in addition to stronger relative economic news in continental Europe, the prospect of French economic reform has reinforced the degree to which the Bund and Euribor are more than happy to lead the way down, and DAX remains the upside leader of the equities.

At that time we also noted that this did not necessarily herald an era of unbridled economic reform in France, as on balance new French President Sarkozy ostensibly carries quite a bit of Gallic mercantilist-protectionist baggage along with his promised labor market reforms. However, in a demonstration of how these things evolve in ways that many observers have a hard time fathoming at first blush (more on that in **Analytic Balance** below), last Friday Monsieur Sarkozy dared to tread where no previous French president felt any need or desire: the government stake in European industrial champion (of sorts) aerospace firm EADS.

As we even questioned in our analysis last week whether the mercantilist-protectionist bent was his true nature, or just a necessary election stance to gain office without appearing to totally abandon European values, the free market thrust of his views was less a shock than the fact it came so soon after the election. Perhaps he has come to the same conclusion as many of his international cohorts that the time to strike at implementing any sort of extensive reforms is in the honeymoon period (such as it may be) immediately following the election.

If so, good for him, as the aggressive nature of some of his cabinet appointments also speaks of an attempt to link his proposed labor market reforms to some of more contentious youth employment and inter-faith relations issues. As noted two weeks ago, we wish him well; if France can succeed, it can be a true leader again within Europe, and even beyond.

China and the Fed

One must respect the Chinese: they sure know how to set the cat loose among the canaries. Last week's combination of higher interest rates of some nominally meaningful proportion to mitigate the more rampant aspects of domestic stock market speculation was accompanied by broader bands for yuan fluctuations (ostensibly a sop to the US Congress that continues to rightfully focus on the extensive trade imbalances.) The subsequent announcement of the \$3.0 billion investment in Blackstone Group provided further timely alleviation from the most draconian demands their US Treasury hosts might have been forced to make. Whether this is a real move into a sustained liberalization or just an expedient is beside the point. The fact they are moving more aggressively toward the sort of regime which will likely benefit them as well in the long run is productive, albeit pending further moves to reinforce the degree to which they understand the benefits.

Whatever the extent and impact of Chinese liberalization of their foreign exchange function and offshore investment of their now vast foreign exchange reserves, there are far better sources for analysis of that than our humble views. The only thing we would care to add is that possibly this is part of the reason the Fed has not wished to weaken to the US economy to a degree that would actually foment more of a global slowdown. While we remain fairly confident that is the only way to head off the resurgence of inflation that has already remained too high for too long in the wake of last year's sustained US economic and equity market strength, the Fed may be onto something that we failed to take into account.

Given their current "data driven" fixation seems to leave them a hostage to the evolution of domestic and global economic factors, it is likely giving them far too much credit for looking significantly down the road to account for the most extensive geopolitical effects. Yet, if it takes the extreme exuberance of what is nothing less than the next bubble (based on equity market weekly oscillator indications that may soon be achieved; see **Markets** section above) to encourage the masters of what was once the last major state controlled economy to abandon all pretense of politics taking precedence over economics, then possibly the risk which may accompany this extension of the equities market is worth it.

Is the Fed still the proverbial deer stuck in the conflicting "data driven" lower growth versus stubborn inflation headlights, or actually taking an extremely forward view? For the latter to be the case, a major portion of the recent extension of transparency into the ongoing debate over whether its worth attempting to force inflation back into their comfort zone, as well as the degree to which housing may or may not be a negative for the broader US economy, and the general implication of their allowing that the US economy will exhibit increasing strength across the remainder of the year after the first quarter weakness might all have been (and continues to be) a giant smoke screen for their hidden agenda: extending global economic strength to complete the evolution of all of the world's major politico-economic cultures (a club which China shall soon join on present trends) to liberal capitalism.

As we noted, that's quite an assumption; also a deliciously Machiavellian thought. While the cost is more inflation, the goal would seem worth achieving. As we've castigated developed world central banks for their less than effective shift into extended transparency (see last week's *CMO* III-20) at this point in the cycle, that would go a long way toward redeeming them in our eyes. Possibly their move from inscrutable to insufferable was not the wholesale abandonment of central bank secrecy that we surmised. Of course, if that is indeed the case, it is such a confidential agenda that neither we nor anybody else is likely to ever know.

Analytic Balance

Recent reviews of how various factors have evolved on the fundamental analysis front of late, with the commensurate shifts in technical activity that have not always been consistent with the breaking economic data releases have encouraged some of you to inquire if we could possibly provide a bit of further discussion on how these factors relate to each other.

Needless to say, any discussion of how fundamental economic analysis works in conjunction with technical analysis creates several concerns. In the first instance, while there are certain interrelated principles, that perspective is of necessity a selective view of the analysts who are providing it on at least some levels; it is not a single accepted model. It also leaves some of the followers of each school a bit uncomfortable, due to their strong belief in the superiority of their approach. And, last but not least, it is actually a bit redundant for those who already appreciate how the two schools relate, and approach the markets accordingly.

With due respect for the latter group's possible lack of desire to revisit this topic, there are more than a few ways in which fundamental and technical analysis are highly correlated, and we shall discuss some of these in a constructive manner below. However, to encourage the more aggressive adherents of each school to explore this further, we feel it is constructive to take a less than constructive view of the alleged 'conflict' between these two approaches, and will first debunk that pseudo-confrontation.

While there are other forms of analysis, such as 'value' analysis of individual companies in the equity markets that have no need or desire for a technical view, trend analysis can indeed benefit from both. While they also ostensibly eschew it, value investors in stocks which have indeed moved substantially in their favor might also benefit from some intermediate-to-long term technical projections. But that is another topic.

Also of note prior to taking fundamental and technical isolationists out to the woodshed for a thorough thrashing, there is one other point we find of extreme interest. It has come to our attention of late that due to the recent lack of volatility, and full maturation and saturation of their analytic approach, even quantitative analysts in the fixed income markets are beginning to look at trend tendencies as a requirement for optimizing their performance. Interesting.

However, the real bottom line is that the idea fundamental and technical 'trend' analysis are 'opposing' schools is rubbish. While they admittedly employ different methods due to the nature of the influences which they assess, at the core they both attempt to derive answers to the four basic price trend analysis questions: Which way? When? How far? How fast?

To avoid ambiguity or misimpressions from the extended review below, we have cautionary as well as supportive insights for each school on this essentially silly and often needlessly acrimonious debate. Our pointed indication to fundamentalists acknowledging the veracity of their theoretical frame of reference with clear articulation of its limitations, and the converse for technicians (identification of limitations that allows for the benefits) is this:

To the Fundamentalists: Okay, you're right: Prices experience sustained major shifts because of supply/demand disequilibrium, and not because a bunch of folks sit around staring at price histories and their derivative indications. Yet, the tolerances necessary to implement your views until categorically disproven are not consistent with anyone's norms of acceptable risk. Great views based on causality; risk of extreme loss (and psychological destruction) if wrong.

To the Technicians: It's not science *per se*. Period. Get over it. While it is useful to 'borrow' terms and constructs from a range of scientific fields, those are metaphorical in application to market analysis in spite of the fact that the mathematics seem to work. However, by utilizing the proper scope of tools from this 'craft' with well-researched tolerance factors, insights can be achieved on the points in time and price levels to consider whether trends are continuing or have reversed. That ultimate benefit is far more important than respect for attributes your form of analysis simply does not possess. That it develops useful perceptions for effective portfolio adjustment and risk management should be enough. Not science; no causality, however useful it may be when properly applied.

For those who appreciate it, on a theoretical level (even in a short term view), the specific intrinsic relationship is based on how fundamental demand elasticity analysis relates very well to technical support and resistance, and especially price objectives (How Far?) Yet, as all technicians allow those levels are important only as an indication of what markets *should* be doing, and fundamentalists similarly allow that assessment of specific thresholds of demand elasticity can *evolve* across time (and are subject to assumptions about the degree of supply displacements), it would seem to make sense to use both complements of the full picture.

The following examples of fundamental analysis failures are not meant in any way to disparage fundamental analysis as a discipline. We began as fundamental analysts, and remain committed to reviewing those factors to confirm that the extensive projections from our technical analysis are indeed realistic on some level. Yet, that is actually the point: these are *complementary* and not contradictory disciplines. Some sort of price performance to confirm a fundamental analysis is necessary to manage the psychological and especially the financial risks; and in that the fundamentalist lapses over into a *de facto* technical outlook.

Similarly, the best technicians have a healthy respect for both economic report releases and communications from financial luminaries. With due apologies to the scientific community, we borrow a term from astrophysics (most folks find market analysts an alien breed in any case), and characterize those as "event horizons." Most 'macro' (as the combined craft is known) analysts actually attempt to construct a 'rationale' for the evolution of the economic influences that will support their more extensive technical projections and trend views. That is not to say it must be consistent with the influence of every near term report release.

In general, the lack of an integrated view has been less than effective of late for either school, reinforcing the need for balance and perspective, and the use of these two as complementary indications for the real trends. If an investor or trader was suspicious of the equity markets into Mr. Greenspan's late February indication of a higher likelihood of a US recession than anyone had discussed for awhile, then they might have assumed US housing weakness had created a definitive reversal in those markets as the break proceeded into mid-March.

While there were some other indications refuting that along the way, the final news that this was not a viable view only came with elections in France reinforcing the economic strength of Europe, and Mr. Bernanke finally refuting the idea so prominently featured (if only by passing mention) in all recent FOMC statements that weak housing market influences might indeed spread through the balance of the US economy. The foundations of the bearish argument for equities that Europe might not be able to sustain its strength (which was actually more of a risk into the major German VAT hike in January) and the US housing sector would create a major drop in US consumer spending were crushed by these and other factors of late.

The much feared (by some participants other than ourselves) carry trade crisis had already failed to develop on the equity market selloff into March, as the asset price deflation clearly led the Japanese yen higher (instead of the yen affecting asset values as had been broadly predicted.) As such, it is not really a surprise that the equities continue ever higher with each fresh piece of good news we are currently seeing. While that brings its own risks, the final capitulation of the bear fundamental argument has occurred at levels which are dramatically higher than the break into mid-March. This is an unacceptable level of ostensible loss engendered by a lack of intrinsic risk management indications from fundamental analysis.

Which reinforces the degree to which any qualified trend analysis that is based primarily on a fundamental view should also include (secondary) review of the 'complementary' technical trend indications of what price movement should timely evolve if that supply and demand (or psychological) analysis is indeed timely as well as viable overall.

The reason for resolving a primary view with secondary indications is that almost all analysts (present company included) still find it hard to evenly balance the two different approaches; nor is it necessary to do so. Indeed, there is nothing intrinsically wrong with the tendency to favor one school over the other according to one's natural inclinations. Yet, those involved in what is considered 'best practice' do not walk out onto the field of global financial combat wearing half a suit of armor, or carrying only the handle of their sword.

The same holds true for the technicians. In the first instance, even as it relates specifically to their craft it is very important to take a global view. The mistake often made by fledglings in this highly challenging area is to look at too narrow a time frame, or ignore intermarket relationships. For example, there are sustained periods when classic counterpoint between the equities and fixed income trends does not apply (as the summer and fall of last year.) The various fixed income markets can also seem to trend in opposite directions for some time, and understanding the 'whys' and 'wherefores' of those tendencies is as important as noting the purely technical aspects.

And that takes an understanding of fundamental background which informed our views of why the Bund could remain bullish far beyond its typical three- to six-month lag, and avoid joining the down trend of the T-note during 2004 and 2005. Without an appreciation of the distortions due to various factors from the 1999 introduction of the Euro to the effects of the German pension reforms it would not have been possible to effectively analyze differences between this intermediate term cycle and those prior to the 2000 major Dot.Com bust long term economic and equity market cycle high. That previous lag is also why the DAX can now lead the rally and Bund lead the break in their respective international complexes.

Another risk to the technician from not having a respect for at least the fundamental 'rationale' is the risk of being whipsawed by near term technical indications which are inconsistent with the economic potential in the markets, especially if they already have a decidedly short term technical orientation. As just one example, undoubtedly some short term technical analysts were also very impressed with the aggressiveness of the equity market break from late February into mid-March. While technicians by nature do not want to count on the influences from the fundamental background, it was necessary in that case to allow that the near term market weakness did not seem to actually reflect most economic data showing any indication of a full reversal of the strong equity market trend into a major break.

While it will not always help, the expectation that Mr. Bernanke would shed his professorial mantle to provide the requisite upbeat reinforcement for the overall strength in the US and international economy (with a major assist from the estimable Mr. Paulson) was fulfilled in his communications during that period. As such, the markets duly stabilized, and the technicians who were savvy enough saw the DJIA hold around the major critical trend support in the upper 11,900 area; that upside leader DAX also held into its 6,500-6,427 support provided further comfort. Yet, to anticipate those sorts of extended levels were the real zones of critical trend support required a broad perspective consistent with the full appreciation of underlying fundamental trend influences. Only a violation of those supports would have signaled the need to reconsider the fundamental influences. It's a cart and horse issue.

In essence (as there are myriad examples which could be included in this review), there is an intrinsic interplay between fundamental and technical analysis that means neither is complete without the other. Prices trend because of real or psychological disequilibrium in supply and demand (which is apparent to some degree whether the underlying is a physical commodity or the intrinsically more psychological financial instruments.) However, to proceed under assumptions a particular fundamental analysis is incontrovertibly accurate at a given time is to ignore how much the fundamentals themselves are a moving target, and in the longer term can shift as much as the technical analyses.

That is just what has occurred as current equity market up trends fulfill the old axiom that, once established, trends will last longer and proceed farther than almost any participants imagine at their inception. That has also been the case in a closely related development: copper prices reaching levels inconceivable to many analysts. This has been substantially due to the evolution of copper use for Chinese exports. That has now been sustained to a degree that has developed a newly expansive middle class, and evolved into copper demand for use in what is going to be major Chinese housing boom. That story is being repeated throughout the rapidly developing economies, as well as the recent reinvigoration of the more well established German domestic economy, also in the wake of very strong exports.

As a friend of mine has aptly noted, in times of major global economic flux, one of the very greatest challenges facing fundamental analysts is their tendency to fully explore all of the factors, "...like peeling away the layers of an onion."¹ They only become aware there is a dilemma when the removal of what would seem the final layer yields not the price projection solution, but "...another whole onion at the core"², and/or highly unexpected price activity.

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

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¹Tinghino, Mark, *Technical Analysis Tools*, Bloomberg Press (available late 2007) ²Ibid.

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