Rohr Report
Capital Markets Observer
Volume III Number 3
Wednesday, January 17, 2007

Overview, Reports & Events,…
…*Quo Vadis* Equities?, Facts on the Ground, Basic Scenario

Overview
Even though we have seen quite a bit of economic data and heard from some financial luminaries, more important influences this week were always going to come from the inflation reports and other key figures which punctuate the typical mid-month US reporting vacuum, These are also going to be accentuated by the release us the US Federal Reserve's Beige Book in preparation for the FOMC meeting at the end of the month, as well as the volume and nature of the central bankers for the balance of the week. All of this will be not only noted but also discussed in the Reports and Events section below.

One of the key determinants of market activity elsewhere as well as the general psychology early this year has been the equity markets ability to sustain their up trends in spite of some of the obvious risk contingencies which evolved into the first part of the year. All of the concerns about potential problems with retail turnover in the US and especially Germany, the possible spillover from US Housing sector weakness, late 2006 weakness of the US dollar, and the weakness of select foreign markets based upon both less than enlightened actions by certain governments that are based upon geopolitical disruption in some cases have done little to bring any sustained weakness into the equity markets.

As long as that was the case, a phenomenon that we expected through much of 2006 yet which did not actually seem to come into effect until the very late part of the year was another distinct aspect of the intermarket influence: sustained equities strength fomenting weakness in the fixed income and some stability and strength in the US dollar. As the reason for the equities strength being at least partially based upon the now well entrenched weakness in energy markets (which we expect to continue on balance for the near term future), that is a distinct compounding factor in weakness of fixed income markets in the intermediate term.

As the lower demands from energy over the winter evolve into the spring 'sweet spot' of lower energy usage in general, it will liberate consumer disposable income in other areas in what is already a more inflationary environment than central banks appreciate. Only once energy is far back below current levels will the disinflationary impact of a lower cost base for the general economy translate into what will become a benign inflation influence once again. However, in the meantime the lower energy expense will be a driver for the strength of equities and weakness in fixed income.

It should also be a nominally supportive factor for the US dollar, as the equity market strength now (finally) being interpreted as a harbinger of greater economic strength also mitigates any potential for the Fed to cut rates unless there is indeed a much more radical spillover from housing sector weakness into the general economy. Even if that is still going to occur, the equities' strength has set up an early year up beat mood that is a bit of self-fulfilling prophecy: With the stock markets so buoyant there is less chance anyone stuck with a home that is not selling will panic into dumping it at a lower price; for now.

MARKETS

FIXED INCOME

The early year technical bottom line for the markets was whether fixed income could hang on to foment some sort of recovery after abysmal activity late last year into the first of this year. As they failed instead, the previous firmer long end trend signals turned back DOWN in a major way with European short money (and the Gilt for that matter) already leading the way down in a manner that was finally reinforced and clarified by the BoE rate last week. In the event all weekly MACDs have returned to DOWN, and that finally infected and is fully reflected in the more resilient US markets as well.

March **T-note** finally failing on the weekly Close back below the major UP Break and other support in the 107-16/-10 range was the final confirmation of a return to a sustained bear trend that is likely the second major leg of the aggressive bear swing from early 2006 into the May-June lows. The cautionary word here is that this phase of the market is sometimes as aggressive as the previous swing, and at other times much more gradual and churning. It is also possible due to the basic economic differentials that in this particular cycle some of the markets will be more aggressive and others less so.

The obvious manifestation of that since early 2006 has been the stronger Euro-zone and UK economies fomenting more weakness in their fixed income markets than in the US. In that regard another relevant factor remains the manner in which the US led the way down so extensively from the mid 2003 extreme deflation scare highs while the European fixed income remained bull markets into late 2005-early 2006 based upon their much weaker economies up until that time. In broad terms, through all of 2001 into late 2004 the lead contract Bund future ranged between a four point discount and four point premium to the T-note.

After escaping its bear tendencies in late 2004 it ranged up to as high as a 12.75 premium to the T-note, and remains more than eight points above it today. That would seem to still leave plenty of room for the Bund to fall relative to the T-note that is also consistent with their relative economic strength within the overall cycle. Similar tendencies are apparent for the Gilt future, which went from roughly a seven point discount to the T-note in early-mid 2004 to a high of a six point premium. It is only now back at roughly parity.

While some may take some comfort from the next interim T-note support coming in as early as the 107-00/106-19 range, the failure below the mid 107-00s means that it is joining the Bund failure below the 117.00 area by violating the only remaining major long term chart UP Break from the summer rally. That would be reinforced by long end weekly failures of the **Bund** and **Gilt** equivalent supports in the 116.00-115.80 and 107.50 areas, respectively, which are now the significant resistances above those markets.

Each of those failures brought the likelihood of another full point lower price activity or more, as below the interim support at 115.50 in the Bund, the next level is the 114.80 area, extending down to the major support held at the 114.55 early May low. The equivalent in the Gilt takes the market down to the 106.40 August 2004 trading low, with some further support into the 106.00-105.70 historic congestion and major weekly oscillator support. Needless to say, any significant destabilization of the long ends in this manner would foment a major failure of the short money forwards as well (more on that tomorrow.)

Needless to say the short money remains burdened as well. The September 2007 contracts have seen the **Eurodollar** weaken below its previous 94.94-.92 major channel UP Break, and slippage below the Tolerance of that UP Break at 94.84-.82 major congestion that includes the six month trading lows; below that area the Eurodollar forwards would be in very deep trouble, with next interim support at 94.70, yet major support not until the 94.60 area.

Of course, the European instruments have been much weaker all along, with previous quiet slippage into serial new lows for the **Euribor** leaving it into the 95.85-.80 historic congestion and daily oscillator support. Much below that it is onto more pronounced DOWN Acceleration into next historic congestion and oscillator thresholds at 95.65-.60 (which not surprisingly would reflect expectations for an accelerated tightening by the ECB.)

Short Sterling had not been quite as weak as the Euribor until last Thursday's BoE action, even though it had dropped back onto its own somewhat less aggressive DOWN Acceleration below 94.47. It has now also obliterated historic congestion and daily oscillator supports into the 94.40-.35 area (now resistance) and next support in the 94.30-.25 range. Next support is the daily oscillator and significant historic congestion (June 2004) in the 94.20 area, below which it has also slipped a bit this week. Given the BoE does expect inflation to moderate fairly soon, possibly this was a last bit of insurance into the buoyant statistics early this year, and it will be very interesting to see whether Short Sterling does indeed break that next support, and if the other markets follow suit. The support below that reverts to the weekly congestion and extended oscillator equivalent in the 94.05-.00 area. While that seems a real reach for now, it likely pays to watch just how aggressively bullish the equities become early this year (to the undoubted consternation of the central bankers.)

FOREIGN EXCHANGE

The US dollar recovery is a decidedly mixed bag, with quite a bit of divergence. Yet, it has been near some very critical resistances at old major congestion or previous DOWN Breaks. With **EUR/USD** back below the 1.3120-00 support (i.e. reinstated resistance) and minor congestion at 1.3050-30, the major support at the 1.2950-00 (with a Tolerance to 1.2850) previous weekly triangle UP Break, congestion, Tolerance of slippage below weekly MA 13 (actually in the upper 1.2900 area), weekly oscillator support, and the likely arbiter of whether the weekly MACD tips over into a DOWN signal. If it fails, next interim support is the mid 1.2700 area, with major support back in the 1.2500 area. If it holds, there will still be interim resistance in the 1.3100 area, yet the major trend will remain at least passingly UP.

On balance this means the US dollar has still stalled at resistance for now, with the equivalent elsewhere at **GBP/USD** 1.9200-1.9150, which has not even been lightly tested so far as Sterling returns to strong sister status into resistance in the 1.9700-50 range. **USD/CHF** has pushed through its resistance in the 1.2325-1.2400 range, and is now approaching its more telling congestion in the 1.2500-50 range. Only above that does it become liberated for a move fully back to mid-upper 1.2700 area early October highs. Yet, **AUD/USD** stubbornly held .7800-.7765 support, and is now approaching the .7900 resistance. Meanwhile, the buck is still at its best against the weak sisters, as **USD/JPY** held its support in the 118.00 area and is right back up through the recent 119.70 high. However, there is more formidable weekly oscillator and congestion resistance into low-mid 121.00 area. **USD/CAD** had pushed to the top end of its upper 1.1700-1.1800 area resistance, above which there is not much until the upper 1.1900-low1.2000 area (also major Fibonacci resistance.)

All of the averages out in the **US Dollar Index** where the buck is just edging back up to the .8515 major weekly Symmetrical Triangle DOWN Break, with a Tolerance to the congestion and weekly MA 41 in the .8550-70 range. That is also the likely arbiter of whether weekly MACD turns up in a more convincing manner as well. In essence, some very big divergences in the trends, yet with the buck still a nominal bear against Europe and the Aussie until proven different. The most important lower supports are .8400 and .8330 congestion, below which the market would break its recent up channel support; next resistance above the .8570 is not until an interim level at .8730, with extended major resistance back up into the major H&S Bottom failed UP Break in the low .9000 area.

<u>EQUITIES</u>
While the equities were still struggling against oscillator resistances around recent highs, über-market **DAX** has now pushed through its next interim oscillator resistance in the low 6,600 area, with next resistance not until the upper 6,700-6,800 area. However, the churn up into these levels also means that the 6,600 area has also become important general near term congestion, gap and daily MA support, with daily MACD already modestly DOWN.

Seemingly this means there is some burden of performance pressure on bulls to implement the push to higher ground as a means to avoid any further erosion of the upward momentum, especially as the strength of the DAX is in contrast to weaker sister **FTSE** failing to remain above its lower oscillator resistance in the 6,250 area, much less extend to the more major resistance in the 6,450-6,500 area. Lower support remains in the 6,100 area.

US markets have stalled into their own higher oscillator resistances at **S&P 500** future (lead contract) 1,450 and **DJIA** 12,500-600 areas. We suspect unless those areas will be challenged again soon, and any escape means that the extension of the DJIA could be to the next major oscillator resistance in the 12,850-900 range (i.e. as that is a weekly Close projection, the trading high might even push up for an approach to the 13,000 area.) Continued extensive weakness of the energy markets should be also help to sustain equities strength across the board. The key supports in the US are DJIA 12,350 (that held so tenaciously and tellingly last week) and 12,250-00, and S&P 1,411 and 1,400, below which key weekly MAs and aggressive up channel support from the summer lows would be broken, and weekly MACDs could turn DOWN.

The other market exhibiting extended strength was the **NIKKEI**, which has been burdened with its extensive year end holiday schedule, causing it to react strongly to both the other markets selloff late last week, and subsequent recovery. Yet, it held its previous 16,800-17,000 resistance (now support), with the next not until the congestion area into the previous 17,600 area April high.

<u>ENERGY</u>
The February Crude Oil (lead contract) has now failed the low end of important longer term trend channel support in the 55.00-54.50 range. With weekly MACD also has in a clear DOWN signal (from UP), and the lower end of that violated support band is also the major Fibonacci 0.382 retracement of the entire move from the 16.70 November 2001 low to the highs, the trend tendencies are extremely bearish. While there is interim support in the 52.00-51.50 area, that seems to be lees than effective at present. Important psychological and congestion support in the 50.00 area may also be temporary, as the next major support below is not until the congestion, gap and oscillators in the 47.00-46.20 range.

Reports & Events

While we have seen a bit of mixed economic news this week that has helped to stabilize the fixed income markets, the UK inflation news reinforced the aggressive move by the Bank, and that leaves various aspects of the remaining news more critical than not. We will concentrate on the most telling influences and leave the less important news this week. Of course, these include both the specific monthly data and macro-economic reports, along with some fairly influential communication from US and European central bankers.

While the UK inflation numbers (DEC) fully backed up the rationale for the BoE rate hike last week on expectations that it was hotter than expected, slightly more benign Euro-zone Core CPI and US Core PPI (both DEC) have had a muted effect on the fixed income markets, even though the headline numbers for the latter were also stronger than expected. In fact, it has been a rather mixed week so far for data other than inflation indications, with weaker than expected UK Output PPI (DEC), Euro-Zone Industrial Production (NOV) and US Empire State Manufacturing (JAN) being countered by higher than estimated Australian Inflation (DEC) and Investment Lending (NOV), Japanese Industrial Production and Capacity Utilization (NOV Final) and UK Jobs data (3 month annualized for NOV.) Of course, the subsequent release of stronger than expected US Industrial Production and Capacity Utilization (DEC) is not constructive for the fixed income, even though the equities are temporarily respecting that by weakening off a bit as well early today.

Yet, the most telling are all yet to come, as the lunchtime release of the US NAHB Housing Market Index (JAN) and the Fed's Mishkin speaking on housing prices in New York are the prelude to the Fed's Beige Book this afternoon (13:00 CST; 14:00 EST; 19:00 GMT.) While that is also followed by speeches from the Fed’s Yellen and Poole, those are likely to be a bit anti-climatic in the wake of the Beige Book.

Tomorrow is also a key brings the Bank of Japan Rate Decision along with their Monthly Report, as well as what will likely be the even more telling ECB Monthly Report (JAN.) Along with the ECB's Bini Smaghi’s speech in London and Euro-zone Construction figures (Quarterly for DEC), the Fed's Pianalto speaks in Dayton, Ohio on the economy prior to release of the US Consumer Price Index (DEC.) As if that were not enough, US Housing Starts and Building Permits (DEC), Leading Indicators (DEC), EIA Crude Oil Stocks (for the week ending JAN 12) and the Philadelphia Fed. Index (JAN) will all be released along with Fed Chairman Bernanke testifying before the Senate Budget Committee, the ECB's Bini Smaghi speaking on monetary policy in London, and the Bank of Canada releasing its Monetary Policy Report update.

Friday is significantly about talking heads, albeit with Australian Export and Import price indices (Q4), UK Retail Sales(DEC) and the US Michigan Consumer Sentiment (JAN Preliminary.) Yet, the net effect of the ECB's Stark Speaking in Budapest, the Fed's Bies speaking early (US time) on the economic Outlook in Tucson, Arizona, along with Richmond Fed President Lacker Speaking on the 2007 economic outlook, and the informational coda of the week in the Fed's Hoenig speaking on the economy at lunchtime will likely outweigh any but the most radical deviation from estimates in the economic data.

Quo Vadis Equities?
The strength of the equities so far this year defies not only all of the general potential drags that we mentioned in the Overview above; it also flies in the face of overwhelmingly bullish consensus that we noted previous. Yet, that last factor is always a nebulous sign, and must be treated as a background factor moreso than a particularly strong incentive to take any sort of strong opposing view or portfolio adjustments. Just because 85% of portfolio managers are bullish is not necessarily a reason to be aggressively bearish in its own right, as the consensus view can be rewarded for quite some time prior to a trigger for the move in the opposite direction actualizing a trend reversal. It is often an indication of how markedly the trend might shift once the reversal occurs, because too many folks are all of the same singular trend perspective.

However, the impressive holding activity of the DJIA at initial 13,500 support out of the end of the first week of the year into the early part of last week has set a strong technical tone and psychological backdrop for a market that does not seem to be actualizing any of the worst expectations for continued weak housing and other risk factors. Using the DJIA a benchmark for the likely activity elsewhere, if it is not going to fail below support in the 12,350 and 12,200 areas early this year, then (as markets are always trending) it is also likely to exceed the next significant weekly oscillator threshold in the 12,620-50 area sometime sooner than not.

If it does exceed that resistance, then the extension into the next oscillator resistances (that we caution once again are very similar to the low end topping levels out of 1999 into 2000) is in the 12,850-12,900 range. As noted in the EQUITIES technical analysis section above, that is a weekly Close projection, and the trading high might even push up for an approach to the 13,000 area. Of course, the equities are also being viewed once again in their classical role as harbingers of the economic outlook. Along with encouragement the equities are getting from the weak energy markets, this is bringing the also classical tendency toward anticipatory counter-trend activity in the fixed income that was so lacking during the “cheap finance” perspective on equities that was part of the mix until the late part of last year.

Facts on the Ground
Given that the inflation indications now seem more pernicious in any event, the prospect of further economic strength can not be very helpful for the fixed income psychology, and may only be problematic for the US dollar. The reason for this is that whatever modestly weaker than expected regular economic releases we may see, that is all a backward view. As such, it is only a temporary influence in what is perceived to be a strengthening economic cycle. While the lack of any near term potential that may leave that the Fed will cut the Federal Funds rate anytime soon, the ECB, BoE, OECD and other sources indicate that the greater strength my be in Europe at this point, and that will be a restraint on any extensive strength of the US dollar against those currencies in the near term. However, even though the BoJ is expected to raise rates at this week’s meeting, that is from such a low base in both rates and economic strength as to encourage the weakness of the yen against all of the premium yield currencies, including the buck.

That is why today’s Beige Book and tomorrow’s US CPI (among the other influences noted above) are so critical. If there is any sense that further weakness from US housing will be at the very least deferred, the basis for the continued optimism on the global economy and weakness of the fixed income (exacerbated by Europe’s weakness) will be confirmed.

Basic Scenario

While the overly exuberant fund manager perspective will likely be refuted by the equities markets at some point, and we have no doubt that the US housing situation is possibly only being ignored for now due to the typically glacial pace at which it evolves, the technical action in equity markets along with what appear to be some better than expected earnings reports building on the strength of that influence from last year likely means more of the early year same for now.

The scenario is for an extension of equity market strength in spite of somewhat higher than expected inflation. What quite a few participants forget cycle to cycle is that it is a mistake to extrapolate the initial stronger than expected inflation indications into interest rates that will be burdensome for the stock markets. In fact, the equities rather like a bit of inflation; it suggests a return of pricing power that will further improve profitability for a while prior to the central bank putting on the brakes.

And as the central bank tendency to avoid premature rate hikes in order not leave themselves with the political (in spite of protestations to the contrary all around, they're ultimately political organizations) liability of blame for the recession until everyone is overtly bothered by the inflation, they tend to let economies run a bit prior to exercising restraint. As we have been very clear previous, we believe the Bernanke Fed's premature signals of dovish tendencies last spring is part of what has left them so restrained in a situation that might have been better handled by more hawkish action previous that would allow them to ease when the housing crunch hits.

If today's Beige Book or tomorrow's US CPI are hotter than expected, it will now put the Fed into a real bind, and that will be exacerbated by likely extensive long end weakness. The US dollar remains much more problematic, and will need to be closely monitored at the technical trend turning points.

All of our previous views on risk factors for the equities and economy remain as background potentials even as the upbeat early year psychology supports the equities and continues to weigh on the fixed income. The most relevant from late last year are still available for review on the **Sample Reports** page of our website in ***Capital Markets Observer*** II-48 and II-49, as well as ***CMO*** III-1 from two weeks ago.

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

-Rohr
(www.rohrintl.com)