ROHR REPORT

CAPITAL MARKETS OBSERVER

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…A 'Bernanke Put'?, *De Facto* Easing, Interbank Indications

Overview

This unusual end of week *CAPITAL MARKETS OBSERVER* is a summary of views expressed previous on a range of issues creating such seemingly convoluted and contentious market tendencies in the current environment; these will last right into the September 18th FOMC meeting, and possibly beyond. A major part of divergent and seemingly confusing trends is the degree to which fundamental indications and near term market responses are on a dual track. This is true for both internal disparities within market complexes as well as intermarket relationships.

However, all of the seeming dislocations can be traced back to the dual track prime mover: Asset value destruction and the anticipated central bank response. While the ECB and other ostensibly strong economy central banks continue to talk the good inflation hawk position, this morning's OECD Composite Leading Indicator (CLI) was instructive. As usual, it is one month behind with July statistics and indications. All the more reason that the topping out of the overall OECD CLI was not just an average; it was broadly spread throughout all of Europe, including the previously buoyant France, Germany and the UK. While the US was rising previous, it came in flat, and all of the six month rate of change forward indications were down; especially Asia, including China. That was before August.

As such, while this week's lack of interest rate hikes from central banks in strong economies anywhere from Australia to the UK was ascribed to a desire to avoid further turmoil in the interbank market, it may prove a convenient excuse to end the tightening cycle in the face of what may be enough asset destruction from the dual subprime and US housing mess to foment the first real bout of economic weakness in awhile. Yet, that raises the key question of whether the FOMC will cut at the Fed Funds rate at their September 18th meeting?

Even more to the point for the overall complexion of markets where the fixed income (other than the interbank market) has rallied along with the equities while the US dollar weakened is the question of whether a cut at that meeting or any other time amount to a 'Bernanke put'? The answer is simple: as with most other aspects of the markets, it is a matter of timing. Lowering the Fed Funds rate while the equities are significantly strong in an effort to front run the weakness sure to emanate from weaker housing would indeed be a 'Bernanke put' that would almost certainly encourage a return to inordinate risk taking. However, if the Fed waits until the equities are significantly weak once again (DJIA at least below the 13,000 area, and more usefully even quite a bit lower), then a rate cut would be a rightful and useful move to underpin overall economic and financial confidence; no 'Bernanke put' there.

While we will have much more to say on that below, we note that the only major report left after a week of very mixed indications was the US Employment report (AUG.) As it was very weak, with downward revisions to previous data, the bad fallout from the housing sector and other strains on consumers seem to finally be showing up in this key indication. It is also a low base from which to enter the more contentious housing market weakness from the subprime mortgage influences. Due to the forward view of the markets, the impact on the equities might be more muted than would otherwise be the case in anticipation of this indication encouraging the Fed to cut sooner than not. That remains problematic.

Markets Summary

EQUITIES

With the **DJIA** experiencing a trading recovery back above the low end of its previous 13,250 trading range, if that can indeed be sustained it will be back up into that higher bracket in spite of the weak US jobs numbers today. As long as it remains no worse than level to the 13,150 Tolerance that was violated previous, that could mean it can see the top end of that range on a retest of the Negated 13,665 Triangle pattern UP Break or even the congestion up in the 13,700 area (as it did two weeks ago today prior to failing.)

That is also consistent with the lead contract **S&P 500** future holding the old lead contract key gap level in the 1,467-61 range, which will receive a boost from the lead contract expiration rollover to December as lead contract two weeks from today. That contract is trading at a thirteen dollar premium to the September contract which is only now into that 1,467-61 range. Lower lead contract support is also in the 1,435-31, 1,410, 1,400, 1,380-75 and 1,325 areas.

That all relates very well to the Tolerances of resistances in the other markets, such as **DAX** being well back above its 7,390 Triangle DOWN Break, and having violated the Tolerance of that pattern above the August 8th 7,614 high. However, it did stall just below the 7,750-7,800 congestion and downward channel from the mid-July high. While near term support is in the 7,500 area (incl. daily MA 18), any failure back below the recent congestion in the mid-7,300 area would represent a reinstatement of the most negative indications for the overall trend.

That said, the DJIA reinstating its rally back above the minor support around the 12,800 area high from back in February after holding the top of more substantial 12,500-400 congestion at the bottom of the volatile selloff several weeks ago remains somewhat impressive. Yet, the ability of the fixed income to keep the bid (and only react modestly to the downside) into to all of the recent equity market recoveries is one of those dual track intermarket actions which speaks of some skepticism the equity market strength is sustainable in the intermediate term. If the fixed income is right in its presumption of bigger economic problems to follow, then in spite of the recent strength the DJIA is still likely to need to extend its overall reaction to the intermediate term 12,000-11,750 major psychological and technical trend supports.

Of course, any return to weakness in the equities will once again buoy fixed income markets which have rallied markedly from the mid-June intermediate-term cyclical lows. As we have noted previous, long ends' leadership being eclipsed by short money's sharp improvement in the wake of the central bank liquidity infusions has now reverted to short money respecting the strength of the equities. Yet all of that could reverse in the proverbial heartbeat if the equities should come back under extensive pressure in spite of the recent moves to relieve the pernicious influence of the credit markets.

FIXED INCOME

The long dated fixed income didn't really care much for the short term liquidity injections, yet demonstrated strength in the **T-note** above 107-16/108-00 and low 109-00 resistances, with the 110-06.5 major January 2006 reaction high above that the December contract still needs to Negate. If so, that would create a very critical situation. As we noted in last Tuesday's ***TrendView*** **MARKET ALERT**, given its already elevated and strong state, it might extend up to one of its broader trend channel resistances from the 2003 high.

While the first of those is as nearby as the 111-00 area over the next couple of weeks, the broadest of the down channels is up in the 113-16 area over the next month or so. While it seems a long way off, any sense of disaster which emanates from a potential equity market debacle could drive the fixed income up beyond reasonable levels on near term emotion; and the operative phrase there is 'near term.' Of course, if the equities were then to be rescued by any Fed action into the extended lower levels, then the extreme premium in the long ends might quickly dissipate. We explored the contingencies surrounding those possibilities in the *Capital Markets Observer* III-26 (Friday, August 17) **Curve Swerve** topical discussion.

As for the other long ends, the **Bund** finally above violated 113.20-.35 long term Fibonacci levels and congestion (and holding repeated dips back to that area) still had trouble over the past several weeks into the 114.00 area. That was a bit of a surprise, as extended significant resistance above is not until the 114.40-.60 area major congestion and weekly chart gaps. However, now that December contract (the new lead as of yesterday's September contract expiration) is above 114.00 along with the December T-note challenging the 110-06.5, the markets appear a bit more back in synch; that is even allowing that the US can continue to lead the way up overall due to the relative fundamental factors. Extended resistance in the Bund remains in the 115.00 and 115.50 areas.

The **Gilt** rally above 106.00 and 106.50 reacted back into that range repeatedly in a similar (if somewhat stronger version) of the serial setbacks to 113.35-.20 in the Bund. And as those setbacks were after the quick test of the 107.50 resistance above a couple of weeks ago, it appeared the Gilt was the strong sister in Europe at that time. Yet, now the Bund has played catch-up to some degree, as the December Gilt (trading almost at parity with the September contract) is only just back to a test of the 107.50 area. If and when it should break through, extended resistance remains in the 108.20-.35 area.

One of the other key factors which we noted last week 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.) While today's US Employment number and OECD CLI makes more of a case that weakening economies call for sustained cuts from the central banks, the short money forwards (March 2008) that traded on such extreme anticipatory tendencies in the face of the temporary equity market panic several weeks ago are only back to their highs in the US, and well short of them in Europe and the UK.

That all relates back to the extreme volatility of the short money forwards. After falling temporarily back below its interim 95.40 support, March **Eurodollar** held extended support into the 95.25-.20 area and is now back up near its previous 95.64 high. Any Close above it likely leads to a test of its 95.80-.90 congestion resistance from late 2004 through late 2005.

We would consider any push to that level as the extreme likely high trade for now, as that would already be anticipating cuts of up to a full percent from the Fed. We do not anticipate anything more than that being necessary (if indeed they even need to go that far) for the purpose of underpinning economic and financial confidence, even in the event of an equity market selloff into that major DJIA 12,000-11,750 support. A move of that magnitude to the upside would also represent a swing back up to daily oscillator resistance at 75 points over daily MA 60; which is a fairly extreme level by recent historical standards, and just where the market stalled on the initial push to 95.64 early last month.

Equivalent March contract support and resistance elsewhere are in the **Euribor** at 96.00, 95.80, 95.60 (which held on the recent selloff), 95.52-.50, and 95.40, and **Short Sterling** at 94.20, 93.98-94.02, 93.85-.80 (which held on the recent selloff), and the 93.73 area.

FOREIGN EXCHANGE

The other very interesting development was the yen actually developing residual strength compared to the weakness of the equities for a while several weeks ago. While this might have seemed the beginning of the much feared carry trade 'crisis', the dilemma was that all of this was 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 previous, those split levels are at **USD/JPY** 115.00 (which secular weakness in the US dollar has allowed the market to drop back below) and the more critical 113.50-112.50 range; **EUR/JPY** 157.50 and 155.0-154.50 (both violated and then recovered back above), and 150.75-149.50; and **GBP/JPY** 229.50-227.50 (also violated and then recovered back above) and 221.00-219.00. It is interesting that the EUR/JPY and GBP/JPY channel support should be in the vicinity of the March pullback lows based upon upward progression of the broader channels since that time. Based on the lack of extensive current yen strength against those two, it seems that secular US dollar weakness is the real trend momentum.

As we noted previous, that is consistent with the US dollar strength during the equity market turmoil several weeks ago possibly only being a by-product of more aggressive selling of other currencies on carry trade liquidation. Which is why the **US Dollar Index** likely only made it to major trendline resistance in the .8200 area prior to falling quickly back below its .8100 support. In fact, that swing to the .8200 area was the potential completion of a major Falling Wedge pattern on the recovery to the higher of two longer term converging trendlines that should have left the buck in a position to establish an UP Break for a move all the way back to the March 2006 .9100 area highs. However, that was a very questionable projection within a fundamental situation where the economic weakness flowing out of the US was going to lead the way down, with commensurate indications for short term US interest rates.

As we often refer to the 'analytic balance' necessary to discern the true 'trend logic', in this case the technical indication was one where the market needed to rally back to .8200 to complete what could have been a major bullish pattern. Yet not being capable of instituting the requisite positive momentum to even institute (much less sustain) the actual UP Break, the failure from .8200 was a sign that the bear trend was actually ready to commence once again. As today's violation of the recent congestion lows in the .8000 area that is also the major low from the April 1995 US dollar bottom, that leaves the door open for a move down to the .7800 area September 1992 next lower major low, which is consistent with the next weekly oscillator support from recent trend tendencies (MA 41 minus 0.4000.)

That is also very similar to the recent analysis for **EUR/USD** dropping below the 1.3666 December 2004 high and violating the 1.3550-00 support, yet holding the major trend and weekly MA 41 support in the 1.3350 area. Also very similar as well to **GBP/USD** slipping back from its rally above the 1991-1992 highs at 2.0050-2.0100, yet holding the next support into the 1.9750-1.9625 area, with lower major trend support not until back in the 1.9400 area. While there is some EUR/USD resistance around the recent mid 1.3800 highs, extended resistance in is not until the 1.40, 1.42 and 1.45 areas; GBP/USD equivalent is 207-210.

ENERGY
Quite a few factors from weather, to geopolitics to plain old strong demand contributed to the strength of **Crude Oil** that had done the obvious and extended its previous rally above the important mid 72.00 area resistance, which (as noted) still had the 70.00-69.00 area as the next important lower support that was held by the new lead contract October two weeks ago. There was not much above that resistance until the 74.70-75.00 area that has now been exceeded once again, and the 77.50-.95 range all-time highs seen in July-August 2006. Whether the market can stage another rally to re-approach those higher resistances (or even possibly exceed them) now likely rests with equities as well, as the recent selloff into support was moreso related to the fears of an economic slowdown fomented by the equity market selloff than any intrinsically weak energy market news.

A 'Bernanke Put'?

So, does today's much weaker than expected US Employment data (and especially the relatively new phenomena of extensive downward revisions to previous data) foment a rate cut from the FOMC September 18th, and if so does that amount to a 'Bernanke put'? Already noted above is the degree to which that will depend on the timing. One of the most divergent of the dual tracks has been due to the fixed income (other than the interbank market) mostly holding the gains of its rallies in spite of the recent resurgence of the equity markets. While there area times early in the up cycle when that sort of mutual strength is reasonable and normal, we doubt anyone would argue we are that phase right now. If anything, it is just the opposite end of the cycle.

As such, this tendency has been a bit contentious. It was a by product of the degree to which the equities were happy to take the bad news as good news (in anticipation of a Fed rate cut to follow) up until the really extreme cases of recent US housing and mortgage indications, and now the US Employment and OECD CLI releases. Yet, even as all of that recent equity market strength occurred (and was further exacerbated by credible attempts of the central banks and US administration to provide hope of a fix for the subprime mess), the fixed income acted as if it knew that what was coming next would at some point be inconsistent with sustained equity market strength. Those birds appear to be coming home to roost.

Yet, even in light of the current weakness, the equities will still need to slip to lower levels prior to the September 18th FOMC meeting to make a Fed Funds rate cut truly necessary or constructive at that time. The reason is simple: as with most other aspects of the markets, it is a matter of timing, and lowering the Fed Funds rate while equities are significantly strong in an effort to front run the weakness sure to emanate from weaker housing would indeed be a 'Bernanke put' that would encourage a return to inordinate risk taking. However, if the Fed waits until the equities are significantly weak once again (DJIA at least below the 13,000 area, and more usefully toward or below the recent 12,500 area trading low), then a rate cut would be a rightful and useful move to underpin overall economic and financial confidence.

The reason the Fed must avoid the sense there is a 'Bernanke put' is to clearly avoid the subsequent return to an over exuberant market which some claim Mr. Greenspan needlessly created from his 1998 rate cuts onward. We do not agree that was necessarily was the case, as reviewed in the *Capital Markets Observer* III-27 (Thursday, August 23) **Neither '87 Nor '98**, yet in the current environment there is surely moral hazard in appearing to wish to inflate an alternative asset bubble in shares to offset the deflating credit and housing bubbles. And that is the timing dilemma which Bernanke & Co. will need to address.

De Facto Easing

In spite of the sustained concern about the US housing and subprime weakness spilling over into US consumer activity, the most recent Retail Sales figures are fairly robust not only in the US, but elsewhere as well. However, as we have noted previous, one looks at current data releases at their peril, due to the degree to which all of the current releases are backward looking, and only useful as a base for further economic developments. That is what is also so disturbing about today's US Employment data and the OECD CLI: the US Employment downward revisions and naturally delayed indications from OECD point out how much weaker things may have been than most observers were even aware.

The other factor that is telling is the degree to which other central banks which held steady this week were previous signaling clearly that they were confident timely further tightening was a necessity this month. Yet, in the event, they all allowed that the US situation and one other key factor which we explore below caused them to hold steady. What that seems to indicate is that while they are not saying so in so many words, they are indeed concerned that the US housing problem is not just a US problem.

The Bank of Canada possibly summed it up best. While they noted that domestic demand in Canada generally remains quite buoyant and growth exceeded expectations in the first half of the year, the bank said the downturn in the US housing market was likely to be "more pronounced and protracted, exacerbated by recent developments in financial markets". Similar sentiments expressed by other central bankers in strong economies with still buoyant inflation tendencies amounts to nothing less than a *de facto* easing. In that they may be enlightened: they can always catch up later, and have bought themselves a month.

The 'pronounced' nature of the subprime problem really became quite a bit more apparent with yesterday's release of the US Mortgage Bankers Association second quarter mortgage delinquency and foreclosure reports. As we have already discussed the extensive and intractable grass roots nature of the extension of the credit bubble into the US housing and financial markets (*Capital Markets Observer* III-27, Thursday, August 23, **Subprime, Housing and Consumers**), we will not revisit the entire potential spillover into the popular psyche and consumer confidence here. Instead we have attached the Online Wall Street Journal coverage from yesterday, which was excellent. It went into all of the key indications for the subprime problem being much worse than expected, and that there were also negative tendencies in the prime mortgage area.

And that is for Q2! Which means it does not even begin to address the looming tsunami of further subprime problems that spill over from weaker housing prices' drag on US consumer psychology into the dual track of the dilemma of the holders of the mortgages at risk. As has been broadly reviewed elsewhere, one of the dilemmas for the central banks of the ostensibly strong economies this week was a need to not upset further an already tumultuous interbank lending market, which is seeing higher yields contrary to the weakness elsewhere.

Interbank Indications

Whether you love him or hate him (and even many of his previous supporters fall into the latter camp), Don Rumsfeld was at his bizarre best when he provided his "what we know…" observations on Iraq and the war on terror. The tenaciously disjointed dual track devolution of the subprime situation includes two major risk factors that 'we know we don't know.'

Primary among these is the true extent to which the problem will spill over into the general economic activity of the US, yet with the dual track major sidebar of the sporadic tendency for those problems to spill over into the portfolios still burdened with the securitized detritus of the debt derivatives mania which was as much a part of the credit bubble as any overt lending to substandard borrowers. The fact is that in spite of all of the encouragement in the world from central bankers, regulators and US administration officials wishing to see lenders provide forbearance and seek workouts for mortgage borrowers, most of those loans are part of packages in portfolios which can not alter the loan covenants even if they happened to know the borrower, and wanted to do so.

In plain terms, the interbank market dilemma is that all parties need to assume not only that the problems in portfolios are going to get that much worse, but that nobody really knows where all of the problems are amongst the major banks and securities firms' clients who will need support along with their own affiliated investment vehicles. While many folks continue to postulate the current crisis is a lot like 1998, it is in fact far more opaque and diffuse. This is why the interbank market has seen such a dislocation: major banks and securities firms not only do not trust that all of the problems on the books of their peers are necessarily known, they also must consider that they may need no small amount of further liquidity to support their own distended family of clients and affiliated vehicles. This was covered very succinctly in a Financial Times article by analyst John Authers' views on the interbank market this Tuesday; it is attached for your review.

As we've noted previous, while the 1998 problem was the LTCM hedge fund using the banks' capital in a misguided over leveraging of what were in essence still viable convergence trades, that only required capital loans to prevent the summary liquidation of viable positions. By contrast, the foreclosures and lower prices for US housing that will be the end result of this cycle are a form of capital destruction. While the major banks and securities firms are right to subject this to the smoothing process of avoiding summary liquidation into illiquid markets, this will still represent a removal of capital from the system that is likely to last for a while and represents a tendency that will lead to weakness well beyond the US along with any overt influence from weaker US consumer activity.

One of the most telling comments may have actually been from a letter to the Editor of the Financial Times yesterday. We felt the writer may have been a bit misguided by adamantly opposing a Fed Funds rate cut, because it would not directly address the mortgaged-backed securities problem, as under tighter lending standards it will not bring back "those buyers who created much of the excess housing demand…" Which is both true, and simultaneously highlights the dilemma: the resale of foreclosed homes will necessarily entail very aggressive price drops (impacting consumer sentiment) to be affordable for the sort of buyers who both find them desirable and can qualify (in part due to the lower prices) for finance. The impact of continued significant US house price slippage on the popular psyche is the issue, not whether a Fed Funds rate cut can directly address the subprime problem (which it can not.)

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

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