ROHR REPORT

CAPITAL MARKETS OBSERVER

Volume III Number 22

Wednesday, May 30, 2007

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…Analytic Balance (revisited), Hypotheses or Just Plain Facts

Overview

As we noted last week, one must respect the Chinese: they sure know how to set the cat loose among the canaries. Their combination two weeks ago 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. Yet, both of those moves as well as the subsequent announcement of the $3.0 billion investment in Blackstone Group seemed moreso designed to alleviate from the most draconian demands their US Treasury hosts might have been forced to make due to the influence of a US Congress that continues to rightfully focus on the extensive trade imbalances.

However, today's moves seem to indicate a much more serious attempt to control their own bubble economy prior to it reaching a point which might foment a catastrophic end, if indeed that has not been already reached. However, the obvious response from the US and other equity markets has been rather subdued, and at least for now that would seem to indicate that the potential for a 'crisis' in China, and that spilling over into a global equity market meltdown is rather limited. In fact, after a rather quiet early reporting week, the extensive news from this afternoon's release of the minutes from the May 9th FOMC meeting onward through the end of the week is rather daunting. These include all of the late and early month economic releases, which in this instance the US Employment report being released this Friday in spite of that being the first day of the month (as this is not always the case.)

In any event, last week's ostensible stallout of the US equity markets as the **DJIA** failed to keep pace with the real upside leader **DAX** left a question over whether the US markets might attempt to fail in their own right if the economic news is less than strong. In fact, unless there is a actual debacle in China, in spite of its very high profile it is still not a large enough market to likely create a full blown asset market rout in the developed economy equity markets and other asset classes. The question therefore remains whether the leading equity indices are going to experience a failure which will allow them to reverse into down trends in their own right rather than whether weakness in China is a prime mover.

The key level which we noted last week and maintains and is actually reinforced as critical this week is the DJIA 13,370 congestion support. While the more significant recent supports remain down at the recent 13,210 reaction lows as well as the late February 12,800 area highs (which remains interim support), this Friday (i.e. US Employment day) 13,370 is also the aggressive up channel support from the mid-March reaction low. With important DAX weekly oscillator projections up to 7,660, and the **S&P 500** future support similarly below last Thursday's 1,507.80 selloff low into the 1,500 area, it is all critical into somewhat lower lows than the recent selloffs. And that is very important for the fixed income markets as well, as they seem to need more than a passing downside correction from the equities to foment any reaction that is more than a minor squeeze. After such sizable equity rallies, at the very least the strong sister June US **T-note** will need to recover back above its failed 107-00/106-24 support to encourage recovery elsewhere. The US dollar continues to churn at present.

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. The FOMC minutes due to be released this afternoon are not expected to change any of that, even though Mr. Bernanke's recent refutation of the idea that the subprime woes and weak housing will spill over into a problem for the balance of the US economy.

Early tomorrow (prior to the opening of European markets) the French Unemployment Change (APR) and UK GfK Consumer Confidence Survey (MAY) are released. Those are followed by the Japanese Manufacturing Purchasing Managers Index (MAY) and Labor Cash Earnings (APR), Australian Private Sector Credit, Trade Balance (both APR), and Private Capital Expenditure (Q1), followed by Japanese Housing Starts and Construction Orders (both APR.) Then it's on to Europe for UK Nationwide House Prices (MAY), German ILO Unemployment Rate (APR), French Consumer Confidence Indicator (MAY) and Producer Price Index (APR), the German Unemployment Change and Unemployment Rate (MAY.) After that it's on to Italian Large Company Employment (MAR) and Bank of Italy Annual General Assembly, back to the UK for money supply and lending figures along with Mortgage Approvals (APR), Euro-zone Consumer Numbers Confidence (MAY) for both business and consumers, as well as the Euro-zone Consumer Price Index Flash Estimate (MAY), Italian Consumer Price Index (MAY Preliminary), and finally the UK CBI Distributive Trades Report, Realized and Expected (MAY).

Did we say finally? That just means prior to the US reports on Gross Domestic Product that includes the closely watched Price Index and Core Personal Consumption Expenditure (all Q1 Preliminary), Weekly Jobless Claims (for the week ending MAY 26), Chicago Purchasing Manager Index (MAY), Construction Spending (APR), Help Wanted Index (APR), House Price Index (Q1) and EIA Crude Oil Stocks (for the week ending MAY 25.)

Friday is another economic data and central bank influence tsunami, as the festivities begin with the Australian AiG Performance of Manufacturing Index, RBA Commodity Index and Japanese Vehicle Sales (all MAY.) Then it's on to Europe for German Retail Sales (APR), the European Central Bank's Trichet speaking in Ankara, the European and UK Purchasing Managers Indices, Manufacturing (MAY), the Fed's Kroszner speaking on the U.S. Economic Outlook in Greece, the Euro-zone Gross Domestic Product and associated numbers (Q1 Preliminary), its Unemployment Rate (APR) and European Commission GDP Forecasts, with the ECB's Bini Smaghi speaking in Trento, Italy as well.

Then it's on to the critical end of week data in the US, which includes the early morning release of Personal Income and Consumption Expenditure (APR) concurrent with the Employment numbers (MAY.) That is followed by Pending Home Sales (APR), the ISM Manufacturing Survey (MAY) and University of Michigan Consumer Sentiment index (MAY Final.) Quite a day at the end of a week that is already quite a week due to the influence of our friends in China.

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 three 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.

Yet, after exceeding that at 13,520 area on a weekly Close two weeks ago, it failed to extend that accelerated state when it failed to Close above the next extension last week into the 13,585 level. As we noted, the previous push up had created what was a bit of a perverse burden of proof on the bulls at the top of a very strong rally, and in fact the DJIA new high and lower Close last week has established a very minor DOWN CPR from 13,556.50 (the weekly Close from two weeks ago), with a Tolerance just above that. While that is a minor reversal that suggests it is not very credible, the market will need to hold its immediate lower support to avoid the near term weakness turning into anything more pernicious.

All of which helps to narrow the decision as the near term support is also as nearby as the 13,370 congestion support is also the aggressive up channel support this Friday (i.e. US Employment day) from the mid-March reaction low. Of note, it is also right in line with the upward shift in the previously violated weekly oscillator resistance (MA 41 plus 1,000 points), as well as a reasonable Tolerance for the daily MA 18 in the low 13,400 area. As noted above the more significant recent supports remain down at the recent 13,210 reaction lows as well as the late February 12,800 area highs (which remains interim support.) Yet, even any failure into the immediate lower trading range will represent the first attempt since the mid-March lows (over 1,600 points below the recent all-time highs) to drop back in a sustained correction to more major supports.

The **S&P 500** future short term support is similar to the DJIA insofar as it is also into the 1,500 area (with a Tolerance to the 1,496 reaction low from three weeks ago.) It has in fact played a bit of upside catch-up with the DJIA, as its oscillator resistance was 1,535 last week, and it stalled there prior to the recent weakness. 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. However, much like the DJIA it will need to push through resistance from last week's DOWN CPR at 1,527.80, also with a Tolerance just above.

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 exceeded two weeks ago, and sustained on the weekly Close above the 7,620 level last week; critically that is up to 7,660 this week. All of which reinforces the DAX upside leadership.

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 it 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 6,500 area, which is now support. 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.

While 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. Possibly due to that lag, it has not fallen back below that 17,500-600 support in the wake of the Chinese machinations. Yet, as we suspected would be the requirement, it still seems like a current impressive holding action and ultimate push through resistance in the DJIA will be needed once again to assist Japan in pushing up once again from the 17,500-600 area as well as Negation of 17,750-850 resistance which the market stalled into once again on the recent 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. The **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 and even the 105.95 January trading low back have now been violated. Below that 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. The failure below 113.35-.20 (now resistance with a Tolerance to the 113.45 congestion) has led to a timely failure to the interim support in the 112.20-111.80 area, which is very critical due to next supports being all the way down at 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 remained 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, along with the next T-note support in the 107-00/106-24 range (now the immediate resistance), the lower major support is not until the 106-00/-105-24 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 relied heavily on whether the T-note could post daily (and ultimately weekly) Closes back above 108-08/-10 fine line resistance. The failure of that to occur was a strong influence on all of the other fixed income markets, and short money as well as they reinstated their major down trends.

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, with next support around 94.60-.56. All of 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 below recent historic congestion at 94.10-.08 (contract low), and 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 (from May-June 2004) congestion and daily oscillator support the next level.

FOREIGN EXCHANGE

Until last week two week's ago the foreign exchange view remained the same weakening US dollar trend in spite of softness in the co-weak sister yen modestly buffering US Dollar Index support levels. However, as noted previous, 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 US dollar strength, along with expectations for further Fed tightening still not envisioned by most market participants.

However, the buck was 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, 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 am 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 recent drops back below interim support at 1.3525-00, as well as yesterday's early week stallout into that area. While extended interim support was 1.3450, 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.

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 recent rally.

Of note, any further break will still need to occur in conjunction with EUR/USD weakness, as seems to be occurring. This is because **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 remain 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 two weeks ago also quickly violated major support at 1.0931 (major May 2006 trend low) and it Tolerance to the 1.0900 area December 1977 low. That does not leave much historic congestion beneath there until the 1.0400 area, and the market has is also now slipping below major weekly oscillator support (MA 41 minus 0.0600) in the 1.0800 area that has held bottoms of every break since the US dollar stabilized in early 2005. That means that the USD/CAD is a true outlier, which can not be counted on to influence, or be influenced by the fortunes of the buck against the other currencies.

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 until last week. Any bad failure below would signify a much greater chance 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 will likely 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. Yet, all of that said, the latter is not necessarily an overt bullish indication for the July **Crude Oil**, and some of those geopolitical factors have eased to some degree as well.

That has led to some slippage in this market, as its recent recovery stalled above 65.00 area once again. It has now slipped right back through the low 64.00-upper 63.00 range to lower congestion in the 62.50 area. However, even if there is some further erosion, all other things equal (i.e. no major equity market debacle) there remains a good deal of lower support at the Negated major weekly channel DOWN Break and congestion in the 60.00-59.00 range.

Analytic Balance (revisited)

TREND DEDUCTION

As we noted last week, any discussion of how fundamental economic analysis works in conjunction with technical analysis creates several concerns. 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. Yet, we hope that last week's review of analytic balance addressed the similarities being more pronounced than the differences for trend analysts.

There were two additional functional observations which we feel are helpful in illuminating this area, yet were not included in the previous review. The first is one we already highlighted at the beginning of the month, and is worth revisiting for its deductive implications related to the trend analysis process. It is especially relevant to the current short term market conditions in the wake of the Chinese government moves this morning.

As we have noted at many previous junctures, trends tend to remain dynamic; eliminate the indication that they are ready to go down, and they find excuses to extend their up trends. While not meaning to sound too-clever-by-half, that can all be related back Sherlock Holmes' investigative methodology explanation from the story 'The Sign of Four.' As he said to Watson in a typical dismissal of any attribution of 'genius' to his prodigious skills, "…when you have eliminated the impossible, whatever remains, however improbable, must be the truth."

Unless support is broken soon, expect there will be further extensions of the equity bull market in spite of the sharp downward reaction in response to the Chinese influence. This all gets back once again to last week's discussion of our trend view shift back to a bullish stance once it became apparent back in mid-January that the German VAT hike from the first of the year was definitely not going to fracture their (and the European) economy. As is often the case, in hindsight we now have a better idea of why that unfolded as it did.

SEISMIC PSYCHOLOGY

The other insight that is both useful in general and applies directly to current market decisions into the end of this week is the market perception of the 'force' and sustained influence of any fundamental or economic impact. Viewing this from the perspective of force encourages a seismic metaphor. While scientific study of those phenomena uses the very exacting Richter Scale, a more general three part hierarchy on influence is likely sufficient for price trends.

That would be whether the impact is merely a 'rumble', has the effect of an 'earthquake', or is a long term 'tectonic' shift in major economic activity or assumptions. For the most part, the day-to-day economic data releases, and even pronouncements from financial luminaries fall into the least significant category, a mere 'rumble.' As most reports are well anticipated, and results are more or less in line with estimates, the room for a major, sustained trend change based on any single report or speech is a fairly rare occurrence.

Among the most prominent examples were last year's US Bureau of Labor Statistics massive upward revision to the employment numbers that sent the fixed income market reeling, and Mr. Greenspan's first mention of 'irrational exuberance' in December 1996 that had a similar effect on the fixed income. The ironic part of the latter is that it was broadly misinterpreted to mean that Mr. Greenspan meant fixed income bulls had bid the bond markets (i.e. dropped long term yields) to levels which were not sustainable in a growing economy. They remained in a bearish trend through the middle of April 1997, while the equities which were the actual target of his comments barely dipped prior to resuming their up trend.

Yet, they each of those divergences from expectations approached the impact which would normally be reserved for an 'earthquake' magnitude of influence. However, more sustained surprises often come from government policy shifts, such as the one which the Chinese are attempting to implement over the past several weeks. While in many cases these are in response to some obvious market anomaly, their timing and degree can be a bit of surprise. Whether there is any sustained market influence is always a question as well.

While it was not our expectation, there were many who felt the first signs of Bank of Japan rate increases would foment an immediate vicious and sustained escalation of the Japanese yen; the proverbial 'carry trade' crisis. Yet, due to underlying economic strength elsewhere and residual weakness of the Japanese economy, the response was moreso a whimper than a bang when the BoJ finally did raise rates. Even though the move was closely followed by the late February through mid-March equity market selloff (in response to Mr. Greenspan's indication of a higher likelihood of a US recession than anyone had discussed for awhile), no carry trade crisis or sustained equity market selloff developed.

Much like an earthquake, these impacts have very obvious and powerful immediate effect, yet the damage is repairable across time. And in the markets that often means in not more than a month to a full quarter of trading. Even after Mr. Greenspan's initial December 1996 'irrational exuberance' comment irrationally depressed the long dated fixed income markets, they reinvigorated their bull trend from the April 1997 lows for a major up trend that would last until October 1998, and see the T-note rally sixteen percent (of par value) and the long term T-bond gain twenty-two percent.

The true 'tectonic' shifts are obviously more influential in the long term, yet are not always easy to discern while they are occurring. This is due to the degree to which they are often longer term economic developments which are not part of the markets' normal perception. One of the most obvious in hindsight was the impact of inflation and deflation, along with floating foreign exchange rates becoming more telling influences once the US abandoned the gold standard and Bretton Woods foreign exchange regime in the early 1970s. What had been a fairly stable post World War II economic environment that allowed for very accurate predictions from classical economic supply/demand analysis was going to (as Mr. Greenspan so prosaically put it years later) "disconnect from its moorings."

As we noted in last week's discussion, a similar plague has recently been visited upon long term participants who have had to radically adjust the assumptions behind the analysis of copper prices. Those have reached and sustained levels inconceivable to many analysts who were burdened by an historic frame of reference which did not allow for assessment of extensive shifts in the demand balance of that market. 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, also in the wake of very strong exports.

Rumble, earthquake, or tectonic shift. Those are the respective metaphors for the seismic equivalents of the impact of standard reports and events, more major government activity of some type, and the long term economic or demographic changes which truly shift the entire frame of reference for one or more markets.

Hypotheses or Just Plain Facts

The major degree to which another form of investment theory has become very popular was highlighted in a Financial Times analysis last weekend. Sadly, that area also seems to have developed its own senseless debate between ardent advocates of two different approaches to the same general type of analysis and investment: classical indexed investing and a variation known as 'fundamental' indexing of investment portfolios.

At least John Authers' Long View "Debate rages on the merits of 'fundamental' indexing" (May 26) finishes with the indication that both sides may be right, and "researchers have uncovered a slight inefficiency in the market over the years." While even that modest sign is of some comfort, it does not go nearly far enough. To trend analysts the discussion looks like congregants in different pews of the same church arguing about how many angels can dance on the head of a pin.

This is not to say that indexed investments are in any way deficient. There are times when investors with certain goals should take advantage of 'average' performance. Yet, according to Mr. Authers' article, 'efficient market' adherents are happy to deride performance adjusted approach proponents as heretics. They are allegedly involved in blind data mining, and their proposed approaches are overblown statements of the obvious, as if they had "discovered that the earth moves around the sun." We can only imagine what they have to say about radically blasphemous 'trend' analysts.

That seems to call for a dissection of the 'efficient market' hypothesis, and whether it rises to anything as impressive as Copernican revelation. In the first instance, who exactly elevated this to the level of hypothesis? That term applies to the primary assumption of an argument. What argument? For trend analysts the fact that markets incorporate all known information at any given moment is learned early. That no further immediate influence should be expected from news which the investing public has already acted upon is a rather obvious, and indeed banal, fact of life. The question then becomes what future influences can be reasonably estimated to impact sustained price trend activity?

As Mr. Authers noted, the efficient market proponents then enter into a very strong marriage of convenience with the random walk theorists' view that price movement is simply the sum of serial news impact twitches. They seem very comfortable that the entire history of economic analysis, including that of intermediate- and long-term cycles and trends should be jettisoned in favor of surrender to 'average' returns. Yet, there are long term cycles which incorporate intermediate term trends that can be discerned, and which some advisors and portfolio managers repeatedly capitalize upon for their clients.

Possibly the most impressive aspect of these theories is that smart and successful folks like Mr. Bogle of Vanguard Group continue to promote the efficient market hypothesis as if it formed some sort of advanced knowledge, and all other views are misguided. The message to the investing public and fund managers is that you can not figure it out, so why try?

One of the primary pieces of evidence which they use to reinforce this view is the degree to which more than half of active managers with published performance records tend to under perform the indices. Yet, that statistic has always looked a bit specious to us, as it fails to take a key factor into account. That is the large number of portfolio managers who neither need nor want to publish their performance record.

These are the proprietary dealers who work for the major international securities firms and banks, as well as private money management firms. Under risk of not being asked to continue, they tend to make significant profits for their firms or clients which are never specifically noted in any league table, even though some attempt is made to discern the overall figures from annual reports and such.

Those dealers tend to capitalize upon trends, and I suspect if their performance was included in the studies it would go a long way toward improving the overall performance figures. Yet, one does not need to be a portfolio manager to appreciate trends; just look at any long term price chart of most active, liquid commodities or securities. The difference between the lessons drawn by the trend analysts and efficient market, random walk proponents is that the trend analysts look beyond the immediate impacts for cyclical and extended forward looking fundamental factors to estimate where prices might proceed after current influences are fully digested by near term price activity.

Trends exist. From late 1970's USDA price studies[1] and others' analysis of truly random number activity[2] the insight trends tend to form even in a vacuum is very firmly established. More recently, Benoit Mandelbrot and Richard Hudson expound on the weakness of theories of modern finance and propose some heresies. Summary implications of just a few of their key points are that regardless of how efficient, markets are highly uncertain; investors are irrational and cause bubbles and busts; as such, timing matters greatly.[3] Even when index investing, consider the significantly different long term return from a portfolio conservatively structured in 1999-2000 versus one funded across time in 2003-2004, once the equity markets had bottomed.

In future it should be hoped that in the interest of investing public financial literacy, specific strengths and weaknesses of each approach should be the focus instead of the sort of acrimonious debate that also infects confrontations between some of the more contentious fundamental and technical analysts. The efficient market advocates simply abandon any attempt to discern future trends. We believe Mr. Authers was very adept in describing these strategies as quantitative, with some incorporating 'value' style. There is nothing intrinsically wrong with either approach; just the degree to which they become obsessed with establishing their superiority to each other, and other portfolio management philosophies.

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

-Rohr
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[1] Jitendar S. Mann and Richard G. Heifner, "The Distribution of Shortrun Commodity Price Movements," Economics Research Service, U.S.D.A., Washington D.C., 1976, p. 16.
[2] Sklarew, Arthur, Techniques of a Professional Commodity Chart Analyst, Commodity Research Bureau, Inc., New York, NY, 1980, pp. 10-12.
[3] Mandelbrot, Benoit and Hudson, Richard L., The (Mis)Behavior of Markets: *A Fractal View of Risk, Ruin and Reward*, Perseus Books Group, New York, NY, 2006.