

ROHR REPORT

CAPITAL MARKETS OBSERVER

Volume III Number 24

Tuesday, June 12, 2007

Overview, Reports & Events, Markets,...

...Same Old Stuff?, Debt Divergence Denouement, Miscellany

Overview

Whereas the normal US mid-month reporting vacuum would have been punctuated by the Retail Sales figures in any event, this week now also includes Wednesday's release of the Beige Book in preparation for the June 27-28 FOMC meeting. The calendar also sees both sets of US inflation numbers coming out late week; PPI Thursday and CPI Friday. As if that were not enough to make it a more interesting than normal early part of the mid-month period which is typically dominated by European news (including their inflation numbers) this is all in the wake of last week's major central bank influence from the ECB stressing its continued hawkish stance while Mr. Bernanke finally took his own talons out of mothballs.

And if anyone happened to think that last week's blast was the summary influence from the central bankers and international treasury officials, guess again. This week is absolutely rife with extensive and potentially trend decisive influences from financial luminaries, including former Fed Chairman Greenspan speaking into lunchtime today. Of course, the question becomes what influence this is likely to have after last week's rather nasty fixed income reaction to the hawkish comments from Messrs. Trichet and Bernanke?

Thankfully, various aspects of the current market technical matrix as well as indications from late last week speak of potentially less volatility than last week unless inflation numbers are wholly more pernicious than we expect. In fact, while a whole series of support levels have not surprisingly failed during the down acceleration phase of the Bund trend (with the equities following suit last week), the debt markets are now approaching conditions which classically allow for a near term bottom even if they are to remain bearish across the longer term cycle. Even if equities manage to rally back from last week's debacle, it will be interesting to see if they are restrained by any further fixed income slippage into those lower support levels; a bit of a classic trend delimiting tug-of-war is the likely scenario in that case for this week.

For the downside leader September **Bund** that means 110.00-109.65 (based on the weekly Close), even though it traded temporarily below a big Fibonacci retracement level at 110.50 last Friday. Similarly the other weak sister September **Gilt** needs to respects its long term support in the 104.00-mid 103.00 range, as well as the September **T-note** holding no worse than 104-00 major historic congestion that it held at the bottom of the down trend last June, as it in fact held higher support in the 105-00/104-24 range last Friday.

All of which brought some relief to equity markets which have now reached and even cleaned out below supports at **DJIA** 13,370, albeit without violating lower supports in the 13,200 and 12,800 areas (previous February high and significant Fibonacci retracement. Indeed the **DAX** (real upside leader) held firm against 7,500 without needing to test the congestion buffer below that into 7,400 area. All of those higher yields also assisted the **US Dollar Index** push above the .8250 resistance Tolerance of the .8225 area. Another interesting aspect of all this is the degree to which the trend divergence might be migrating from the fixed income to foreign exchange; all of which is reviewed in the topical discussions below.

Reports & Events

Yesterday morning saw mixed news on the Japanese Gross Domestic Product Annualized & Gross Domestic Product Deflator (Q1 Final), French and Italian Industrial Production and French Manufacturing Production (APR), followed by comments from both the relatively hawkish comments from the ECB's Hurley and Fed's Pinalto at an international finance conference in Dublin, and UK Producer Price Index (MAY.) That was followed by ECB President Trichet's quarterly testimony before the European Parliament Committee on Economic and Monetary Affairs, and the Fed's Moskow providing welcoming remarks at the Chicago Fed Auto Industry Conference; neither with much effect.

Today began with Japanese Domestic Corporate Goods Price Index, general Consumer Confidence Index and Consumer Confidence Households, as well as their Bankruptcies (all MAY), and the National Australia Bank Business Conditions (also MAY.) Then it was over to Europe for the German Wholesale Price Index and UK Consumer Price Index and Retail Price Index (all MAY), as well as their Trade Balance (APR), after which it was back to the continent for Euro-Zone Industrial Production (APR.) In the US Treasury Secretary Paulson speaks at trade conference in Atlanta, and Chicago Fed President Moskow provides welcoming remarks to the second day of the in Chicago autos conference; albeit we do not believe his views will be very trend decisive unless he diverges digresses from his planned topic: Using Payment Innovations to Improve Transportation Networks. However, comments which may be more telling are offered into lunchtime by former Fed Chairman Greenspan speaks at a mortgage conference in New York. That is followed by the US Monthly Budget Statement (MAY), which can be important when the fixed income is fragile.

Wednesday sees the Japanese Current Account Total and Balance of Payments Basis (both APR), Australian HIA New Home Sales (APR), then back to Japan for Industrial Production, Shipments and Capacity Utilization (APR Final) and Machine Tool Orders (MAY Final.) Then it's Europe's turn, with ECB Council Member Liikanen holding a news conference, and the French and Italian Consumer Price Index (MAY), UK and Euro-zone employment figures, including UK Average Earnings and Manufacturing Unit Wage Costs; in the UK that's the rolling quarterly figures into April, while the Euro-zone numbers are simply Q1.

During the US trading day on Wednesday we see Retail Sales and the Import and Export Price Indices (all MAY) the Fed's Geithner Speaks on Asia, Economy & Finance in Singapore followed by US Business Inventories (APR), the UK Leading Indicator and Coincident Indices (APR), EIA Crude Oil Stocks (for the week ending JUN 08), Bank of Canada Governor Dodge speaks at St. John's Board of Trade, the European Central Bank's Trichet Speaks in Berlin, the Fed's Fisher Speaks on the Texas Economy at the Rotary Club in Dallas, and then the Federal Reserve's Beige Book is released in the afternoon.

All of which is just the prelude to the US inflation number punctuation in the middle of the typical mid-month reporting vacuum. Thursday sees the release of the UK RICS House Price Balance (MAY) and the Bank of England publishes its Q2 Inflation Attitudes Survey, followed by Australian Consumer Inflation Expectations (JUN) and a speech by Reserve Bank of Australia Governor Glenn Stevens, followed by Japanese Tokyo Condominium Sales (MAY.) Then Thursday shifts back to Europe for the German Consumer Price Index (MAY Final), Bank of France Business Sentiment (MAY) and French Non-Farm Payrolls (Q1 Final.)

One of the more prominent broad influences follows, in the form of the ECB Monthly Report (JUN), followed by UK Retail Sales and the Euro-zone Consumer Price Index (MAY.) The US sees Treasury Secretary Paulson delivering remarks in New York on national security, while the Fed holds a Washington hearing on mortgage regulations, followed by the Producer Price Index (MAY), Weekly Initial Jobless Claims (for the week ending JUN 09), and the ECB's Weber speaking in London.

Friday is another big day that begins with the Japanese Tertiary Industry Index (APR), and the Bank of Japan announcement of their Target Rate (broadly anticipated as no change), followed by Governor Fukui's regular press conference. We also see their Leading Economic Index (MAY) and Coincident Diffusion Index (APR Final.) After which it's off to Europe for the Italian Trade Balance (APR), as well as Euro-zone Labor Costs (Q1) and their Trade Balance (APR), along with the ECB's Papademos presenting their Financial Stability Report (APR), and Gonzalez-Paramo speaking on central bank credibility.

However interesting all that may be, things then get even more engaging in the US as the Fed's Lockhart provides welcoming remarks at the Atlanta Fed Credit Conference shortly before Chairman Bernanke speaks at the conclave. It is of course very interesting that is coincident with release of the US Consumer Price Index and Empire State Manufacturing Index (both MAY), as well as the US Current Account Balance (JUN.) All of which is followed by Industrial Production and Capacity Utilization, along with University of Michigan Consumer Sentiment Index (all MAY.) And in a week where the financial luminaries have had so much influence what could be more appropriate than them getting the last word in the form of the Fed's Yellen speaking at a free trade conference in Massachusetts into lunchtime?

Markets

EQUITIES

Just as the **DJIA** had exceeded all of the resistances on the way up, it came slamming down through quite a few levels on the way down under the influence of higher yields last week. However, it still managed to hold a couple of key supports back toward the 13,200 area, which included the intermediate term weekly UP Acceleration (from back in early May out of the up channel from last July's major 104-00 area low) as well as weekly MA 9. Yet, even moreso than any further immediate major meltdown there is a question of whether yields have pushed up far enough to give investors pause either back up near or even slightly above the recent highs?

As was the case last week in the mighty DAX as well as DJIA, weekly oscillator indications dipped marginally back below major levels previously violated on the way up. That is often a sign the undertone is weakening even if the markets put on the next push to the upside due to any feeling the yields are topping out (more on that below.) In fact, the advance of weekly MA 41 means the reinstated weekly oscillator resistance for the DJIA is around the 13,500 area, reinforced by the 13,475 DOWN Break below the aggressive daily up channel (from March's major reaction low.) All of which may be very bearish right into that area, except for one minor point: as part of equity bull markets having long tails is the first DOWN Break rarely works, at least initially. The market often seems to Negate that reversal signal by Closing back above it, and only on the secondary failure back below it does the trend actually demonstrate definitive weakness. That would also be consistent with a choppy basing action in the fixed income markets.

As such, and especially in light of the DAX potential ability to return to a bullish enough state due to special influences over the next week or so (see *CAPITAL MARKETS OBSERVER* III-23 'Sarkomania', June 8th) to provide a very friendly influence, the higher resistances in the DJIA above 13,475-13,500 remain important as well. Those are 13,600, the 13,692 current all-time high, and extended weekly oscillator resistances in the 13,750 area (ergo the concerns about a minor new high), and fully extended oscillator resistance into the 14,000 area. That said, we are skeptical of the DJIA achieving the latter, as any news which would be strong enough to foment a rally to that sort of extended level would also possibly be enough to put the fixed income markets below major supports, and thereby weigh heavily on the equities once again in the current tug-of-war. Lower DJIA supports remain 13,200, 12,800 and 12,500. Much below that, the market has reversed the recent up trend in a manner which leaves the door open to a sustained trend reversal.

The **S&P 500** future was not subject to the same lack of spread between the lead contract (June) nearing expiration and the second month (September) as the long dated fixed income. In fact, on current form September S&P 500 future will become lead contract on Thursday's Close at a premium of almost 15.00 to the expiring June contract. In and of itself that will go a long way toward defending the lower 1,480 support (which was just missed at the 1,488 lead contract trading low last week.) That will also put September contract back up toward the highs on any further rally, with interim resistance at 1,418 already below the current price. That said, there are both continuation and contract resistances into the 1,534 and 1,542.80 (the current rally high in the lead contract.) Beyond that is the contract has its own extended resistance back up into the 1,550 area and 1,557.70 trading high from early last week. Interim lower supports are 1,510-06 and 1,494-90.

Viewing it once again through the prism of developed economies' upside leader, the **DAX** was just recently (mid-May) getting up to its own resistance at 1,000-1,100 over weekly MA 41 for the first time, and stalled until pushing through resistance in the 7,500 area. Lo and behold, last week's vicious selloff was enough to drop the market back below that oscillator threshold (to MA 41 plus 880), which could be interpreted as a failure even though DAX held the 7,500 area without the need to test lower congestion Tolerance at 7,400. Lower supports remain 7,300, 7,150 and the 7,000 area.

The dilemma for the oscillator slippage is the same as for the DJIA 13,475 DOWN Break below the aggressive daily up channel, equity bull market long tails mean the first DOWN Break (or slippage back below oscillator levels) rarely signals a directional reversal, at least initially. The market often seems to push back above resistance, and only on the secondary failure back below it does the trend demonstrate sustained definitive weakness. That would also be consistent with a choppy basing action in the fixed income markets.

As such, it pays to keep an eye on the extended higher DAX resistances into the 7,780, 7,900 and 8,000 areas. Given the confidence in the European (and especially German) economy right now, there is also a case for a modest new high above last week's 8,010. However, as we note in the topical discussion below, while higher yields of the past several weeks have not seemed to directly reverse the sentiment or cause the equities to violate their more important underlying technical support, there is a question of whether the stock markets remain resolutely exuberant at the top of the next rally, or yields are now high enough to give them pause. We shall see.

Of note in its own right and for the topical discussion below is that these markets have all seen the same sort of 'overbought' conditions exhibited on late 1990's into 2000 extensions. Any inability to reinvigorate the momentum on the next rally would be a sign that the yields are indeed performing their delimiting function on the extended up trend in the equities.

FTSE maintaining the bid above 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. Much like the DAX, that then became support which was duly retested last week. Also like DAX, FTSE has fallen back below weekly oscillator resistance (MA 41 plus 350), and never actually violated extended resistance at MA 41 plus 450-500 (as it never really knocked out oscillator resistance in quite the same way as the DAX and DJIA.) That will now reinforce its own daily DOWN Break in the 6,600 area, and even more critically, the extended resistance at the 6,686 high right into a new high in the low 6,700 area. Lower support remains in the 6,400 area and not again until the 6,250 area.

Possibly one of the most interesting aspects of last week's markets was the relative calm of lagging equity index **NIKKEI**. While carnage reigned all around, it only backed off slightly from its 18,145 peak. This was likely due to the degree to which it sensed that the other developed world equity market selloffs were more so financial weakness respecting the higher yields than any sign of economic weakness which might affect the Japanese export sector. However, that still leaves the extended resistance intact at the 18,315 February continuation high, with the market back testing Negated 17,750-850 resistance. However, even if that should not hold, the more critical support remains back at the 17,600-500 congestion, which is also now weekly MA 9 & 13. Lower supports also remain in the 17,250-00 area, as well as 17,000 that is also important as weekly MA 41.

FIXED INCOME

As noted previous, the more critical trend support tests were unfolding in Europe due to the relatively stronger state of the European economies and equity markets which has once again been demonstrated on the most recent price swings in spite of the renewed weakness of the US long end under the pressure from a seemingly more hawkish Mr. Bernanke.

All of which keeps the pressure already weak fixed income. However, the major supports noted previous are not too far below last week's lows. Any test of those lower supports brings the long ends to junctures where they must decide whether to hyper-accelerate to the downside for a massively higher yield indication, or base out for a more sustained recovery than the markets have experienced since the last extended upside correction highs back in mid-March (when the T-note and failed from their respective low 108-00 areas, and the Bund was, incredibly still back up attempting to be a bull into the upper 116.00 area.)

All contract technical levels are now based on the September contract. The **Gilt** was already well below interim and major supports at 106.40 and even the 105.95 January trading low, and did not even waste much time extending that new continuation low right through the next support at the June-July 2004 105.14-104.86 congestion, the bottom of which was a major 15 year trading low. As long as the Bund holds it is likely the **Gilt** respects its long term support in the 104.00-mid 103.00 range, with a Tolerance to the 103.17 April 2002 seventeen year trading low. Much below that there is not much until the 100.00 area.

Speaking of the current downside leader, the June **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 was so critical. All of which also left all of the daily MACD's in the long DOWN.

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 has led to several additional weeks of relentless weakness that leaves the Bund near very critical long term continuation and oscillator support into the 110.00-109.65 range, even though it traded below a major Fibonacci retracement level at 110.50 last week.

That lower support is the multiple August-October 2002 pullback lows from during the overall up trend to the major 2003 highs. Much below that the 110.50 major Fibonacci retracement would be definitively violated, and the next support is not until the mid 107.50-00 area, with major support not until the low 106.00 area. Yet, a violation of 110.00-109.65 would mean a drop to more than 6.00 points below weekly MA 41, which is historically a rare occurrence. That said, the violated interim supports should act as resistance on any rally, and those include 111.24 (November 2003 overall reaction low), and the 111.81-112.20 range (the bottom of which is the secondary June 2004 reaction low that was part of the basing action prior to the resumption of the bull trend serial new highs into 2005.)

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.) Yet, the increasingly weak European markets, as well as Mr. Bernanke's more hawkish jettisoning of any weak housing focus in the past couple of weeks left even this more staunch sister breaking support in the 107-00/106-24 range, and even gapping below more major support in the 106-00/-105-24 range last Thursday as all trend indications remain DOWN.

All of which has now brought the T-note to trade below its 105-00/104-24 interim support, with only the major support tested and held last June in the 104-00 area as a buffer against the weak trend in Europe. Yet, in its way that remains very critical for several reasons, some of which are reviewed in the 'Debt Divergence Denouement' topical discussion below. From a strictly technical perspective, the historically the T-note does not seem to like spending too much time in the 104-00 area. Some churning on a downside correction of a bull move into summer 2001 notwithstanding, it tends to prefer quickly surging to a full two points above 104-00, or dropping a full two points below rather than spend any time in the 104-00 area. While oscillator indications suggest the potential for some support into the 103-16 area, we are skeptical the T-note would hold if the Bund and Gilt are below their major supports.

Of course, the short money forwards are likely to follow where the long ends lead, as has been confirmed once again of late. As such, 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, as well as the recent historic congestion at 94.10-.08 (previous contract low.) That left it vulnerable to an extension to support at daily oscillator levels in the 93.85-.80 area which it has been sagging near of late.

September **Euribor** dropping below the long held 95.85-.80 area ultimately also saw interim historic congestion in the 95.70 area violated. Much like the Short Sterling but moreso on an historic basis, that left the major 95.60-.57 May-June 2004 congestion and daily oscillator support as next level which the market has not quite reached as yet. .

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 was then resistance on all subsequent rallies. That left it vulnerable to also violating 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 our long held perspective of a very low percentage potential for an FOMC rate cut by as early as their early August meeting.

FOREIGN EXCHANGE

Until several weeks 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 would 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.

Yet, it has been a very uneven recovery for the buck, and the dividing line between weakness and strength in the robust global economic environment seems to be difference across the commodity economy divide. As such, the continued relative US dollar weakness against the Canadian and Australian dollar makes a bit of sense, as does its strength against the other non-commodity economies.

As such, while 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, and **USD/CHF** 1.2300, it has managed to surmount each of those for what appears to be at least more of a trend correction than seen since the early this year. Extended supports for those currencies should be now calibrated to the EUR/USD 1.3250, 1.3100-1.3000 range, and last ditch 1.2900 area UP break support, which held multiple tests back in January of this year.

However, the US dollar's inability to see the **AUD/USD** sustain weakness back below the .8230-12 trend support (weekly MA 13) and historic congestion (the December 1996 high) in spite of a one time weekly Close back below it left the buck back under extensive pressure on the push up through the .8396 April high. Yet, there remains another historic resistance at the .8493 trading high from August 1990.

However, even the strength of the Aussie has been overshadowed by the previous and sustained strength of the Canadian dollar. The massive capitulation into a new low of the **USD/CAD** after attempting to hold the initial tests of 1.1050-00 back in early May left it quickly below the 1.0900 area December 1977 low, which then acted as resistance on any of the short term rallies several weeks ago. Now the market is below weekly oscillator support (weekly MA 41 minus 0.0600) that should have reinforced the 1.1000 area support, yet has not sunk to the extended oscillator and historic congestion in the 1.0450-.10360 area. All of which leaves the market without any long term decision potential at current levels, albeit with near term congestion resistance at 1.0750-1.0800, and support at mid 1.0500 trading lows.

We continue to hold the same view of the co-weak Japanese yen, as there is not really any particular level against the 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 could have been totally adrift with the buck breaking the noted resistances, yet remains in a relatively tight balance around current levels. With the recent return to weaker Japanese economic indications of late, it will once again be no surprise when the BoJ leaves their base rate at 0.50, which also still underpins the carry trade for now.

Of note, any further carry trade strength by the non-commodity currencies will likely require the US dollar to break those resistances against the yen while the Euro and Sterling weaken against the buck. 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. Yet, as noted previous, EUR/GBP also 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 mutual trends against other currencies, now that they have violated their supports against the buck together to confirm a return to some sort of sustained near term US dollar strength.

As noted previous on the Japanese yen cross rates as well, the recovery of the US dollar would only be of assistance to the yen if USD/JPY also headed 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, it is struggling 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.) Much below the 1.6110 mid-May trading low it might lapse into a much weaker trend signal, albeit with the more major technical and psychological support remaining in the 1.6000 area.

Similarly, **GBP/JPY** pushed 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, as well as the upper 2.3000s. Having accomplished all of that and a weekly Close above the 240.88 previous major August 1988 high, it failed to maintain its push above the 241.51 late January trading high. It will also be critical back into the mid-May 2.3650 trading low, albeit with the more major technical and psychological support remaining in the 2.3500-2.3350 area. Higher resistance remains in the 247.00-248.00 area, consistent with a EUR/JPY 170 or 175 area.

ENERGY

Also as noted previous, geopolitical and weather concerns have continued to underpin and then bolster the energy markets, as expected. However, while July **Crude Oil** held well on the recent tests of lower support, variously in the low 64.00-upper 63.00 range to lower congestion in the 62.50 area, the continuation congestion resistance in the upper 66.00 area is now reinforced by the July contract 67.10 trading high from two weeks ago. The extended resistance remains in the contract at the 69.00 early April trading high. Extended continuation resistance remains in the 71.00 and mid 72.00 areas.

Same Old Stuff?

As the fixed income breaks a bit again today, and the equities seem to be taking it serious once again, it is right to ask whether this is back to another major selloff which the markets experienced in tandem over the past week, or something else is going on. While the mutual weakness might seem to indicate that the weakness is inflation sensitive fixed income suddenly taking a much more pernicious view of the outlook for a return to US growth over the next couple of quarter, along with the extended growth in Europe being exacerbated by the prospect of extensive French labor market reforms, this view must be moderated by several factors.

In the first instance, the long dated debt market weakness over the past several weeks was just reflecting tendencies which fixed income bears had warned was the essential adjustment to excessive liquidity and growth existing for too long; without much central bank indication they were even interested in doing very much about it. A friend of ours pointed out that after their move to a 'pause' last year, the Fed laid the groundwork for its evolution into a full blown 'exuberant' psychology when they removed the further tightening language from the FOMC statements early this year. The continued indication which was only recently jettisoned by Mr. Bernanke was that housing was enough of a concern to possibly foment real weakness (and Fed Funds rate cuts), as evidenced by its very mention in a series of FOMC statements.

That left the rest of the world very cheery, as they understood what the Fed seemed to miss until just recently: that the US consumer was still in good shape in spite of their home prices failure to escalate at the previous astounding rate. Yet, due to Fed concerns, as well as some very aggressive pricing of the 2007 Eurodollar (i.e. US short term interest rate) forward contracts, all manner of very astute market analysts and portfolio managers were drawn into predicting (and unfortunately in many cases, investing) based upon the weaker outlook for the economy, and even a possibility of a top in the equity markets. Wrong.

The ancillary point which stems from that is the degree to which any near term weakness of the equity markets will buffer the support in the fixed income. The fixed income weakness is indeed based on a certain amount of actual inflation in volatile items such as food and energy (always such a wonderfully specious exclusion from the CPI numbers.) Yet, the debt market weakness has also been based on two other factors: the degree to which continued equity market strength would signal and endless further extension of psychological exuberance, as well as actual growth in demand for industrial commodities. Yet, a close look at the activity of the CRB Commodity Index in particular and metals prices on the recent gyrations in the debt and equity markets is instructive.

While the CRB Index has maintained prices above the previous highs in the 400 area since late February, it had established a move above the 410 congestion resistance early last week in the wake of the previous equity market push to new highs for the rally. Yet, as soon as it was obvious the equities were taking the extension of yield escalation serious last week, it dropped back below 410. Indeed, after a recovery to that level yesterday, it has weakened again on the modest equity market weakness today.

All of which weakens the case for the commodity prices reigniting the irrevocable sort of resurgence which was the case during the various equity market activity between late 2001 and May of last year. That is also reflected in the weakening of prices for both Copper and Gold on the equities selloff, the latter of which has been in a pronounced down trend since its April highs. That is definitely not consistent with inflation concerns, and a US dollar that is weak against commodity currencies.

The recent upsurge in yields raises another point that may be a bit less meaningful in markets which rightfully take a forward view, yet might provide a critical near term influence. With the long term yields now up considerably in the past couple of months, what are the various inflation reports this week going to tell us. While the shift to a far more hawkish stance by Bernanke & Company (well, a good bit of the company actually was pretty hawkish previous) is welcome, the long yields have now gone premium to short yields (or at least removed that pesky inversion.)

The other telling point might be the degree to which they can now impact the housing market. It would be a wonderful bit of irony if the Fed's previous nod to the potential impact of housing weakness actually was the factor that kept long rates low enough to stem the most pernicious aspects of it. What if current admonitions to forget housing and subprime mortgage market woes as a potential factor for the rest of the US economy was the catalyst for rates moving up to levels where those actually come to the forefront as real world negative factors that might yet derail consumer spending? As odd a comment as that may seem, that is the dynamic nature of the degree to which being accurate about a particular trend creates influences that may spawn the very indications which eventually counter it.

And along with their reaction to the inflation numbers this week, the long dated fixed income is likely to let us know soon whether it will respect those important lower supports noted in the 'Markets' section above, or collapse into hyper-acceleration of their down trend (with the attendant massive further upward spiral in yields.) While it may appear risky, historically it is rare for the fixed income to follow through on any major swing with a massive extension in the same direction; for all of the offsetting factors noted above.

Any extensive weakness of the equity markets only reinforces the degree to which the prices of inflation harbingers from the commodity sector might also abate in a manner which will lead to a temporary bottom in the fixed income. And the operative term there is 'temporary': regardless of a near term bounce, we remain bearish fixed income across the broader cycle. That is true even if the upside reaction lasts for months. Yet, the current extreme focus on inflation since Mr. Bernanke's return to Mr. Trichet's strident level of rhetoric seems a bit too obvious for comfort. As we noted last week in the classic active trader and trend analysts' market axiom in the form of an (alleged) ancient Chinese proverb: "Confucius say man who trades based on headlines today will possibly be out selling newspapers tomorrow."

Debt Divergence Denouement

As a final bit of perspective, it seems a good time to revisit the major trend divergence that has been so evident at the long end of the yield curve for the obvious economic disparity reasons since the major 2003 high of debt instruments into the 'disinflation' scare.' While we have remained bearish the US fixed income across the cycle since failure from those extreme highs in 2003, and Europe and the UK from the late 2005 through early 2006 highs, the fact that higher long term yields are now headlines is just one part of the equation.

The lackluster performance of the Gilt throughout more substantial recoveries in the T-note and Bund last summer also left the Gilt leading the way down early this year. Yet it was to be taken over as downside leader by the very sharp selloff in the Bund, as extended strength of the German and European economy became ever more apparent. That has occurred just as the long dated fixed income markets are nearing historically significant over-extended dimensions for their down trends, and it reinforces our skepticism of the value of anticipating any further major escalation in yields. We are moreso inclined to move to neutral after a modest further yield increase from last week (i.e. at slightly lower fixed income price levels.)

In fact, given the degree to which the US long end led the break consistently after the 2003 high while the Bund and Gilt remained bull markets until late 2005-early 2006, it is possible that if the T-note can hold the 104-00 area support from last June, that may have been its intermediate term cycle low!! That's right, as ugly as the T-note looks back near that low a full year later, it is still no worse than a double bottom or very gradual up trend. The failure early last year below the 108-00 area was the second wave of its bear trend, and that may be all it needed to complete the intermediate term cycle if external conditions allow (including the decision on whether or not to hold support by the more accelerated down trends in Europe.)

How can this perception be correct in the face of the face of such massive weakness in European fixed income and further bearish expectations? Simply that the Bund and Gilt were only putting in the primary reversal waves down from their bull market highs when they sold off in early 2006. As such, the break below the low 108.00 level in the Gilt early this year, and the belated Bund failure below the mid 114.00 area was just the beginning of their extension into the second wave of their bear trends. If (and it's a not insubstantial 'if') they manage to see either enough equity market weakness, and/or benign enough inflation data this week, then their holding action into the major supports noted in the 'Markets' section will almost assuredly allow for the T-note to remain a 'bull.'

We use that term in the loosest sense. Many years ago, one of our mentors explained the concept of a 'bad' bull. It is a market which is a bull on paper because it is leaving higher lows (the classic and technical definition.) Yet, it gets so near the previous low at such a distended point into the future, it feels like a bear because nobody who happens to be long can make any money unless they wait to enter at very selective intermediate term junctures. At this point, even if the T-note holds, it is indeed a pretty 'bad' bull.

However, if all of these markets do hold the next supports, then it is not just the technical factors and recent yield convergence (of sorts) which lead us to believe they can moreso trend together. Review of last week's OECD Composite Leading Indicator also seems to show the US recovery turning up while Germany may not be quite as strong as the headline indications suggest, even with some labor market reform likely in France. Note the interesting Financial Times analysis from Wolfgang Munchau today (attached.)

Miscellany

ALAN GRANVILLESPAN

He's baaaack! We are all going to be treated (such as it is) to the latest economic missives from Mr. Greenspan at lunchtime today. While it is normal to allow a broad view for which he is noted a very wide berth, the performance of the US and other world equity markets since his perception that the US was vulnerable to a recession back at the end of February have not exactly been an indication of his near term portfolio management sagacity.

Of course we offer that observation as a tongue-in-cheek comment, as it neither was nor is his brief to provide short term timing ideas. He is also likely right that the potential is there, regardless of what the current chairman has to say about the lack of risk from the weak housing sector and subprime mess. As noted above, while they might not have been so burdensome previous, with the mortgage and short term rates (the arbiters of Adjustable Rate Mortgage interest levels and monthly payments) now elevated, the dynamic influence might actually become more pernicious out of that area.

In any even, it has been our long held belief that the central bankers' role is indeed to risk, or overtly (albeit never actually admitting it is the explicit agenda) to create recessions to be able to guarantee the cooling of inflation. Possibly one of Mr. Greenspan's most impressive, well deserved, yet in its way pernicious accomplishments was to go from *enfant terrible* who pretty much precipitated the 1987 Crash (and then got credit for saving the world) to the 'beloved' central banker that had established endless non-inflationary growth. It reminds us of the scene from the movie "A League of their Own" about the World War II era women's baseball league that flourished while the 'boys' were off fighting the good fight. In response to one of his female players crying due to his sharp criticism the manager of the team pointedly shouts, "Are you crying? There is no crying in baseball."

Similarly, other than getting their job done, there is no overt need for or intrinsic advantage derived from adulation in central banking; disdain is okay if it relates to the necessary pain to keep inflation in check. Along with our comments last week (*CAPITAL MARKETS OBSERVER* III-22) on "The Fed & the ECB" that pointed out all of the current crop of central bankers (including ostensible Überhawk Trichet) have allowed themselves to fall behind inflation expectations, they seem to feel it is moreso their mandate to engineer soft landings than allow that actual economic weakness for a brief spell may be no bad thing.

That gets us back to our current concerns about Mr. Greenspan's fixation on being out in front of predicting the percentage potential for a US recession; a term which had essentially been banned by all upstanding members of the international financial and legislative classes. While he may certainly say anything he wishes as a private citizen, and the initial warning was certainly a breath of fresh air (okay, more like a gale force wind) into a market which had become too complacent, we would hate to see him become yet another Cassandra who is married to a particular view.

There has now been enough shift in perspective since his initial remarks and subsequent timely reaffirmation of them that the healthy warning is well taken even if the equity markets chose to move up to new highs after the February-March reaction. It would be a shame if as august an economic and market mind as Mr. Greenspan did not move on to discussing more of the specific background which is relevant to his view, and continue to comment on other aspects of the world economy.

If he continues to fixate on attempts to be the one who predicted a recession that his successor should indeed be trying to institute in any event, then when it finally comes his views may appear too stubborn to command the credibility he has rightfully established over the years. Like the proverbial stopped analog clock that displays the exact right time twice a day, it would be a shame if the estimable Mr. Greenspan's observations began to be regarded (at least in terms of how they relate to subsequent market activity) as so many of the entrenched entreaties from the previous generations of Cassandra's who have eventually been laughed off of the global financial stage.

We frankly prefer all of Mr. Greenspan's rightfully complex and extended observations on the world economy than any of the somewhat shocking missives from an Alan Granvillespan, who will seem to have lapsed into playing to the needs of the mob if the recession percentage potential observations continue.

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

-Rohr
(www.rohrintl.com)

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

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