

## **ROHR REPORT**

### ***CAPITAL MARKETS OBSERVER***

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

#### **...Self-Defeating Prophecy, FOMC Alternatives, a Radical Thought**

##### **Overview**

We have already given quite a bit of consideration to what the FOMC might do today, and the received wisdom seems more appropriate than not: they will provide a 25 basis point cut in the Federal Funds target rate, and provide a statement which allows them more flexibility than the previous, seemingly out of touch hawkish inflation oriented statement. Both anticipation of the further spillover of the housing and subprime problems into the general US economy (as well as the global effect that might engender) and the facts on the ground regarding weaker employment and economic indications allows for a cut and accompanying softer, flexible statement.

They will still need to pay some heed to the inflation factors. Yet, with core inflation back within their 'comfort' band for now, they can afford a bit of ease in spite of the indications from inflation influences like food, energy and metals prices. We have noted previous Rohr's first rule for central bankers: To manage an economy, first you need an economy to manage. Considering the alleged underlying strength of the global economy, that may seem a bit of a tongue in cheek observation. Yet, the experience of Japan in the early 1990's is that once real estate values begin to deflate it does not pay for a central bank to remain too aggressive in reinforcing the anti-inflationary aspects of what may (indeed most likely will) become consumer demoralization that will be hard to reverse if it goes too far.

Humpty Real Estate can not be put back together and propped up on the wall if the sense of weakness gets too extreme at the grass roots level. And as we have noted in recent issues, one of the biggest problems with the current dilemma is that its diffuse nature means it is impossible for the central banks to put money into the hands of the subprime borrowers who are facing default. The dual track of the subprime problem is that those foreclosures affect a while range of securitized vehicles which contain some bit of blended subprime paper. It was quite a revelation from Mr. Paulson last week that not only was this problem different from either 1987 or 1998 in being so entrenched and diffuse, but that after a week of meeting with top bankers he had to admit that they had no idea how to value those securities.

This is likely why those who are calling for the FOMC to cut 50 basis points today feel within their rights; a 25 basis point cut is not likely nearly enough to offset all of the negative effects of the subprime and housing problems as they play out in securities markets and economies. Yet, that is 'self-defeating prophesy' insofar as it is not the Fed's job to ensure equity markets hold up at current levels, and especially much less that they make new highs. As such, while it will be a nod to the already apparent signs of weakness, the likely 25 basis point cut today will actually leave the equity market vulnerable to future weakness. That is the reason the most constructive thing the Fed can do is leave itself more flexibility for future action which may be necessary if conditions become disorderly again at some point.

As such, we remain negative on equities, with DJIA resistances at 13,500 and 13,700 likely to hold, the December **T-note** likely to hold the lower 109-00 support at worst, albeit with 110-06 and especially 111-00 area resistances, and the US dollar Index likely to fail .8040-00 again.

## Markets Summary

### EQUITIES

The **DJIA** once again experiencing a trading recovery back above the low end of its previous 13,250 trading range (and the 13,150 Tolerance) has likely been reinforced by some degree by quite a few folks calling for (and likely expecting) the Fed to cut by at least 50 basis points, and to provide the necessary accommodative language in the statement as well. While we do not believe that will be the case, we must allow that the psychology may allow for the DJIA to remain rangebound between roughly 13,000 and 13,400-500 until then.

What we would find surprising, yet must allow upbeat expectations my foment, is a recovery back up to or above the trading high from early in the week two weeks ago in the 13,500 congestion area. That was prior to both the MBA Q2 Foreclosure and Delinquency reports, as well as the surprisingly weak US August Employment report. As such, it is hard to imagine that anything but a major Fed Funds rate cut would be sufficient to drive the equities that much higher. We shall see.

However, even if the 13,500 area is exceeded for some reason, the top end of the previous trading range would be the best we would expect to see on a retest; that includes Negated 13,665 major Triangle pattern UP Break, and even the congestion up in the 13,700-50 area (as was seen after the last FOMC meeting, just prior to the initial early August sharp failure.)

That is also consistent with the lead contract **S&P 500** future slipping temporarily back below the old lead contract key gap level in the 1,467-61 range to near 1,435-31 support, yet now recovering back above the gap area. That will also receive a boost from the lead contract expiration rollover to December late next week if the market is not decimated by extensive disappointment from the FOMC either holding steady or only cutting a half point. That the December contract (lead contract at the end of this week) is trading at a thirteen dollar premium to the September contract means it will need to fail more than thirty dollars from current levels to be back below that gap, and more than fifty dollars to fail the 1,435-31 area. Higher lead contract resistances remain in the 1,500, 1,510-12, 1,522-25 and 1,540 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 after having traded back below it temporarily on Monday. However, it did stall just below the 7,750-7,800 congestion and downward channel from the mid-July high, and left what appears to be a failed (i.e. Negated) short term H&S Bottom UP Break at 7,580 two weeks ago.

In fact, one of the troubling overall questions for the equities is why the leading stock market of Europe that is supposed to be the savior of any weakness emanating from the US housing mess is now the weak sister (even compared to FTSE that has been burdened of late by the UK banking problems)?

We feel that relates back to the OECD Composite Leading Indicator (JUL) which we highlighted two weeks ago as showing that the Far East and even Europe may not be the power houses that hawkish central banks seem to want to believe they are. That said, it will still take a failure back below the recent congestion in the mid-7,300 area to reinstate the most negative indications for the overall DAX trend.

In the broader view, 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 impressive. However, the ability of 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. 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 not only back to the recent 12,500 area trading lows, yet also to new lows into the broad 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, as the especially the long ends could come back under pressure very quickly (even if it is from somewhat substantially higher levels than we are trading at present) once the central banks coming in with more major short term rate cuts to rescue the equities from any return to extreme weakness (i.e. only once the DJIA is back around or below those 12,500 area trading lows.)

### **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, low 109-00 area, and finally the 110-06.5 major January 2006 reaction high in the December contract (which is now reinstated as resistance in the wake of last week's late week selloff.) As noted previous, that creates a very critical situation given its already elevated and strong state, as 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 which the December contract tested early this week, 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 renewed 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 extensive 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, until liberated by the US Employment report. It was no surprise that is also then moved through extended significant resistance in the 114.40-.60 area major congestion and weekly chart gaps. However, now that December is lead contract, 114.00 is the support, even though the commensurate congestion in the contract was in the 113.80-.65 range. Extended support is 113.50, and back at 113.35-.20 once again, with resistance remaining in the 115.00 and 115.50-.70 and mid-upper 116.00 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 several weeks ago after the quick test of the 107.50 resistance. Of course, the rotation of the crisis around to the UK has left the Gilt the strong sister once again, with the December Gilt (trading almost at parity with September contract) even pushing through its lower extended resistance in the 108.20-.35 range temporarily prior to falling back; extended resistance is the 109.00-.25 area.

One of the other key factors is the degree to which short money forwards have levitated to interim price areas which are consistent with an outlook that will result in the central banks easing sharply. Yet, that means whenever the equity markets hold up for a bit too long, the short money forwards also experience sharp downdrafts. This is all reasonable, given the degree to which the equities are becoming more of an 'all or nothing' game into the FOMC decision today. That said, regardless of what the Fed may or may not do, as noted previous the recent US Employment number and OECD CLI makes more of a case that weakening economies call for sustained cuts from the central banks. Short money forwards (March 2008) that traded on such extreme anticipatory tendencies in the face of temporary early August market panic ago have fallen back from their highs in the US and Europe, yet still have a better bid in the UK where they had spiked up to a new crisis driven high.

That all relates back to extreme volatility of short money forwards. After falling temporarily back below its interim 95.45-.40 support (now relevant once again in the face of the near term bid in the equities), March **Eurodollar** held extended support into the 95.25-.20 area and pushed above its previous 95.64 high. Extended 95.80-.90 congestion resistance from late 2004 through late 2005 is the next upside target. However, now back below the 95.45-.40 area in anticipation of only a 25 basis point cut from the FOMC today, it will likely take a return to extensive weakness in the equities to reinvigorate its up trend. In the meantime, lower interim support is at the 95.35 area gaps, with 95.20-.20 more major support.

We also still consider any push to the 95.90 area as the likely extreme 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 94.45-.50 (already tested and failed from), 94.20, 94.00 area, 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 awhile during the early August equity market weakness. 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 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, which once again held nicely on last week's test. **EUR/JPY** supports are once again at 157.50 and 155.0-154.50 (both violated and then recovered back above), and 150.75-149.50; resistance is as nearby as 161.50 and the 164.00 areas. **GBP/JPY** equivalents are 229.50-227.50 (also violated, recovered back above and even held on the recent relative GBP weakness) and 221.00-219.00; resistance is back at the major 235-236 level at which the market has stalled repeatedly over the past month.

It is still also interesting that the EUR/JPY and GBP/JPY major channel support should be in the vicinity of the March pullback lows based upon upward progression of 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 mid-August equity market turmoil 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 the bear trend was actually ready to commence once again. Violation of the recent congestion lows in the .8000 area (also the major low from April 1995) had a Tolerance to the mid .7900 area which was only modestly violated prior to the current equally modest recovery, which we do not trust. Any failure back below that for a second time leaves the door open for a move down to the .7800 area September 1992 next lower major low, which is consistent with the next interim 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. As it is now above the previous mid 1.3800 highs, and favored compared to a weaker GBP, 1.3700 is near term trend support, with resistances not until the 1.40, 1.42 and 1.45 areas. While the pound has suffered somewhat, the overall trend remains very similar on the **GBP/USD** slipping back below its most recent rally above the 1991-1992 highs at 2.0050-2.0100, yet not even quite reaching the next support into the 1.9750-1.9625 area, with lower major trend support not until back in the 1.9400 area. Yet, as long as the slippage is contained, we suspect the GBP/USD will also benefit from general US dollar weakness once again, with extended resistance not until the 207-210 and 216-218.

## **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 held 70.00-69.00 area prior to extending its rally above the important mid 72.00 area resistance, the 74.70-75.00 area and even the old July-August 2006 77.50-.95 range all-time highs. All of those are now lower supports once again, with only the weekly oscillator to point up resistance into the 80.00 area that the market seems to grinding above at present, and the 83.00-.50 area, the latter of which was last seen on the oscillators in September-October 1990.

## **Reports & Events**

Along with the FOMC this afternoon, there are a few very telling reports this week, as well as no small number of pronouncements from financial luminaries. In fact, after yesterday's much weaker than expected US Empire Manufacturing (SEP) and this morning's similarly soft PPI (AUG) and other restrained economic releases from the balance of the world, there is another key piece of economic data barely an hour prior to the FOMC announcement: the US NAHB Housing Market Index (SEP), which is the first bit of current housing market news prior to the less than critical US Housing Starts and Building Permits after CPI tomorrow, and next week's far more important Existing Home Sales, New Home Sales and Construction Spending.

Tomorrow begins with the Australian Westpac Leading Index (JUL) as well as announcement of the Bank of Japan Target Rate that is expected to be steady at 0.50 percent in light of the global problems and especially Japan's lapse back into economic weakness. Of interest in that regard is that we will also see their Leading and Coincident Indices (JUL Final) and their Nationwide and Tokyo Department Sales (AUG.) After that it's an ostensibly light reporting day in Europe with only German Producer Prices (AUG), yet also including the Bank of England MPC September 5-6 Meeting Minutes, and the Reserve Bank of Australia's Battellino providing an 'Australian Financial Markets Report' which may prove interesting. That is followed by the US MBA Mortgage Applications (for the week ending SEP 14) and previously noted US Consumer Price Index, as well as Housing Starts and Building Permits (all AUG.)

Thursday brings the Japanese Large All Industry and Large Manufacturing BSI (Q3), their Convenience Store Sales (AUG) and BOJ Governor Fukui speaking at a Tokyo Convention, after which the Australian HIA New Home Sales (AUG), Reserve Bank Monthly Bulletin and Foreign Exchange Transaction report (AUG) area released while ECB President Trichet provides what is likely to be a fairly innocuous welcoming address at the Ceremonial gala dinner marking "50 years of the Bundesbank" in Frankfurt, Germany; yet, in the current circumstances any pronouncement from the President must be closely reviewed.

Then it's onto the Italian Unemployment Rate (Q2), UK Retail Sales (AUG), Public Finances (PSNCR & PSNB, also AUG), and M4 Money Supply and Sterling Lending (AUG Preliminary) as well as BSA Mortgage Approvals (AUG) and CBI September Industrial Trends (SEP.) Euro-zone Construction Output (JUL) follows that prior to US Weekly Initial Jobless Claims (for the week ending SEP 15), Mr. Bernanke testifying before the House Financial Services Committee, US Leading Indicators (AUG) and the Philadelphia Fed Index (SEP).

Friday is rife with talking heads, yet begins with the Japanese MOF Foreign Net Stock and Bond Investments (for the week ending SEP 14), and their All Industry Activity Index (JUL.) Then it's the Bank of Spain's Vinals and Malo de Molina speaking in Brussels, while along with the ECB's Stark, the ECB's Papademos and Fed SuperDove Mishkin speak in Frankfurt on (of all things) "Will monetary policy become more of a science?" After which it's Australian New Motor Vehicle Sales (AUG), French Wages and then the ECB's Bini Smaghi speaking in Paris prior to the Euro-zone Current Account (JUL), and President Trichet speaking once again, this time on the euro. That all precedes more Fed-speak that includes Dr. Plosser making the opening remarks at a Philadelphia Conference, and Mr. Warsh speaking on financial market developments in Albany; it should be interesting.

### Self-Defeating Prophecy

As we inquired last week, does a rate cut from the FOMC September 18<sup>th</sup> amount to a 'Bernanke put'? Also as noted previous, that will depend on the timing. Yet, it appears there is a very substantial market contingent who believe the Fed will both cut rates markedly (at least 50 basis points) while providing accommodative language in their statement today.

In fact, the sheer strength of the equity market into today's meeting is in large measure a very clear 'self-defeating' prophesy. Can the FOMC provide a major rate cut to an equity market where a leading index is well less than five percent below recently established all-time highs? Not likely, as along with the accommodative 'flexible' language we have discussed from as far back as *CAPITAL MARKETS OBSERVER* III-28 (Friday, September 7<sup>th</sup>.) The reason for that is many fold, even in addition to the over stimulation that would foment, which would be perceived as nothing less that institution of a 'Bernanke put.'

### FOMC Alternatives

The other key reason is the fear that even a 50 basis point cut would not prevent problems from returning to the equity markets sooner than not. How could that possibly occur after a major rate cut? Quite simply for the very reason that not just we, yet a goodly number of other informed observers have been pointing out for some time: the reduction in the Federal funds rate will not put the required capital into the hands of those who can actually prevent the problem from progressing: subprime borrowers who can not meet their inflated mortgage payment obligations at soon to be 'reset' interest rates on Hybrid Adjustable Rate Mortgages (HARM's; as note previous, that acronym should have been a red flag unto itself.)

If the equity markets were revert to extensive weakness after the FOMC action today, then the Fed will potentially need to move once again on an inter-meeting basis (as it did with the Discount Rate and Discount Window operations so shortly after the misguidedly hawkish August 7<sup>th</sup> FOMC statement.) Such central bank moves are always more effective if seen to be progressively more aggressive. We presume that the Fed is savvy enough to know this (or at least we would hope so), and will not want to provide a half point cut today where they might need to increase the degree of accommodation to impress the markets if they need to step in at a more disorderly juncture; such as a DJIA spill back down near or below the recent 12,500 area trading lows. If they provide a 25 basis point cut today, then a 50 basis point inter-meeting cut would look impressive; if they provide 50 basis points today, what can they do at the next juncture? A full point cut? That is likely something they want to avoid.

As such, we stick with our expectation it will be a 25 basis point cut with accommodative language including some extensive mention of 'flexibility.' That will show they are ready to move if the situation deteriorates, reserve plenty of ammunition for further support efforts, and address the rightful concerns of any critics that might take issue with the prospect of a 'Bernanke put.' In any event, the Fed should always have been more 'forecast' driven than data driven, in which case the return to strong growth projected for 2008 would have empowered them to firm rates sooner in a way that might have suppressed at least the worst late phase excesses.

In the current circumstances some accommodation should be made to 'evolving conditions' instead of remaining just plain 'data driven.' That will empower them to address disorderly market conditions in a manner which the previous very hawkish statement did not. It is very amazing that the FOMC needed to cut the discount rate and even heavily adjust the discount window policies only seven business days after a misguided hawkish statement accompanied their 'no action' last month. With all of the best intentions of remaining as calm as possible, we have likely hit the point where it will pay for Bernanke & Company to allow themselves some flexibility to move rates in response to markets and real-time economic sentiment.

After a long period where incrementalism has been a central bank prerogative, we are likely at a phase in the combined economic, equities, credit and commodities cycles where more active interest rate management may be necessary once again. The situation which shifted so rapidly on the Bank of England in the Northern Rock case demonstrates that surprises can now come from even just the pure higher interest rates on near term financing. One wonders how many other businesses will have future problems due not to subprime or housing, but rather having pursued a business model which counted on cheap short term funding and will now be in trouble at some point.

In any event, nobody could claim later a 'Bernanke put' had been implemented if the Federal Funds rate returns timely to an effective inflation mitigation level once the situation stabilizes. Those who yearn for Mr. Bernanke to become the next Alan Greenspan should be careful what they wish for. Possibly they should be hoping for the next Paul Volcker.

### **A Radical Thought**

While 'radical' is often seen as being wild or extreme, in fact the term's root is indeed 'root.' At time it pays to return to the root of an issue, process or problem to seek a radical solution. What we find a most unusual and ultimately pernicious tendency has beset financial markets and economies in recent years, and it has reached the point in this last cycle that it warrants a bit of comment.

At some point in the late years of the Greenspan era at the Federal Reserve it was accepted on his authority that central banks are not responsible for deflating economic or financial bubbles, and we have heard much the same during the brief Bernanke regime to date. Really? And why not? In classical terms, their primary mandate being one of preventing excess in the form of inflation would seem to indicate it is indeed well within their brief to prevent anything which threatens the well being of the financial system or economy.

However, it seems sometime after Mr. Greenspan realized that the Fed Funds rate tightening of 1994 had not been sufficient to restrain the later excesses of the US equity market boom that even he characterized later as having “slipped its moorings” he decided that deflating the subsequent Dot.Com Bubble was not his job; he would rather attempt to mop up the problem after the bubble burst. Well, that was likely a more painful experience than had he decided to be more proactively restrictive in the late 1990’s once the LTCM/Russian Crisis had passed.

In fact, that same “not my problem” attitude seems to have been inherent in Mr. Bernanke’s very sanguine assessment of the degree to which the new all-time high in the DJIA last fall. As we have noted previous, if the Fed had not so much targeted strong equities psychology contributing to the current global credit market bubble and attendant excesses, yet rather enforced their classic role of pulling the proverbial punchbowl when things threatened to get too strong, they may have restrained the financial services and consumer psychology.

While that may have meant they were responsible for a bit of a slowdown into early this year, in that case they’d be in a better position to ease now if the global situation warranted. And that is our issue with the Fed: insofar as perceptions of the American economy remained a very significant driver for the rest of the world, the Fed is not just the US central bank.

While its influence may soon (in historic terms) be surpassed by rapidly developing economies, the Fed remains the ‘Central Banker to the World’, at least psychologically. Mr. Greenspan’s forbearance in the over extension of the US equity market and economy in the context of the problematic Dot.Com boom was in deference to a potential US slowdown exacerbating crises elsewhere into a full blown global economic meltdown.

With the extreme strength of the past several years in the Chinese and Indian economies, as well as the significant resurgence of Europe from a very low (Euro currency and reform extended) cycle bottom, Mr. Bernanke had the luxury of cooling the US economy while the rest of the world was substantially counter cyclical. Instead he chose to “not rock the boat.”

He and his fellow central bankers now need to stem what otherwise may become a crisis. Classic central bank activity is meant to keep things on an even keel. Mr. Bernanke’s desire to not reap criticism for erring on the side of caution and possibly fomenting a recession have shown that he has yet to make the full transition from ‘professor’ to ‘prime mover.’ That was never going to be easy. Yet, it will only be that much harder to establish that sort of *gravitas* now that he has been thrust into a crisis after not demonstrating the proactive credentials which might have avoided quite a bit of the excess leading to the current risk of instability.

We are reminded yet again of La Fontaine’s observation “*On recontre sa destinée souvent par des chemins qu’on prend pour l’éviter.*” (Our destiny is frequently met in the very paths we take to avoid it. -Jean de La Fontaine, *Fables, Book VII, fable 16, The Horoscope, 1679.*) That will likely be shown to be very true today, as Mr. Bernanke will be roundly criticized from one quarter or another whatever the FOMC decides to do and say.

That the Fed was historically capable of doggedly deflating excesses is evident in some of the previous observations and testimony of one of its most successful heads, Arthur Burns.

To wit: "The changes in beliefs in the mid-1970s were reflected in monetary policy actions. In 1974, the Federal Reserve adopted a significantly contractionary policy at a time when output was already falling. The Federal Reserve was explicit that the action was motivated by its model of inflation dynamics. Burns testified in August: "For a time, we should be prepared to tolerate a slower rate of economic growth and a higher rate of unemployment than any of us would like. A period of slow growth is needed to permit an unwinding of the inflationary processes that have been built into our economy through years of neglect." (Bulletin, August 1974, p. 566). In September, when unemployment was 5.9 percent, Burns stated that he "would not wish to see a prompt recovery in economic activity. If recovery began promptly, economic activity would turn up at a time when inflation was continuing at a two-digit rate" (Minutes, 9/10/74, p. 65). This view was seconded by other FOMC members (for example, pp. 66, 68, 80)."

That is from a paper we have cited previous (regarding the errors of the G. William Miller Fed that are some of the same perspectives now being furthered by Federal Reserve Governor Frederick Mishkin.) It is by Professors Christina and David Romer of the National Bureau of Economic Research in Cambridge, Massachusetts on a history of "Choosing the Federal Reserve Chair: Lessons from History" (December 2003.) It is available in its entirety at <http://emlab.berkeley.edu/users/cromer/draftpost.pdf>.

Admittedly, inflation is at present nowhere near the 'two-digit rate' to which Chairman Burns referred, and the entire complexion of the US and global labor market has evolved to a degree that means it will not likely return to that level soon in spite of the continued upward pressures on inflation inputs. That citation was moreso to illustrate the point that Chairmen prior to the disastrous G. William Miller, and even as recently as the Volcker regime were willing to tolerate slow economic growth or even recession to fulfill their primary mandate.

Unfortunately, once a bubble has been allowed to balloon and is in the process of a rapid deflation, it is not the time to attempt to re-institute central banking best practice. As a further cogent assessment of the risks now facing the markets and economies we refer to a very good analysis by Charles Goodhart, emeritus professor of banking and finance at the financial markets group, London School of Economics that appeared in last Friday's Financial Times (highlighted version attached.)

While he spends quite a bit of time exploring the serial failures of various regulators and agencies in the recent boom, his most telling indication for future problems is (as he puts it) the "pro-cyclicality of Basel II" (the new banking protocols which will affect capital adequacy ratios from the first of 2008.) As is often the case, these systemic changes are scheduled well ahead of time, and occur at the worst possible time.

All the more reason the Fed is within its rights to provide the beginning of overall economic relief to counter the subprime, housing, securitization and higher cost of finance issues now, even if they must give a nod to the need to keep an eye on inflation pressures. Yet, the broader brief should be to restore the credibility of the Fed as an organization that is willing to take the criticism for pulling the punchbowl when the party is first starting to get out of hand, and not as a serial blower of bubbles which does not feel it is its job to lean against excesses in the economic system. To do just that is its ultimate mandate.

As we have repeatedly noted, had Mr. Bernanke not been so fearful of the moderate criticism some parties would have undoubtedly delivered, he could have at the very least muted the extent of the current crisis by moving last fall. If the benefit from the current crisis is nothing more than a lesson well learned, it seems long past time for central bankers to reinvigorate the art of pulling the punchbowl.

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

-Rohr

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