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Overview with FOMC Dislocation Aspects, Reports & Events,… …Long End Equalization, Dollar Debacle?

Overview

There has been quite a bit of news so far this week. On balance it has highlighted current or anticipated further weakness of the US economy, which is mildly spilling over elsewhere. While we normally discuss the overall background in this section prior to brief market views, this week it is far more effective to combine discussion of how divergent market tendencies relate to the overall environment and news.

The reason for that is the degree to which significant shifts in influences from the FOMC action last week continue to affect markets in diverse ways, precluding summary comment. That also diminishes the need of a Markets Summary, as all trend perspectives and technical levels remain very consistent with last Friday's ***TrendView* GENERAL UPDATE**, and we refer you back to that for those indications prior to a full update later this week.

In essence, the FOMC action and especially the 'Bernanke put' implied in their statement (as explored previous) changed the entire frame of reference for different markets in different countries, and even the individual instruments in different parts of the same complex. Most telling of these, and a driving force for the weakness of the long dated fixed income (as discussed further in 'Long End Equalization'), is the extent to which the equity markets (especially in the US) have been substantially bullet-proofed. That is due to the institution of a 'Goldilocks' moderate growth expectation meeting up with a 'bad news is good news' mentality (the "Bernanke Bull Beach Party.")

This was extremely apparent in yesterday's DJIA reaction to the combined predations of extremely weak housing news, the various disturbing (at least to the West) pronouncements by Iranian President Ahmedinijad, the first United Auto Workers national strike in many years, as well as other weaker than expected news (spilling over into today's US Durable Goods.)

And the **DJIA** response? To dip back barely to the 13,700 overrun resistance (noted last week) prior to stabilizing and getting the bid back. Noted previous was the degree to which any weak news was likely to create a more accommodative interest rate atmosphere, and that was duly reflected in higher prices for the March 2008 **Eurodollar** US short term interest rate future. However, that only maintained until the equities regained the ground they had lost in the morning, at which point the entire fixed income complex weakened once again, yet moreso in the longer end of the yield curve.

Economic weakness is still rightfully presumed to likely flow out from the US subprime and housing problems to more robust economies elsewhere, and that was also reflected in the tones of various other markets. While the US December **T-note** was able to temporarily squeeze back above its violated 190-06/-00 support, the **Bund** did not even make it back to its violated 113.00 Tolerance of the 113.35-.20 support; similarly, the **Gilt** only approached its 107.20 Tolerance of violated 107.50-.35 support. Also similarly in the short end, while the March Eurodollar and even UK **Short Sterling** were able to squeeze up five basis points while the equities were weak, the March Euribor barely budged.

In fact, there is a serious question of whether the short term Euro-zone interest rates will be easing overall in the intermediate term. There used to be a normal lag of three to six months in the trend of European interest rates behind the US. That was due to the US initiating a coordinated global recovery or slump, with Europe in tow. However, for various reasons reviewed extensively in previous editions, the Euro-zone economic dislocations of 2003-2005 have put the economies and interest rate trends into more of a true counter-cyclical phase.

The resulting market effect is that the December 2007 **Euribor** is back down at 95.40 area major congestion into its June-July trading lows!! In fact that is also still at a slight futures pricing premium (i.e. lower yield indication) than current cash market interest rates. What is equally of interest is that after the March 2008 contract spiked up to the 96.00 area during the worst of the equity market meltdown fears in Mid-August, it has remained around the 95.70 area for the past several weeks.

While that appears to be generally consistent with other short term interest rate instrument trend swings, it does project a full 50 basis point easing by the ECB into early next year. Even in consideration of various good arguments that the strength of the euro or that the European economy is not the tower of strength it is convenient for the ECB to use as an excuse to remain hawkish, that may only restrain them from hiking rates.

It is one of the paradoxes of the 'Bernanke put' that to the degree it will only 'forestall' (as the FOMC and all manner of other sources have noted) the economic weakness from subprime and housing, its constructive influence on the equity markets and more robust international economies will make it less likely the ECB feels compelled to ease. That is very likely the case into the end of this year, and probably early 2008; they may even still hike! All of which would seem to indicate a potential for sustained weakness (other than during any future equity market scares) for the early-mid 2008 Euribor futures.

Reasoning along those same divergent and moderately perverse lines bring us back to further consideration of the equity markets. The degree to which it is now assumed the Fed is willing and able to provide more accommodation if necessary is also restraining the European equity markets compared to their US brethren. While the DJIA and S&P 500 are well back above their mid-August to early September trading highs (especially that 13,500 area congestion in the DJIA), the DAX and FTSE sagged back just below their equivalent levels yesterday. This illustrates the degree to which the 'Bernanke put' has the most influence in the US markets. That works hand in glove with the weakness of European fixed income and even their equity markets being based upon expectations for economies which are stronger on balance than the US.

Weaker energy markets (albeit only modestly so to date) are also a more likely tonic for the equities in the near term, and (admittedly only in light of the countervailing trends) that has been a negative for the fixed income. Of course, the one equity market that only a significant move to higher levels in the others will help is the **NIKKEI**, due to Japan slipping back into negative economic growth and political malaise. It is important to remain focused on the fact that the NIKKEI never even pushed out above its 18,300 area February high when the rest of the equities recovered into April and beyond. It only challenged that level on the more extensive rally elsewhere into July, and is well back below it. However, that weakness in the Japanese economy is also likely to continue to eliminate the potential for a 'carry trade crisis.'

All of which brings us around to the foreign exchange picture, where the key question is whether there will indeed be a US dollar debacle? In a word, "yes." In a phrase, "Yes, yet only in slow motion" (as explored further in the 'Dollar Debacle?' discussion below.) The bottom line is that there are many reasons why the buck will not attract the requisite foreign flows at present to offset the ingrained US twin trade and current account deficits. In a slowing global economy where the US is leading the way down, there is little overall investment or interest rate differential reason to convert other currencies to US dollars for a sustained period, and that's what actually determines the overall trends.

While there might be occasional shocks for US dollar bears if and when some major foreign buyers move in a major way to scoop up some cheap assets, that will be temporary. In fact, as we have noted previous, the weekly oscillator supports may well cause a temporary bounce from not too far below the .7820 **US dollar Index** 1992 all-time lows (and possibly as early as the .7700 area.) However, the extended supports are not until the .7500 and .7200 areas, and in 'Dollar Debacle?' we will be discussing why even those may be optimistic.

Reports & Events

While the economic releases are going to remain rather robust over the next couple of days, indications from financial luminaries (especially a major dose of late session Fed-speak on Friday) must also be actively assessed.

Tomorrow begins with Australian Job vacancies (AUG), Japanese Small Business Confidence (SEP) and BOJ Board Member Suda both speaking at Financial Conference and holding a separate press conference as well. After which it is on to Europe for UK Nationwide House Prices (SEP), Italian Retailers' Confidence General (SEP) and Services Survey (SEP), and various German employment data which includes ILO Unemployment Rate (AUG) and the Unemployment Change (SEP.) Then it's the various Bloomberg Retail PMI's (SEP), Italian Trade Balance Non-EU (AUG), Euro-zone M3 (AUG) and UK Index of Services (JUL quarter-on-quarter), BBA Loans for House Purchase (AUG) and CBI September Distributive Trades Report (SEP.)

Then the Fed's Rosengren provides the welcoming remarks at a conference, and US Gross Domestic Product, Personal Consumption, GDP Price Index and Core PCE (all Q2 Final) are released, along with Weekly Jobless Claims (week ending SEP 22), and what is likely to be the more influential New Home Sales (AUG), followed by the Help Wanted Index (AUG.) After that the Fed's Evans provides the opening remarks at the Globalization Conference, the Australian Reserve Bank's Lowe speaks, Bernanke provides some further brief welcoming remarks at the Fed Conference, and the dovish Governor Mishkin speaks as well. All of which ends with the incongruous release of the French Unemployment Rate and Unemployment Change (AUG.)

Friday begins with a data tsunami from the East in the form of the release of the Japanese Jobless Rate and Job-to-Applicant Ratio (AUG), Nomura/JMMA Manufacturing PMI (SEP), Overall Household Spending (AUG), Tokyo Consumer Price Index (SEP) and National Consumer Price Index, Large Retailers' Sales, Retail Trade (both AUG), MOF Foreign Net Stock and Bond Investments (week ending SEP 21), Vehicle Production, Housing Starts and Construction Orders (all AUG.) Along the way Australian TD Securities Inflation (SEP) and Private Sector Credit (AUG) are reported.

Then it's on to Europe for Italian Industrial Production (AUG Preliminary), German Retail Sales (AUG), French Consumer Confidence Indicator (SEP) and Gross Domestic Product (Q2 Final) and Producer Prices (AUG), after which the ECB's Bini Smaghi Speaks in Venice. Very appropriate preface to the Italian Producer Price Index (AUG) and CPI (SEP), along with the Euro-zone CPI Estimate, Consumer Confidence, Industrial Confidence, Economic Confidence, Services Confidence and Business Climate Indicator (all SEP), and UK GfK Consumer Confidence Survey (SEP.)

After that the US continues the end of month deluge with Personal Income and Consumption and the PCE Deflator (AUG), the Chicago Purchasing Manager Index (SEP), after which the Fed's Lockhart Speaks on U.S. Economic Outlook in Tennessee, and we see the release of US Construction Spending (AUG), University of Michigan Consumer Sentiment Index (SEP Final.) It all ends up with the Fed-speak troika of Yellen at Federal Reserve Bank of Boston, Poole on Central Banking at the Princeton Club in New York, and Mishkin speaking at the Chicago Banking Conference.

In the current environment, we are not surprised that the Fed saved the dovish best for last. Yet, it will be very interesting to hear what Mr. Poole has to say in light of his ostensible acquiescence in the unanimous vote for the FOMC 50 basis point cut last Tuesday after having seemed so comfortable previous with the correction weighing on those who had made overly aggressive assumptions and bad investment decisions. We shall see.

Long End Equalization

As we have already engaged in quite a bit of market condition reference in this week's Overview, we will keep this brief. One of our clients pointed out that even as early as last Thursday the June 2008 Eurodollar future had dropped all the way back the its pre-FOMC meeting Close of 95.565 (from Monday, September 17th.) That got us to thinking about the ways in which other markets might be viewing the equity market surge in the US, and its implication for a significant mitigation of the influence the subprime and housing problems on the balance of the US economy. Of course, as noted previous that also applies to the degree to which that weakness might spill over to a lesser degree into the rest of the global economy as well.

Therefore, just as an exercise in reasonable observation as opposed to any sort of specific objective projection, it is reasonable to look back in the frame of reference to where the long dated fixed income markets were trading prior to the full early-mid August equity market rout. It is quite interesting that the trading levels in late July into the early August equity market extreme weakness were 108-00/107-00 range for lead contract T-note, 106.00-105.00 range for the Gilt, and the Bund ranging from the 113.00 area down into the 112.00-111.65 range.

The Bund is already therefore down into that previous range, while the lower ranges in both the T-note and Gilt represent our extended intermediate term support. Yet, due consideration for everything we have noted previous about the relative US economic weakness, moreso problematically stronger conditions in the UK, and Europe being strong sister over the near term future would seem to fit very well with the idea that the Bund might need to slip back below that range prior to stabilizing on the break. The next support below 112.00-111.65 is back into the 111.00-mid 110.00 area last seen during the June-early July basing action.

Dollar Debacle?

There are many considerations operative in the foreign exchange markets right now on everything from the secular strength of the euro to how unlikely the prospect of a yen strength inspired 'carry trade crisis' has become. Yet, the key question remains whether there will indeed be a US dollar debacle? As we noted above, while the answer in a word is "yes", the answer in a phrase is, "Yes, yet only in slow motion."

That might raise the question of whether something that happens in slow motion can actually still be considered a debacle? Our considered opinion is that can indeed be the case if it involves enough loss of value, and a further loss of twelve percent below the recently violated major historic and recent support in the .8000 area would indeed represent a 'debacle.' Considering that the extended projections point to .7000 as a very possible intermediate term objective (albeit short term traders may consider that in fact a long term view), that loss of twelve percent below the .8000 area is thoroughly possible; indeed probable.

As is consistent with our balanced and thorough view, the first consideration is a simple psychological one, reinforced by somewhat more sophisticated technical indications. While it is often the case that the markets can churn around the major round number price levels (the 'big penny' as it is known), once it is clear that a market has completely abandoned an attempt to hold that sort of psychological support it is often the case that the next major stabilization does not occur until the next 'big penny.' That is true whether the price trend is up or down. As such, the longer the US Dollar Index remains below .8000, the more likely it is that the down trend will extend to the .7000 area. Historically that has also been the case when the market escapes a significant 'half-penny' level (i.e. 1.0500, etc.)

That is reinforced by the historic weekly oscillator indications. We have noted of late that the next intermediate term oscillator support is not too far below the .7820 US Dollar Index 1992 all-time lows; more or less in the low .7700 area (weekly MA 41 minus 0.0500.) Yet, broader extensions of the oscillator support are moreso into the areas at weekly MA 41 minus 0.0700, and even as far as the 0.1000 thresholds. At present that extends to the .7500 and .7200 areas noted in recent analysis. Yet, even those projections may be optimistic, as they are based upon the current level of the 41-week moving average, which is of course continuing to incrementally weaken as the buck continues the down trend into new lows.

In fact, as the US dollar has been in this down trend for some time, the influence of its drop to new lows is to accelerate the downward trajectory of weekly MA 41. While it had been dropping by approximately 10 points (0.0010) per week back in August, since the FOMC inspired further weakness below the .8000 area it has been falling moreso by approximately 12 points per week. On current form (i.e. any further extension of the down trend) it will likely see that turn into 15 point per week drops very soon.

Without attempting to run a technical analysis course in this topical discussion, that has to do with a purely 'technical' aspect of moving average calculation, which drops the oldest data in the series as each new week's data is added. The practical implication for this function is that the 41 week moving average calculation will be replacing the data from nine months previous over the coming quarter. As it happens, the market was on a rally between December 2006 and February 2007, and that means the pace of decline in the weekly MA 41 will increase a bit even if the current prices stand still.

What is the point for the broader objective projections? Simple: Unless the US Dollar Index drops sharply to current extended oscillator support thresholds at the .7500 or .7200 levels (which we do not expect, yet few would deny was a 'debacle' if it does occur), then the intrinsic erosion of the weekly MA 41 over the coming quarters will naturally diminish those thresholds to something more on the order to .7300 or even .7000 into early 2008.

Once again, that sounds like a rather extensive projection for a market which has only just recently failed the .8000 area. Yet, on historic form we have made many projections such as that previous, and most have worked out as estimated. The US Dollar Index reaching or in fact exceeding those projections is the norm. It has done so over thirty times (including both bull and bear phases) since free floating exchange rates began in the early 1970's.

The most telling recent examples of the US dollar Index escaping 'big penny' or 'half-penny' levels were the post-official Euro launch escape from the .9500 area leading to a test of the 1.0500 area, which was subsequently exceeded for a move above the 1.1500 area to almost 1.2000; on the downside those were offset by the failures since 2002 below 1.1500 leading to a test of the 1.0500 area, which subsequently failed for to the a move down to the .9500 area once again. There was then a clear weekly gap down (a most unusual and telling indication) below .9500 leading to a very timely drop to the .8500 area into early 2004.

While the market has been quite a bit more rangebound since then (albeit broadly so), that is all the more reason any failure of the .7700 area support will reinstitute the worst sort of historic tendencies. The one major mitigating factor for that occurring in a rapid manner is the degree to which the US dollar is already so depreciated. In spite of the degree to which it might continue down to those lower objectives, that will be buffered by the degree to which it is cyclically and in terms of raw value moreso in a condition that likely indicates the tendency to be an 'eroding' bear market than a near term debacle.

Yet, as with all of the other perverse dislocations which have been at least partially instituted by the unexpectedly sharp FOMC easing last week, by only sliding slowly, it tends to allow for the weekly MA 41 to fully diminish over the coming quarter and into early next year to make the more extensive lower objectives at .7300 and even possibly .7000 realistic.

On the fundamental front, the one additional buffer is supposed to be the degree to which the FOMC will not be able to lower interest rates very much further due to inflation implications of the weaker US dollar. As with most consensus positions, this should not be trusted. It is a manifestation of the widely debunked "J Curve" theory of foreign exchange value equalization after the devaluation of a currency. It substantially implies that a country's trade balance should improve following the currency devaluation.

The lower exchange rate initially means cheaper exports and more expensive imports. While that might make the current account worse (a bigger deficit or smaller surplus) in the short run, after a while the volume of exports is supposed to rise because of their lower price to foreign buyers, and domestic consumers would commensurately purchase fewer of the costlier imports. Eventually, the trade balance is supposed to improve to better levels than prior to the devaluation. The obvious off-the-cuff response to that is to note that the developers of this theory never met the modern American consumer.

As with most of our outré comments, the reality is more complex and indeed logical than that flippant observation. As we have noted previous at various points, we glean quite a bit of excellent information from classical financial press sources; a good deal of that has even been shared in the form of attachments to these reports.

However, in the background we also keep the electronic financial press tuned in. To some degree that is merely to monitor the 'buzz' of any unexpected breaking events, or to review what in many cases is the misguided views of various guests that have a particular agenda for propagandizing the public. However, a certain number of the guests are very enlightened, and as (one very good example) CNBC has some very well-informed and insightful analysts.

Among the best of these is their chief economic analyst, Steve Liesman. The chances are fairly good that if a major report has just been released, we are listening to Mr. Liesman's dissection of it. While we do not always agree with all of his views, his ability to rapidly review and spot key aspects or anomalies is outstanding, and we thank him or that. He has had very thorough academic and practical (spending some extended time in Russia) economics training; but we tend to not hold that against him.

As the US dollar sank to new intermediate term lows in the wake of the FOMC action last week, there was quite a bit of 'buzz' about how the inflation implications would limit the Fed's room for maneuver. While that may be true across time, especially if it sinks markedly, he presented a very well-informed view on that, noting that while US dollar is 'a' factor in inflation, it is not 'the' factor.

He went on to articulate that although they are a growing portion of the US economy, imports still only represent 16%. That means domestic wages and prices remain a much more critical factor for any sustained inflationary influence. The inflation influence of that import portion of the US economy is further mitigated by the degree to which many of the imports are from countries which have 'pegged' their currency to the US dollar. As the ongoing acrimonious debate and occasional bi-lateral flare-ups indicate, China is the most important of these.

Even beyond that, he pointed out that the diminished manufacturing sector means that the services portion of the US economy dwarfs the imports overall. If I correctly recall his figures, even with all of the occasional hyperventilation over the accelerating growth in the developing world, the US service sector represents 25% of the global economy. Which is all the more reason why consideration that a modest depreciation of the US dollar will be self-correcting is as misguided now as ever.

While it is my observation and not his, it seems that has especially been the case during other periods of countercyclical economic phases between what remain the major global economies in the US and Europe. As such, the potential for a US dollar debacle is indeed very prominent at present, even if it is much more likely to evolve in slow motion.

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

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