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…Central Banks, Forward Failure, Mind-Blowing

Overview

As the normal US mid-month reporting vacuum was punctuated by the Retail Sales figures and Beige Book, it is only fitting that the return to the typical late month economic release crunch should be accentuated by the FOMC decision and statement today. In fact, the while there have been no small number of economic reports this week, the real fun began with this morning's major crunch into tomorrow. The most important influences so far actually seem to go beyond the formal reports of weakness in the US housing sector to the return to a very downbeat outlook from the major home builders. That is consistent with various interest rate influences discussed previous, and Mr. Bernanke's return to a greater concern about the influence of weak housing on the US economy (more in the topical discussion below.)

Weak US reports into yesterday that included US Durable Goods Orders (MAY) reinforced the degree which the long dated fixed income lows from two weeks ago (as opposed to the post-Bank of England MPC minutes release new low in the UK short money last week) seem to be evolving into the intermediate term lows we suspected might occur from those levels. Allowing some Tolerance, they remain critical short-to-intermediate term supports. Yet, even the weakness of yesterday's reports (including the UK CBI Distributive Trades Survey) did not allow the September T-note to sustain its recovery above the 105-16/-21 gap resistance in the current choppy reactive markets.

All of the flux and uncertainty notwithstanding, there seem to be two aspects of the markets which are reasonably clear. In the wake of the fixed income bottom and equities struggling at the top of the last rally, the directional trends appear to be over for now, as noted since back on Thursday June 14th. There is now moreso an ongoing tug-of-war between the higher yield levels and the equities still attempting to shake off weak news any time the yields slip back down a bit. This was in evidence again as the equities held key supports on the back of the recent fixed income strength, in spite of the fixed income now slipping just a bit once again. The US long rate influence is telling in that regard, as indicated by shifts in Mr. Bernanke's sentiments on housing's potential impact on the US economy.

The second reasonable clear aspect is that (as noted back into mid-June) the divergence between the long dated fixed income markets is significantly over for now as well. While the Gilt has also been induced to become weak sister of late by the hawkish BoE MPC minutes (taking over from the Bund), and the US rightfully remains most resilient sister after leading the way down through all of 2004-2005, a weakish UK CBI Distributive Trades Survey (JUN) yesterday morning at least assisted the Gilt and Short Sterling in maintaining the recovery with the stronger sisters. While that is all nice, the real crux of how the markets perform from here might well have quite a bit to do with just how constructive today's FOMC statement treats the outlook for the US economy, and especially any indication for the housing market.

As those are imponderables, and there are a significant number of other influences (noted in Reports & Events), the technical assessment remains primary to effective analysis of the near term trends. What is of note this morning is just how well the long dated fixed income, and especially the weak sister Gilt and the Bund are holding up in the wake of the some strong overall economic news this morning. Those include UK Nationwide House Prices (JUN) and German Employment (MAY), albeit with benign German lander inflation numbers and Italian CPI (both JUN) once again. As that is also in the wake of equity markets recovering smartly from important near term supports once again, it is likely that the fixed income is on hold until the impact from the any subtle changes to FOMC statement indications on housing, inflation and future growth.

Markets Summary

Prior to review of specifics for fixed income and equities it is important to note a technical tendency which reinforces our perception that the directional trends are indeed over for now. While broader trend indicators still reinforce the recent major trends, one of the key technical influences is that the reactions have now proceeded far enough that daily MACD is DOWN for all of the equities, and up for the fixed income. And that includes the equities' upside leader DAX, as well as the recent weakest of the fixed income weak sisters in the Short Sterling.

FIXED INCOME

What all of that means to the markets is likely that the September **T-note** still needs to push up for a Close above the 105-16/-21 range gap to liberate itself for a test of more significant 106-08/-16 resistance. Support remains back into 105-00/104-24 range and below that into the low 104-00 area. Equivalent near term resistance and support for Europe are the **Bund** resistance back at violated supports in the 111.24 and 111.86-112-.15 range, with support back into 110.60-.50, and the major 110.00-109.65 range. Similar conditions for the weak sister **Gilt** point to the near term resistance it has struggled with moreso then the others in the 104.00-.20 range, with extended resistance around the 104.86 failed major low that extends to the congestion resistance in the 105.15 area. The short money should follow suit.

EQUITIES

The equity markets need to see if **DJIA** holds 13,250 area low, below which the supports are 13,000 and the late February trading high (prior to the sharp correction) in the 12,800 area. Higher resistances remain in the 13,475-13,500 area, as well as up into 13,600 and 13,700. That is all very similar to the September **S&P 500** future supports in the low 1,500-1,495 range holding, even though extended support is down into the 1,488 and 1,482-80 range. Resistance is back up into the 1,525-28 and 1,533-35 areas. Similar conditions that are skewed slightly to the upside continue to exist in upside leader **DAX**, which held the top of 7,750-7,680 range gap support yesterday prior to its smart recovery. Indeed, lower supports from the recent reaction extend down to the 7,600 and 7,500 areas. Higher resistance areas remain in the 7,950, 8,000 and 8,060-85 areas.

FOREIGN EXCHANGE

While we would like to provide more forceful insights on the foreign exchange, it remains disjointed and choppy, as the **US Dollar Index** push above the .8225 area (still support with a Tolerance down to the .8200 area) had stalled into more critical mid .8300 resistance, above which it might actually follow through for another full point. Higher resistance remains in the .8260, .8300 and especially the .8340-60 areas.

The two real points of interest are the **USD/JPY** push above the 122.00 resistance on secular weakness in the yen after the BoJ held steady again at their recent meeting fomented a move above the resistance in the 123.00 area as well. That still points to a likely extension to the mid-upper 125.00 area resistance as long as the market does not drop back below the 122.00 area support Tolerance first. In fact, while 122.00-121.50 was the congestion support in any event, the directional trend Fibonacci 0.25 retracement, weekly MAs and aggressive daily channel support all dictate that area is critical trend support late this week into early next. Therefore, whether any of the renewed cautionary indications from the Bank for International Settlements as well as the BoJ, and all of the typical carry trade Cassandra's that have been reinvigorated by those more influential bodies amount to anything once again have a clear technical level upon which to focus (much like 115.00 and 113.50 areas back in March.)

Also, with Sterling strong again versus the US dollar, **GBP/USD** is likely a 1.97/2.00-2.01 trading range, and that means **GBP/JPY** can likely extend to the 250.00 area, with support back into the 242.50-00 range (i.e. much lower than commensurate USD/JPY levels.) It is of note that **EUR/GBP** has not suffered too terribly much in the wake of British pound strength last Wednesday, holding the low .6700 support once again. That also means that **EUR/JPY** can likely push to the 168.00-170.00 range if the USD/JPY maintains support (depending on the Euro's tone against the US dollar), with lower supports also in the 164.50 and 162.50-00 (also historic) areas.

Much like the US Dollar Index, **EUR/USD** is stuck in a low-mid 1.3500 to 1.3380-50 trading range, with commodity currencies Canadian and Australian dollars still the real strong sisters against the buck in spite of the potential for somewhat sharp near term corrections on the sporadic carry trade concerns.

ENERGY

The energy market remains much the same geopolitical and weather inspired bull market. The lead contract held recent tests of lower support anywhere from the low 64.00 to upper 63.00 range, as well as the lower congestion in the 62.50 area, and August **Crude Oil** is has now sustained activity above the continuation congestion resistance in the upper 66.00 area (now support) that was reinforced by the July contract 67.10 trading high from late May. The extended continuation resistance remains in the 71.00 and mid 72.00 areas; especially the latter, which is a not yet retested June 2006 Triangle UP Break Negation, as well as a major weekly Area Gap from 71.20 to the 72.51 Close from August 24, 2006.

Reports & Events

The next major influence on markets will be this afternoon's FOMC decision and statement at approximately 13:15 CDT (14:15 EDT; 18:15 GMT.) After that the European reporting day begins the end of month data tsunami very early with this evening's release of the French Unemployment Rate and Change (MAY), followed by Japanese Jobless numbers (also MAY), Manufacturing Purchasing Managers Index (JUN), Overall Household Spending (MAY), Tokyo Consumer Price Index (JUN), National Consumer Price Index (MAY), and Housing Starts and Construction Orders (both MAY), with Australian Private Sector Credit Change (MAY) in the midst of all that. After which it's over to Europe for French GDP (Q1 Final) and Producer Prices (MAY), UK Money Supply and Lending figures (MAY Final), Total Business Investment, GDP and Current Account (Q1 Final), GfK Consumer Confidence Survey (JUN), and various Euro-Zone Confidence numbers (JUN.)

Then it's on to the US for Personal Income and Consumption (MAY) along with the key core readings, Chicago Purchasing Managers Index (JUN), Construction Spending (MAY) and the University of Michigan Consumer Sentiment Index (JUN Final.) Possibly they are on holiday, or just thought better of saying too much into the FOMC decision and statement, but the late part of this week is void of any major speeches or testimony by financial luminaries.

Central Banks

FED FOLLIES

The delicious irony of Mr. Bernanke's recent vacillation on the impact of housing on the balance of the US economy might be that he was reflecting very reasonable views while shifting back and forth over the past month. The previous sustained bullish activity of the equity markets seemed to confirm his more hawkish view early this month that the weakness of housing was just not going to be a significant impact on the balance of the economy. Sustained attractive housing finance interest rates seemed to reinforce that notion.

Yet, that very upbeat assessment of the economy was the trigger for the US to participate more actively in what was already a very aggressive down trend in long dated fixed income (i.e. move to higher long yields) in Europe. As noted in ***CMO*** III-24, "the recent upsurge in yields raises… …the degree to which they can now impact the housing market." What if previous 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.'

Indeed, Mr. Bernanke's flip-flop two weeks ago Friday in a speech summarily reinstating the concerns about how significant housing weakness may indeed affect consumer sentiment seems to return to the reality reflected in the problems now triggered by the yield bump. However, all of this leaves Mr. Bernanke as the most enigmatic transparent Fed Chairman in quite a while. Surely he had to understand that with a strong yield environment elsewhere his comments might cause US long yields to back up as well; or so we hope. If so, this was possibly a clever ploy to finally address the inverted yield curve. If not, it means our worst fears about 'The World's Central Banker' now being a spectator who is only capable of reacting once conditions are glaringly apparent may moreso be the case.

Unfortunately, the latter pernicious inference is consistent with the continued assertions that the Fed is 'data driven.' As we have expressed previous, that is a pretty banal and ineffective stance for folks who are supposed to be in control of the situation as opposed to strictly reactive. It is also a further sad conclusion his recent vacillation will allow for all manner of reading quite a bit into the statement accompanying today's (highly likely) 'no action.'

BANK OF ENGLAND

On the other hand, it is very encouraging to see the BoE MPC minutes reflect what we shall euphemistically refer to as a "live ammo" psychology on base rates. As opposed to the ECB where ostensible Überhawk J.C. Trichet has reduced his focus to once-a-quarter nominal rate bumps, the Old Lady maintains a more aggressively active stance. That is encouraging for a potential to actually slow consumption, as that's what's necessary regarding global inflation.

Some aspects of those minutes are most interesting, and worth noting here, beginning with their observations on money supply growth. "Broad money and credit continued to expand rapidly. M4 and M4 lending (excluding the effects of securitisation) had grown by just over 13% in the year to April. The Committee discussed the possible implications for the wider economy. It was important to understand what lay behind these increases in order to assess the consequences for spending and inflation." "Increases in the supply of broad money, however, could lead to an imbalance in the relationship between money and prices. This could have implications for higher asset prices, money spending and the general price level, to which monetary policy would have to respond."

Their hawkishness was further reinforced by the strength of business sentiment, to wit… "…the picture from business surveys was different for retailers. The backward-looking prices balance in the CBI *Distributive Trades Survey* had risen sharply to a nine-year high in May, while the one-month-ahead price expectations balance had also increased." Last. Yet by no means least, was their assessment of whether previous interest rate increases had been effective in accomplishing their primary inflation mitigation and economic growth stabilization mandate. "The economy was still growing robustly despite the rise in official interest rates since August 2006. A slowing of demand growth to below potential was probably necessary if inflation was to hit the target in the medium term. It was not clear what would precipitate that slowing without a further rise in Bank Rate. The easing in the household spending numbers was at best tentative, as these data were volatile from month to month."

"The rapid growth of money and credit in part reflected the easiness of credit conditions, and posed an upside risk to spending and inflation. That would need to be offset by a higher level of Bank Rate." "Business investment showed strong year-on-year growth and investment intentions were still very positive. The evidence pointed to a confident and buoyant corporate sector. Survey measures of capacity pressures were generally high and increasing. The world economy was also strong."

Kudos to the Old Lady; obviously still in full control of her faculties, which includes the sort of institutional memory we must fear the Fed has lost. It is refreshing to see a central bank that still focuses on forward looking measures to head off worse inflation problems than exist at present, and specifically noted that it is necessary to foment demand growth below potential as necessary to subdue inflation. In that regard, it is also interesting that the recent criticism of the Fed centers on its dropping the M3 broad money supply measure after a period of very rapid credit expansion since the initial need to counter the deflation scare in 2003.

Forward Failure

It is no secret that there have recently been some very public capitulations of opinion by many extremely talented securities firm research analysts, as well as some of the world's largest and best portfolio managers regarding their misplaced notions since last Fall on the potential for Fed rate cuts this year. All we can say about that is we hope it finally puts to rest forever the notion that there is any predictive value in the pricing of short term interest rate future forward contracts. While we can not say that we saw all of it, we did see quite a bit of specious statistical analysis of the market itself 'predicting' the drop in Federal Funds.

Just to be glaringly clear, the market does not predict anything. As we have noted previous, the market is a clearing house for all of the opinion which is both able and willing to back up the view with an actual purchase or sale in the market. That such smart folks were willing to take such a strong view based on a very limited set of previous data (as there were only a select number of previous instances across the modern yield cycle), and ignore the broader implication of continued strength in related markets (as the equities held all reactions in their relentless march higher) is indeed sad and disconcerting.

The disturbing part is just how many previous instances of even greater mispricing and a less than effective predictive value had been demonstrated by the Eurodollar short term interest rate contract. While there were quite a few, possibly the most extreme recent occurrence had been during the post 9/11 equity market recoveries into late 2001 and early 2002. Consistent with the Fed's form during the previous equity market and economic recoveries from the late 1980's through the 1990's, during those periods the various Eurodollar interest rate future forwards traded at levels consistent with the FOMC raising the Federal Funds rate back up from the 2.00% area to as high as 3.00-4.00% by late 2002, and to (amazingly enough) between 5.00% and 6.00% by late 2003.

Of course, in the event, the rate actually dropped to the historically low 1.00% into mid-2003. The glaring error back then was the lack of the analysts and traders ability to properly assess the real fundamentals as opposed to market psychology which has bled over from previous intermediate term cycles. That is why we were very pointed in our recent exposition on 'Analytic Balance' that even as analysts who are primarily technicians, we are always keeping an eye on whether there is fundamental justification for current pricing and projections. The classic mistake made by the folks who misread the US short term interest outlook in from late 2001 into early 2002 was to confuse the financial recovery of the DJIA with an economic recovery that did not have the potential to be nearly as robust as the previous intermediate term cycle recoveries prior to the end of major long term cycle Dot.Com Bust.

A full discussion of the 2001-2003 background and activity (with chart illustrations) is still available on the Sample Reports page of our website in the '1970's Redux: Son of Stagflation' report from March of 2005 (http://www.rohrintl.com/sample_reports.php) on pages 9-11. If it is of any interest, the discussion of why the inverted yield curve is not any sort of conundrum at this phase of the cycle directly precedes that on pages 4-8. If those topics are of interest, for your ease of access we kindly suggest saving a copy to your computer, as navigating this very lengthy report online can be a bit cumbersome.

Mind-Blowing

Following up on other recent themes, in our humble (okay, make that quasi-humble) opinion the 'Efficient Market Hypothesis' and 'Random Walk' theory are both a lot of twaddle which a bunch of benighted or self-serving individuals have used to further their agenda. Which is not to say that their agenda is necessarily pernicious or fraudulent, as these two closely related perspectives are often used to reinforce the efficacy of "indexed' investing. There is certainly something to be said for that approach to portfolio management for certain types of investors at specific points in their investment life cycle. Yet, the degree to which the proponents of these two very mundane and banal assumptions disparage folks who are actually talented at analyzing trends is needles and a bit offensive. Our previous dissection of those two ideas can be found in the *CMO* III-22 topical discussion "Hypotheses or Just Plain Facts."

Then, shortly after we provide that perspective what should we see in the Financial Times? Nothing less than one of their adept analysts citing a quote at a conference from one of the progenitors and main proponents of the 'Random Walk' theory. He was explaining his reasons for seeing value in China, with clear confirmation that on a selective basis he does attempt to beat the market. That affirmation from nobody less than Mr. Burton Malkiel is nothing less than (with apologies for the 1960's vernacular)…

...mind-blowing; absolutely mind-blowing!!

Mr. Malkiel is the author of *A Random Walk Down Wall Street.* As columnist John Authers notes, that was published more than 30 years ago, and is a seminal text. It trashes claims that it is possible to beat the market with consistency. Previous to our recent dissection of why that is actually not a reasonable position, quite a few other respected folks had debunked that proposition. Not the least of these was Benoit Mandelbrot in his *The (Mis) Behavior of Markets: A Fractal View of Risk, Ruin And Reward*, where he refutes modern financial market theory by pointing out that markets are neither efficient, rational nor random.

Yet, for Mr. Malkiel himself to agree that, gee, yes there is merit to broad economic analysis (as we can only infer from his willingness to engage in an overall positive view of a 'country' investment) was nothing less than striking. It is at the very least tacit admission that for the purposes of a long term view either a cyclical and or trend analysis can be effectively applied to successful dealing or portfolio management.

That reinforces the trend perspective which has been successfully employed by some (and certainly not all) of the folks who take a diametrically opposite view to 'Random Walk' theory. In that regard it is the exception that goes way beyond a 'test' of the rule. It amounts to nothing less than a total refutation of one of the key tenets for the foundation of the view which raised him to prominence, and has been a needless thorn in the side of every professional trend analyst and portfolio manager ever since. Good riddance.

Mr. Authers full column is attached for your review.

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

-Rohr
(www.rohrintl.com)
