

## **ROHR REPORT**

# ***CAPITAL MARKETS OBSERVER***

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## **Overview with Markets Summary, Reports & Events,...**

### **...Momentum Moment, Curve Swerve, Cassandra's Conundrum**

#### **Overview**

The irony should be lost on no one. Almost exactly one month to the day prior to Monday of this week the **DJIA** left a 13,665 Triangle pattern UP Break that was the alleged harbinger of its return to leadership of the equity bull market. Momentum seemed to be firmly with the bulls, as most other US equity indices also pushed to somewhat of a new high. Yet, previous upside leaders in Europe stalled back at previous highs. As we noted then, considering the DJIA UP Break projected an Objective to 15,417, it was very curious that previous upside leaders should not have responded better. There were other suspicious earmarks, including the migration of near term technical resistance up to 14,000-14,100 while the DJIA had been rangebound for the previous six weeks, as well as the lack of volume on the upswing.

All of those suspicious internal and intermarket technical indications still needed some form of fundamental trigger to actualize a failure back below the 13,665 UP Break. As we have noted many times previous, technical indicators anticipate potentials, and actualization of projected trend activity requires some form of trigger from the real-time price movement. In this case, as opposed to the straight down drop to support in March, any aggressive failure back below 13,665 would be that much worse for having attempted such a major UP Break that would end up being an obvious 'false' UP signal 'bull trap.' And after that occurred it was hard for many participants to accept the reversal of trend logic, which now dictates the prospect of no new high anytime soon, and means markets must continue to seek lower levels until they reach some sort of significant support; a complete reversal into downside momentum.

In addition to our technical skepticism (which actually extends back to warning that cyclical indications meant equities would struggle into new highs after holding support in early June), there were timely warnings from other sources that the surprises which the credit markets might hold for the outlook would be exacerbated by the opaque nature of the positions at major securities firms and elsewhere. One of our favorite was the Financial Times Short View of July 17<sup>th</sup> (right into the first test of 14,000) by analyst Tony Tassell (attached.)

As we grappled with multiple tests of that extended DJIA 14,000 area resistance, it was good to be reminded that (for better or worse) the decision to reverse trend by US equities which would set the tone for the balance of the world was not going to be in response to a current (i.e. backward looking) economic report. It was "...only likely to be revealed in a slow drip from investment banks, hedge funds and other market participants." In addition to that particularly prescient view of irrationally exuberant equities about to be swamped by an opaque debt dam burst, Mr. Tassell also highlighted the extreme levels of foreign US equity purchases (albeit for May) signaling manic bullishness, which might prove unsustainable.

Of course, as momentum reverses and bull signals fail, news all seems to turn the opposite way as well. While we are not gloom and doom merchants (and the levels noted here are likely to staunch the bearish tide), our previous observations on the intermediate term trend support residing down at 12,000-11,750 received major reinforcement Thursday; as did the negative influence from Wednesday's 13,000 area weekly channel DOWN Break.

Thursday's financial headlines were that the European Commission is the most prominent among governmental bodies calling for investigation of debt rating agencies. This is likely to amount to nothing more than politicians accumulating soundbites for election campaign ads, and agencies pleading they are constrained from providing any negative shift in their assessment until some actual indication of underperformance is documented. Yet, it is likely the worst news since the early 2002 accounting scandal scuppered the intermediate term recovery from the fall of 2001. Again, without any desire to scare monger, the lack of ability to know whose books were true reflections of their business back then seems very much akin to not knowing the quality of the holdings on various firms' books at present, albeit with the current headlines being moreso a confirmation than a surprise for the markets.

Of course, any further weakness in the equities will surely buoy fixed income markets which have already rallied markedly from the mid-June intermediate-term cyclical lows. As we have noted previous, the long ends' leadership seems to have been eclipsed by the short money's sharp improvement in the wake of the central bank liquidity infusions. The long dated fixed income doesn't really care for short term liquidity injections, yet has demonstrated strength in the **T-note** above 107-16/108-00 resistance with the low 109-00's and low 110-00's above, with the **Bund** finally above the violated 113.20-.35 long term Fibonacci levels and congestion with 114.40-.60 above, and the **Gilt** having recovered back above 106.00 and 106.50, with 107.50 and 108.20-.35 above.

One of the other key factors is the degree to which short money forwards have levitated to interim price areas which are not consistent with an outlook that will result in the central banks either easing sharply or remaining on hold (or even hiking in the case of the ECB.) That was reviewed recently by FT analyst John Authers in an excellent column on citing the influence of the statistical concept of "expected value" (also attached.) As the short term interest futures have always been lacking in real predictive value, this illustrates yet another aspect of their limitations that applies to unstable conditions that creates pricing for "...an expectation of a 0.25 cut - even though nobody expects this." It's an interesting and informative read.

The other very interesting development is the yen actually developing residual strength compared to the weakness of the equities. Might this be the beginning of the much feared carry trade 'crisis'? Possibly. Yet, as we discuss further below, the dilemma is that all of this is so much equalization of the previous excesses that are still needing to see the yen Break UP through long-term resistance prior to actualization of the full potential for the sort of sustained yen strength which might foment a crisis. As noted in Wednesday's analysis, those split levels are at USD/JPY 115.00 and the 113.50-112.50 range; EUR/JPY 157.50 and 155.0-154.50 (both already violated), and 150.75-149.50; and GBP/JPY 229.50-227.50 (also already violated) and 221.00-219.00. (That last one is in addition to Wednesday's levels, and based upon the up channel from the 179.43 October 2003 low.) It is interesting that the EUR/JPY and GBP/JPY channel support should in the vicinity of the March pullback lows based upon upward progression of the broader channels since that time.

That is in consistent with **EUR/USD** dropping below the 1.3666 December 2004 high, and violating the 1.3550-00 support, with the major trend and weekly MA 41 in the 1.3350 area. That is very similar to **GBP/USD** sustaining its extended rally above the 1991-1992 twenty-six year highs at 2.0050-2.0100, yet now failing back below the support in the 2.02-2.00. That means the market must hold the next support into the 1.9750-1.9625 area or risk falling all the way back to major trend support in the 1.9400 area.

Quite a few of obvious factors have contributed to the strength of September **Crude Oil** that had done the obvious and extended its rally above the important mid 72.00 area resistance, which (as noted previous) still has the 70.00-69.00 area as the next important lower support. There was not much above that resistance until the 74.70-75.00 area that was whipsawed around prior to pushing up to next higher resistances in the 77.50-.95 range all-time highs seen in July-August of last year. As we have now seen, those violated resistances are now support, with extended support back into the 66.00-65.00 areas, and extended psychological and weekly oscillator resistance up at 80.00-81.00.

## Reports & Events

While most of the news is already in the market for this week, it is important to note that the across the board (or globe in this case) were of no help to equity markets in the way in which they had classically been during the more bullish phases of the markets. Inflation numbers In fact are often a 'one-edged sword' which are either mutually good or bad for both equities and fixed income markets depending on whether they are above estimate or softer than expected. This month might was always going be just a bit trickier once the equities started down, as stronger numbers might be seen to tie the Fed's hands, while weak numbers might not be as constructive as usual for equities if interpreted as reinforcing the sense of overall economic weakness, as has been the case.

Yet, as noted above, markets are less focused on current (i.e. backward looking) economic reports than what the credit market 'normalization' (as ECB President Trichet out it) might mean for the economy and financial markets in future. While the current reports might not be the ultimate driving force for the markets, that figures other than UK Retail Sales (JUL) and US Industrial Production and Capacity Utilization (JUL) have been roundly weaker than expected this week have certainly not helped the equity markets.

Yesterday's zero reading on the US Philadelphia Fed Index (AUG) was only the coda to weakness in European GDP numbers that are for the economy that is supposed to buffer weakness in the US. As next week is the back end of the normal US mid-month reporting vacuum until next Friday's New Home Sales (JUL), the markets are going to be trading even moreso on pure psychology than at present. As such, expect that they will both be very much more vulnerable to any surprises, and that there will be no economic news to even nominally assist the equity markets if they get back into trouble; all the more reason the onus will be on the Fed if that should occur.

## Momentum Moment

We have focused quite a bit of the major trend decision influence on the DJIA significant intermediate term support in the 12,000-11,750 area, and that potential further trend decision extends beyond the equities into their influence on the other markets. This is why any drop to that area is likely the Momentum Moment when Mr. Bernanke and fellow Fed governors will be tested to the maximum extent of their powers of system management and psychological influence. In the first instance, recall that the DJIA is the most critical at present due to being the most resilient of the equity markets. While this may simply be due to the international big cap nature of its component stocks, it still means (as noted previous) it will be the last shoe to fall in the violation of any technical price trend support. As such, only a failure from the DJIA will confirm any of the failures elsewhere, even if the other major indices may have already slipped quite a bit further in general, and previously violated their own trend support.

Yet, even more telling is the combined nature of 12,000 and 11,750, as this goes well beyond their psychological influence as the respective psychological 'big penny' recent (March) trading low (more specifically at 11,940) of the last selloff, and the old January 2000 all-time high that the market only exceeded once again last fall. This is not to diminish the importance of previous major trading lows when the market is exhibiting "falling knife" tendencies, nor the sheer exuberance and confidence provided the global economies, equities and credit markets which DJIA exceeding 11,750 provided once it was apparent that the Fed was comfortable with this development.

In fact, Mr. Bernanke remaining sanguine in light of US and international economic and commodity price strength was the signal for the credit market bubble to continue inflating in pursuit of improved prospects for asset price increases which might have been less likely had the Fed chosen to cool things for a while in the face of the strong indications. It is an imponderable what may have transpired had the Fed acted differently, and there are quite a few positive developments which extended from its passive approach.

The first strong domestic economy in Europe for decades will likely buffer any slowdown in the US, and was also likely responsible for the economic confidence (and frustration with their underperformance) which convinced the French to buy into Mr. Sarkozy's reform agenda. Similarly, the extended export strength in China has evolved into a burgeoning middle class which is driving its own domestic economic strength. Even near term quality problems with Chinese exports may also serve the positive end of elevating their production values as well as demands from the middle class for more effective stewardship of the environment along with profits.

While still a tightly controlled culture on some levels, possibly it will reach the point where the next generation thinks the Little Red Book is an internet social community guide. As noted in what many felt was one of our more specious and far fetched topical discussions ([China and the Fed](#), *CMO* III-21 May 23, 2007) possibly the 'transparency' drive at a time in the cycle not particularly amenable to such an effort was in fact "...a giant smoke screen for their hidden agenda: extending global economic strength to complete the evolution of all of the world's major politico-economic cultures (a club which China shall soon join on present trends) to liberal capitalism." "...quite an assumption; also a deliciously Machiavellian thought."

Yet, whether or not he is the most profound politico-economic genius of a new century which is less than a decade old, allowing that bubble to develop always carried with it the prospect that its deflation would need aggressive management. On balance, the Fed has done a decent job so far, but the biggest tests are yet to come if the DJIA does indeed slide down to the 12,000 or 11,750 levels. This is due to the additional technical indications for those levels. The 12,000 area is also the overall up channel trend support from the October 2004 pre-election selloff low. Even more telling is that the 11,750 area is overall up channel trend support from the October 2002 major cycle low at 7,197.50.

Below there DJIA is no longer in an up trend from that major low, and as noted previous that would only exacerbate any commensurate failures below support in weaker equity markets at a time when the slippage back below such an obvious historic level would catch the attention of the public. And that is the crux of why any break to the 12,000 area becomes such a critical juncture for the Fed, especially after *de facto* easing this morning which occurred through the vehicle of extended discount window operations.

Whatever may transpire in the short term, the last thing anyone from the folks around the conference tables at the central banks to (especially) the proverbial 'man in the street' wants to see is the DJIA fail back below a level which would cause concerns to spill over to in the real economy. And that is why the Fed will actually cut the Federal Funds target rate if the markets fail to sustain near term strength generated by the discount window operations. Any drop to the 12,000 area will bring about the 'Momentum Moment' requiring the Fed to act well before it appears they are panicking due to the DJIA actually failing back below 11,750.

Quite a few folks still criticize Mr. Greenspan for the mid 2003 interest rate cuts to avoid global deflationary tendencies getting out of hand; due in part to the fact that the ever hawkish ECB was not going to be of any assistance in spite of their economy being among the greatest drags. Mr. Bernanke can expect no better support from that quarter in the current environment. In fact, acting timely to ensure there was not a liquidity crisis back then was prescient, and laid the groundwork for the extent of the overall economic recovery of the past several years.

It was a matter of confidence, and that will be the case once again if DJIA drops near 11,750 in the near term, even if current circumstances are quite a bit different. Mr. Greenspan understands something which his counterparts at the ECB seemingly fail to comprehend, the BoJ made the mistake of ignoring during their own crunch back in the early 1990's, and the Bank of England seems the only other bank to realize: that all of the major central banks are to some degree the "Central Banker to the World" and not just their own domestic economies.

We refer to this as the Rohr International Number One Rule for Central Bankers: "In order to manage an economy, first you need an economy to manage."

While that may seem a classic "too clever by half" observation, it is the sort of imperative under which Mr. Greenspan acted during very different conditions in both 1987 and 2003. That also informed Mr. Greenspan's 1998 easing, in spite of the fact that it was a move to mitigate a global problem that was not related to a relatively strong US economy; in that way the current situation is most certainly not like 1998, which so many of the 'experts' seem to claim it is. It was also the guiding principle behind Mr. Volcker's very effective moves to wring out the endemic inflation from the early 1980's economy, in between taking the market to the brink of a deflationary psychology back in that era. It was with that sort of finesse that he substantially set the stage for Mr. Greenspan's future success at inflation mitigation.

Some may gripe that it is inconsistent with the previous (as well as very recent) Fed/FOMC admonitions about the potential inflation problems for them to cut rates at present. Yet, as we have historically seen so many times, maintaining a healthy tone for the overall economy is actually paramount in trying times, and that is still consistent with mopping up the inflationary influences later. The BoJ failure to move in the early 1990's is a glaring example of the very good reasons to not let general economic psychology drop down the rabbit hole; the levers which central bankers count on in the real world don't seem to work so well in Wonderland.

While noted previous, in avoiding a cool down last fall, Mr. Bernanke likely knew his destiny would be to manage the deflation of a bubble, and DJIA 12,000 and 11,750 trend supports will be key to his success in preventing a bad result. As French fabulist Jean de la Fontaine noted in the 1600s, "Our destiny is frequently met in the very paths we take to avoid it."

## Curve Swerve

As also noted previous, the long ends' leadership seems to have been eclipsed by the short money's sharp improvement in the wake of the central bank liquidity infusions. It is not really much of mystery why the long dated fixed income doesn't really care for short term liquidity injections at a point in the commodity cycle where prices are still strong and global demand shows little sign of weakness. While any weakness in the US economy will mitigate the inflation fears to some modest degree, the fact is that any more extensive move on short term rates by the Fed will ultimately not be very constructive for long dated fixed income markets which have felt obliged to rally when the equities experience their heaviest breaks.

As such, if there is any cut in the Fed Funds target rate that we still believe will be necessary if the discount window activity today does not prevent a resumed slide in the equities to the lower supports (i.e. quite a bit nearer DJIA 12,000-11,750), then the short money forwards are likely to retain most of their gains even when the equity markets demonstrate more of a sustained recovery. However, whatever levels are attained by the long dated fixed income, whether that is only back to September T-note low 109-00, up to the 110-00 area, or even higher (and equivalent levels elsewhere), once the equity markets recover in a manner which is more obviously sustainable, the long dated fixed income will be extremely vulnerable.

The basic dichotomy between the necessary equity market and economic psychology rescue to which the Fed has already alluded today, and the degree to which all of the additional liquidity is a possible problem from an inflationary standpoint means that some fairly sharp falls are possible in the long ends. It would not be surprising to see lead contract T-note futures drop back to at least 107-00, and possibly the 106-00 area in the wake of any definitive equity market bottom fostered by an official (i.e. likely sustained) Fed easing.

Potential weakness in the long ends for the stronger economy equivalents in Europe are naturally even more daunting (as evidenced by their more reluctant rallies to date.) The Bund might drop quickly back to 112.00, and even swing back into the more major 111.50-111.00 support if Über-Hawk ECB chooses to highlight the influence of their own rather extensive liquidity injections (which is a highly likely), and the Gilt could easily flop back to 106.00 as well, with the 105.00-104.50 area support the next levels on the basis of the recent congestion activity just prior to the recent extension above 106.00.

## Cassandra's Conundrum

While we still do not believe the current calibration of the various markets will result in a full carry trade crisis, we must give the Cassandra's their due. Over the course of this week the yen certainly developed a bit of residual strength relative to the equivalent drop in equity prices which we had felt were leading the yen buying previous. That said, we wonder if those additional gains were indeed sustainable secular strength in the yen, or possibly moreso a bit of 'front running' of yen purchases by those who were expecting further equity market weakness, or a cut in interest rates elsewhere to trigger the actual yen explosion?

In the event, markets saw both. The result was that even while the European equities were still under pressure this morning the yen saw a very temporary new high and then backed off toward its Closes from yesterday. Possibly even more bizarre in our view was the degree to which the Fed's discount window *de facto* easing further weakened the yen in the wake of equity market improvements. That seemed to refute a primary carry trade Cassandra assertion that the first signs of easing anywhere would trigger the yen primacy.

The fact is that the Japanese economy remains weak enough that nobody expects those yields elsewhere to drop far enough to encourage a wholesale flight from interest rate differential-based carry trade borrowings. As we had noted previous, the only way for the situation to devolve into that sort of massive interest rate convergence would be for the central banks elsewhere to completely drop the economic management ball, and allow current equity market weakness to become a global market and economic crash. As the US Federal Reserve has already exhibited its determination to move incrementally toward the policy steps that will most likely avoid such a terrible outcome, it is unlikely.

As such, the Japanese yen will need to find a reason to create and sustain the UP Breaks against the other currencies without the impetus from an equity market crash fomenting a wholesale asset price devaluation triggering massive repatriation of yen borrowings. It is somewhat ironic, yet wholly consistent with the current major intermediate term support in the DJIA being right back in the 12,000 area of the March selloff low, that evolved broader trend support of EUR/JPY should also be in the 150.00 area, and GBP/JPY in the 220.00 area.

In that regard, any equity bears and yen bulls are right to consider their task has evolved from the normal expectation of trend support being vulnerable at progressively higher levels into a far more Sisyphean requirement. They must push through the last major reaction levels in spite of the trend advancing markedly from those levels over the past five months. This is not to say that the carry trade Cassandra's might not prove right; just that their recent joy is only an overdue adjustment to the equity market weakness leading the correction. The full yen trend decision is now once again more likely calibrated to whether the equities survive the current test than any independent strength by a yen still challenged by a weak Japanese economy and commensurately depressed yields.

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

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