

ROHR REPORT

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

...Belated Anniversary, Rates vs. Reality, Frame of Reference

Overview

We are returning to our normal format this week of the 'Overview' being followed by a concise 'Markets Summary.' The last couple of weeks' need to discuss the 'FOMC Dislocations' in the various markets in the 'Overview' as part of the market trend analysis will be superseded by the extended 'Frame of Reference' topical discussion. As we have noted repeatedly since the somewhat surprising September 18th FOMC decision and statement, the Fed has shifted the entire 'frame of reference' for many international and individual country market influences, and we felt a discussion of that rather interesting topic was in order.

Along with the general background on how market frames of reference develop, we will explore how the current economic and financial trend situation now seems so convoluted and challenging to so many participants. That includes everyone from central bankers, to securities firms and banks as well as professional portfolio managers and the investing public. As this is a very broad and at times admittedly philosophical discussion, we shall review the bottom line presently, and move on to the concise 'Markets Summary.'

The current frame of reference shift reinforces both the Fed's previous 'transparency' and 'data driven' inclination, and means that the surprisingly large FOMC 50 basis point easing and accompanying statement back on September 18th might support equity market strength into next month, and potentially out into the end of the year. Sustained strength in the wake of somewhat accommodative FOMC minutes (which provided ample evidence that their goal is indeed maintaining 'moderate growth') will be encouraged if the current US corporate earnings reporting season meets or exceeds some very low estimates.

If that should carry on at least through the next US Employment report in early November, then the natural window dressing tendencies of portfolio managers who do not want to appear to be anything less than fully invested will prevail. If the equities are at or near all-time highs, money will likely be mindlessly thrown at any near term selloff from that point forward into mid-December. The equities do not necessarily need to become accelerating bull markets for the fixed income to be depressed by that. The previous fixed income strength was encouraged by very weak equity markets. Even a grudgingly sustained bid in the equities will be enough to restrain the fixed income. The US dollar will likely vacillate between its overall weak trend, and moments of strength when the equities rally strongly.

Yet, the broader frame of reference actually means that the equities are likely headed for a more telling intermediate term top, and the long dated fixed income is likely still going to be an intermediate term bull market. However, various factors affecting the timing of negative pressure on the US economy from housing weakness (Rates & Reality) will likely allow it all to be deferred into next year. Similarly, it is likely that the US dollar will churn itself in a narrow fashion until pressures on the US economy bring more dramatic weakness sometime early next year. Energy markets are likely to remain strong into the US seasonal shift to home heating. On an historic note, even if the factors which led many to anticipate the major fixed income directional trend reversals were well known, it is interesting how many of the trend turns seemed to wait for confirmation early the following year.

Markets Summary

EQUITIES

As we did not mention it at the beginning of the Overview, all of the trend perspectives and technical levels that remain very consistent with last Friday's *TrendView* **GENERAL UPDATE**. In essence, the FOMC action and especially the 'Bernanke put' implied in their statement (as explored previous) changed the frame of reference for different markets. For now, 'bad news is good news' remains the *modus operandi* of equities, and that was even given a boost by last Friday's strong US Employment number ensuring that even bad news is in the context of moderately good job growth.

In that context, the **DJIA** secondary push back above the previous 14,022 all-time high last Friday opened the door for a move into the 14,100-200 area, consistent with weekly oscillator indications (MA 41 plus 1,000.) Yet the major topping lines allow for an extension up into the 14,350-400 range as the next critical resistance. While any downside failure still requires a weekly Close back below the 13,700 overrun resistance (with a Tolerance to 13,650), there is near term support in the 13,900-850 area (congestion and daily MA 18.)

As noted previous, 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 of the more robust international economies will also leave pressure on the other international fixed income markets. That was in evidence in the UK today. Yet, the lower likelihood that other central banks will ease while that is the case means that while the DJIA and S&P 500 are well back above both their mid-August to early September trading highs and previous all-time highs, the DAX and FTSE have yet to challenge their summer highs.

Of course, the one equity market that only a significant move to higher levels in the others has assisted 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.'

FIXED INCOME

December **T-note** dropped back below the 109-06/-00 resistance, which is now reinforced congestion due to the multiple recent attempts to hold it as support while not even fully testing 110-00/-06 resistance. If it can not recover back above the 109-06 area soon, it is likely to test more major congestion and UP Break support at the 108-00 and 107-16 area (with a final Tolerance in the 107-00 area.) Much below that major congestion and December contract gaps in the mid-low 106-00 area become reasonable next support. That is also about as low as we suspect the T-note will drop in the near term, even if the equities push to new highs.

Yet, with the notable exception of the recent strength of the UK Gilt, the US long ends are the most resilient due to the US being the potential center of economic weakness which will only later spillover into the balance of the world. Last week's OECD Composite Leading Indicators brings European strength into question; yet that is not yet apparent in the markets.

The **Bund** has not done any better than barely test its violated 113.00 Tolerance of the 113.35-.20 support. Below that it is into far more treacherous ground, as while interim support on the contract in the 112.50-.35 range seems to be holding again after modest previous slippage, more significant combined continuation and contract support is not until 112.00-111.65 range, and the 111.00-mid 110.00 area.

Similar conditions apply to the **Gilt**, although the seemingly more sanguine inflation view from Bank of England has assisted with its recovery outpacing the Bund. The December contract had slipped quickly back below the 108.20-.35 resistance in the wake of the central bank retail bank deposit guarantees, all the way below the 107.50-.35 support Tolerance at 107.20. Unlike the Bund's inability to strengthen back up to its 113.00 violated support Tolerance, the Gilt pushed back above 107.35-.50 temporarily on Tuesday, yet gapped back down this morning to reinforce it once again as resistance. Lower supports remain the split 106.50 and 106.00 levels, with extended support not until the 150.00-upper 104.00 area.

Even though the March **Eurodollar** was quite strong for some time after the FOMC easing, it failed from higher resistances in the 95.65, 95.72 (high of the rally) areas as well as back below the 95.50-.45 congestion. Friday's strong US Employment report left it back below the 95.365 pre-FOMC trading low (now near term resistance) which it had been testing previous. It is currently sagging below lower support at the previously held 95.25-.20 congestion.

As interesting as that support may appear, the market needs to see sustained signs of economic weakness to stage any strong rally from that level which implies no further easing into the first quarter of next year. Next lower support is 95.07-.00, which is also the lowest we suspect the market will fall even if the equities rally, as anything below that would begin to imply a Fed Funds rate hike which we do not expect is a possibility in the near term.

Also similarly in the short end, while the March Eurodollar and even UK Short Sterling were able to squeeze up in recent trading, the March **Euribor** had already dropped from its 95.80 resistance back down to 95.60-.55 support. In fact, there is a serious question of whether the short term Euro-zone interest rates will be easing overall in the intermediate term. What is equally of interest is that after the March 2008 contract drop back to the 95.60 area. While that appears to be generally consistent with other short-money forward rate instrument premiums to cash markets, it does project a full 50 basis point easing into early next year.

March **Short Sterling** actually capitulated below its 94.20-.17 support (now resistance) in the past couple of days, and quickly dropped into lower 94.05-.00 area support. It all still points out the degree to which short term interbank rates are still unsettled, and the Bank of England is signaling a lack of confidence that UK inflation's slide back to the 2.00 percent area may not be sustainable in the intermediate term. While the 94.00-93.95 area is indeed some very good support (hefty congestion and daily MA 60), if it fails then a move back down to the 93.80-.75 area tested in early August and early September is a strong possibility.

FOREIGN EXCHANGE

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."

The bottom line is that there are many reasons the buck will not attract the requisite foreign flows at present to offset the ingrained US twin trade and current account deficits. A slowing global economy where the US is leading the way down is an environment that is neither conducive to an interest rate differential rationale to convert other currencies to US dollars for a sustained period nor overall investment in the US, 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 temporary bounces from not too far below the .7820 **US dollar Index** 1992 all-time lows (and possibly as early as the .7700 area), as already seen. That tendency may be reinforced by the anticipation of the G7 meeting later this month, which will surely issue a *de rigueur* "joint action to stabilize disorderly markets" decree. However, the extended supports are not until the .7500 and .7200 areas, and even those may be optimistic. In the meantime, resistances above the market are in the .7875 (currently being exceeded), .7900-50, and the .8000 area, with support back at .7820-00.

ENERGY

Quite a few factors from weather to geopolitics contributed to the strength of **Crude Oil** that will now be reinforced by the start of the northern tier heating season. Yet, it had already done the obvious and held 70.00-69.00 area prior to extending its rally above 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, with only the weekly oscillator to point up resistance into the 80.00 area that the market seems to be grinding back above at present, and the 83.00-.50 area. Much above that weekly oscillator resistance our next resistance is the August 2005-July 2006 topping line that projects fully to the mid-upper 88.00s over the next month. While that may seem a bit aggressive, above the mid 83.00 area the lead contract is demonstrating UP Acceleration out of the trend channel from the last major correction low in January.

Reports & Events

While there has been a good deal of news this week, markets seem more psychologically tied to events than reports or planned speeches. A good example were the very strong French and Italian Industrial Production (AUG) numbers earlier today. Yet, the European fixed income hardly seemed to notice. Similarly, the sharp drop in the DJIA in the wake of the United Auto Workers striking Chrysler Corporation seemed to bring little positive response in the US fixed income, and the UK fixed income came under pressure. That was likely due to the degree to which the markets expect the strike issues to be addressed timely, and for that to foment a recovery in the equities.

That said, the nature of the US economic releases and overall input from financial luminaries becomes more critical late this week. Tomorrow begins with the early release of the UK RICS House Price Balance (SEP) followed by a major slew of Japanese economic data, including Machine Orders (AUG), Money Supply and Broad Liquidity (both SEP) and Current Account and Trade Balance (AUG), along with Bank Lending (SEP.) That is followed by Australian Consumer Inflation Expectations (OCT) and Employment numbers (SEP), after which the BOJ announces the Target Rate and provides their Monthly Report.

After that it's off to Europe for the ECB Monthly Report, along with the Euro-zone Gross Domestic Product (Q2 Final) and associated indications for Gross Fixed Capital Investment, Government Expenditure and Household Consumption, and typical European Commission GDP Forecasts for the next few quarters. Then the ECB's Trichet speaks in Moscow prior to the US Trade Balance (AUG), Weekly Jobless Claims (for the week ending OCT 6), and the Import Price Index (SEP.) The ECB's Gonzalez-Paramo speaks in La Coruna, just as the Fed's Kroszner speaks to Bankers in North Carolina. In a preview of Friday's Retail Sales, we then see the ICSC Chain Store Sales (SEP.)

Friday begins with Japanese Domestic CGPI (SEP), the MOF Foreign Net Stock and Bond Investments (for the week ending OCT 5), Bankruptcies and Consumer Confidence (both SEP.) Europe then sees the French Consumer Price Index (SEP), Costs of Construction (Q2), and Current Account (AUG), followed by Euro-zone Industrial Production (AUG) with the ECB's Stark speaking in Brussels. Then it's on to the US for Producer Price Index (SEP), Advance Retail (SEP) and Fed Chairman Bernanke providing opening remarks at a Dallas Fed Conference, followed by Mr. Fisher, after which the University of Michigan Consumer Sentiment Index (OCT Preliminary) and Business Inventories (AUG) are released. It is all wrapped up with Yves Mersch speaking at the ACI 50th Anniversary in Luxembourg, and the Fed's Janet Yellen and Richard Fisher appearing on a panel at the Dallas Fed Conference. The talking heads always seem to get the last word at present.

[Belated Anniversary](#)

While last week was too crowded with important reports and events to take time out to reflect on it, last Thursday (October 4th) was the one year anniversary of the DJIA exceeding its previous 11,750 January 2000 all-time high. What a difference a year makes. There was a distinct inability on the part of the Federal Reserve to figure out that even if the equity markets were not as overvalued as during some previous bubbles, the extensive exuberance that the DJIA would encourage with a sustained rally back above the 11,750 level would significantly contribute to excesses elsewhere.

One of our primary concerns regarding recurring economic and financial bubbles is the degree to which the gatekeepers seem to have completely abandoned the guard house. It all seems to have begun after the Greenspan Fed realized that their 1994 tightening exercise was not sufficient to restrain the burgeoning Dot.Com Bubble, and were leery of deflating it once it became large enough. Early in his career Mr. Greenspan was happy to be the policeman who pulled the punchbowl when the party became too raucous.

That was also the case with previous Chairmen of the Federal Reserve, going back to Arthur Burns in the 1960's and early 1970's, and continued by Paul Volcker when he took over for the ineffectual G. William Miller. Yet, in a suspiciously convenient manner, once the equity market had "slipped its moorings" into 1996 (as he put it in 2005), Mr. Greenspan suddenly made it a *fait accompli* that it was not the job of central bankers to burst bubbles. That received wisdom (such as it may be) from an otherwise respectable source is how it became a point of faith that it is better for them to wait, and manage the fallout later.

Really? Who is supposed to deflate the bubbles then? Securities firms and unregulated product brokers rightfully earning windfall fees from what is a perfectly legal and highly incentivized activity? The public, who's always happy as long as they are making profits?

Of course not; that is why the central bank is the gatekeeper who should remind everyone that whatever form it takes, excess always leave a hangover. As we noted back at the time, the Fed did not need to specifically target the US equity markets to move against what was becoming an overly exuberant environment. In fact, it is our view that it makes it that much more interesting the equity markets were not the specific vehicle *per se* of the current excesses that are moreso related to the credit bubble.

Allowing that little monster to develop has left both a significant negative impact pending for US housing into next year, as well as the closely related problems of securities portfolios burdened with subprime loans underwriting those very properties; it is deliciously pernicious. The Fed is now grappling with the offshoot of an inability to see that relationship's downside. Everyone rightfully noted all along that the equities were not really overvalued relative to underlying earnings trends, and that made it not really quite like 1987 or 1998-2000. Yet, in its way the securitized risk problem is even worse due to the degree it is very entrenched in the bowels of both the previously booming housing industry and contingent liabilities of banks and securities firms, due to either direct involvement or financial commitments to others on tainted portfolios.

The Fed forgot a key observation from Mark Twain in addition to our oft noted, "There are three kinds of lies: lies, damned lies and statistics." That one could be used to question the models that supposedly ensured "non-correlation" of portfolios that were subsequently shown to indeed be correlated in a general liquidity seizure. Yet, that is only the end game of the Fed (and most investors) feeling that as long as the problem was not the sort of Dot.Com equity market over exuberance seen in 1998-2000, there was not likely anything wrong. Indeed, they forgot the other compelling Samuel Clemens (Twain's real name) admonition: "History doesn't repeat itself, but it rhymes."

Happy Anniversary to a DJIA that pushed to yet another all-time high last Friday. Are we to believe once again that a market which fosters excessive exuberance among the investing classes and their securities firms is grounds for celebration? Well, that all depends on your frame of reference: is it short term, or does it extend beyond the holiday season?

Rates vs. Reality

The bottom line is that the Fed's success in creating upbeat current economic sentiment may prove counterproductive in the intermediate term. Along with any sort of reasonably decent third quarter corporate earnings reports and the natural delays in the house foreclosure process, there may be a general sense of well being prior to the real problems that are more likely to develop into early 2008. The degree to which the Bernanke Fed has made both being 'data driven' and a commitment to extensive 'transparency' their mode of operation, means that near term buoyant sentiment and equity markets will deter any effort to provide aggressive anticipatory accommodation that the US economy may actually need.

An interesting question was posed by an associate recently: Did we believe that the Fed will lower the Fed Funds rate enough to prevent the extended subprime loan 'reset' weakness in the US housing market? We felt it necessary to first reset the frame of reference by politely pointing out that either our friend was not aware of the dynamics of the situation, or that they had possibly (much more likely, of course) misspoke.

Easing the Federal Funds target rate will not 'prevent' the problems which are developing due to the significant number of subprime mortgage interest rate resets that are just beginning for borrowers with Hybrid Adjustable Rate Mortgages (HARM's; as noted previous, that acronym should have been a huge red flag.) All anyone can hope for is that they can mitigate it to some meaningful degree that will spare the US economy from a major downturn (i.e. possible recession), and the rest of the world the spillover from that difficulty. Unless they are going to drop the Fed Funds rate far further than anyone considers healthy with inflation pressures lurking in the background, it will not have much effect on the HARM reset problem.

As we have noted previous, subprime and housing are two aspects of one and the same problem: as subprime borrowers can not meet their inflated mortgage payment obligations at 'reset' interest rates on Hybrid Adjustable Rate Mortgages, the associated foreclosures into next year will also create further portfolio problems that will flare up from time to time. It's kind of like termites armed with hand grenades, and a problem that is sure to continue at the very least well into next year, and possibly beyond.

A critical portion of that is the reason that even major Fed Funds easing will not 'prevent' the housing pressure: the subprime HARM interest rate resets are not based upon the classic US 'prime' rate set at a premium to Fed Funds. Most of the subprime borrowings that represent the bulk of the problem have the London Interbank Offered Rate (LIBOR) as the underlying index against which their premium rate is set. That is due to the degree to which lenders want borrowers with substandard credit histories to have their rates tied to something other than the sometimes artificially low Fed Funds rate.

Yet, that means that any further credit market turbulence from those very subprime mortgage defaults will also tighten interbank lending conditions once again. As we have seen of late, any sort of liquidity squeeze that leads securities firms and banks to withhold funds from the interbank lending market (rightfully so if conditions are uncertain) leaves a shortage of funds that can 'squeeze' interbank yields higher. Which is why the Fed took the step of Discount Window (their interbank lending facility) easing and policy adjustments when they wanted to lubricate the sticky interbank market in mid-August.

The somewhat opaque nature of the derivative debt securities that were supposed to diversify risk have left an environment which is prone to further interbank lending dislocations if there are further failures of portfolios containing subprime tainted securities. Even upbeat US Treasury Secretary Paulson had to admit that serial meetings with top bankers had not produced any meaningful way to effectively value those securities and portfolios. We have more to say on that below.

The saving grace for now is that the process by which the hapless homeowners plagued with subprime mortgage interest rate 'resets' will have their homes foreclosed is governed by their individual state laws. It is an enlightened practice that protects those who are in temporary difficulty from summary eviction from their homes. As is the case with the current efforts of various US government bodies, it encourages the borrower and lender to find a constructive path to avoid foreclosure. However, in the current case of the major number of 'problem' subprime mortgages held by borrowers who can not possibly make monthly payments hundreds of dollars higher than that of the promotional rate used to entice them into the loan, it is only deferring an inevitable reality; and that will still lead to a long phase of many homes coming back to the lenders throughout next year.

That delay is indeed a mixed blessing. On one hand, it will 'forestall' the problem by allowing the homeowners to challenge the foreclosure proceedings for awhile, and hope for a miracle to rescue them. That's fair enough, as we do not relish the idea of anyone being evicted from their home. The dilemma is that the major number of 'resets' which are just beginning to shove interest rates up to unbearable levels have just begun in the last two months. As such, the delay is only a temporary reprieve for the system. Once the full process hits the critical stage, it will be in full bloom for many months from approximately next March.

The truly ironic aspect is the degree to which the problem not surfacing sooner will indeed also leave some wondering whether it will be all that bad once it occurs. That was part of the dilemma ('moral hazard' as it is known) with the FOMC easing a full 50 basis points with the DJIA less than four percent below the previous (mid-July) 14,022 all-time high instead of being willing to allow for a bit of weakness and then intervening *ad hoc*.

Now the entire frame of reference is completely different, and miles removed from fixation on the true nature and extent of the pending housing problems. Does anyone really want to worry about a 'problem' into the holiday season if the Fed has guaranteed Happy Days Are Here Again? If the US equity markets survive the early November release of the October US Employment report are there any portfolio managers who are going to question the efficacy of burnishing their image by applying the cash reserves to 'safe' stocks in pursuit of a 'fully invested' portfolio profile for the calendar year end (regardless of how they did for the year)?

And if the economic and corporate news remain buoyant, and the equity markets remain near their all-time highs into late year, and if consumer sentiment recovers a bit into a fairly strong holiday sales season,... ..that's a lot of 'ifs.' Yet, it all boils down to one question, can the Fed actually ease further if the DJIA is up near the (ostensible technical and psychological resistance in the) 14,300 area? It's the same as we noted at the end of the last section: it all depends on frame of reference: is it short term, or does it extend beyond the holiday season?

Given that it does indeed take approximately six to nine months for any Federal Funds target rate changes to filter through to the general economy, did the FOMC really do everyone a favor (themselves included) by restoring such a high degree of confidence at this juncture? Or did they only strengthen the bars on a prison of their own devise? What we know for sure is that if the pending problem is as bad as we (and quite a few other informed observers) believe, the Fed has tied its own hands by acting too aggressively to restore confidence now.

Of course, all of their current fans will likely be the first to lay the blame at their feet for not doing more at present. Regarding the last FOMC rate cut, it seems to us that 'less' would have been 'more.' Had they allowed the equities to drop a bit instead of being afraid to do so, they would have more latitude now to provide the aggressive accommodation that is very likely necessary to 'mitigate' the problem that they have no way to 'prevent.'

Frame of Reference

"Ahhh, how quickly they forget."

That has been a longstanding retort of comedians whose latest punchline has garnered groans instead of guffaws, as well as the (occasionally rightful) observation of conquerors whose fading glory has left the natives restless.

Yet, forgetting is a natural part of memory, which is in turn directly linked to learning. Learning lessons and appreciating their full measure is something which many observers fear is a lost art among some members of the professional financial services community, as well as the public investing classes. Yet, as the markets are just a more intensely concentrated shard of everyday life, as with so many other endeavors there is an element of selective memory; quite a bit of which has to do with incentives and risk.

That covers many areas. Some of it has to do with changes in the way information is delivered, which is a major focus in recent years. Other aspects relate to the seemingly unique developments in different intermediate term economic and financial activity across the major, long wave economic cycles. Just as interesting in that regard are how and why economic and financial bubbles are abetted by the serial belief in various forms of misguided 'received wisdom', are deflated to everyone's chagrin, and then seem to pop up again. All of which is related back to our perspective on the highly disjointed nature of the current global and individual country economic and financial trends. Whether or not our conclusions are shared by everyone is less important than the exploration itself.

The most relevant part of this very broad assessment is the degree to which the markets are currently torn between highly divergent short and intermediate term influences. This has turned up in many ways in the different country markets, and even varying tendencies within the same country complexes and yield curves. We will revisit that in the 'Market Implications' at the end of this review.

The Nature of Memory & Learning

As we presume most people are at least passingly aware, memory and learning include both physical and psychological aspects. The generation of neurons during the observation and thought process is abetted by the any repetition cycle, yet with more powerful learning occurring during certain types of repetitive observation and practice. Of course, it all takes place in a context, which can also affect the ability to recall lessons learned.

At the risk of stating the obvious, whether lessons are adequately employed in future situations is also dependent upon them not being forgotten. Yet, in clinical terms 'forgetting' can be a matter of failure to recognize the previous lesson as applicable in a similar context, and not just the sheer loss of the previous memory. Full appreciation of a lesson should go well beyond repeating the same process only in identical situations.

The physical aspects of memory and learning are quite interesting in their own right, and deserve a brief review here. In their study of the effect on learning of the spacing of the training incidents, professors in the Psychology Department at Rutgers University note,...

"Information that is spaced over time is better remembered than the same amount of information massed together. This phenomenon, known as the spacing effect, was explored with respect to its effect on learning and neurogenesis in the adult dentate gyrus of the hippocampal formation. Because the cells are generated over time and because learning enhances their survival, we hypothesized that training with spaced trials would rescue more new neurons from death than the same number of massed trials.

“...animals that learned well retained more cells than animals that did not learn or learned poorly. Moreover, performance during acquisition correlated with the number of cells remaining in the dentate gyrus after training. In the second experiment, the time between blocks of trials was increased. Consequently, animals trained with spaced trials performed as well as those trained with massed, but remembered the location better two weeks later.

“Together, these data indicate that learning, and not mere exposure to training, enhances the survival of cells that are generated 1 wk before training. They also indicate that learning over an extended period of time induces a more persistent memory, which then relates to the number of cells that reside in the hippocampus.”¹

In general it is very interesting that learning over a period of time, and experiences that are spread out to reinforce the learning is the case. That would seem to at least partially explain why short term traders sometimes have a hard time understanding the market dynamics when the price trends enter a different phase, or reach a broader technical or psychological decision price level. What they have learned in their ‘massed’ activity on short term situations may not allow them to retain the lessons of the broader decision phases as well as those who take a more incremental approach to studying market trends.

The more incremental approach and possibly serious review of historic situations would seem to be of benefit regarding remembering the lessons farther forward in the future. It is an axiom of the trading business that the worst thing that can happen to a new trader is to make money on their first three trades. The potential to believe they understand more than they actually do, and infer too much from their brief experience is a real trap. Thinking one knows a lot from too limited a sample is always a problem. Even experienced analysts and investment managers must always be vigilant about ensuring they are applying previous lessons properly in the current context, and developing an effective ‘trend logic.’

Much of that has to do with psychology, and context is a major consideration in whether the lesson has been properly remembered or possibly forgotten. Researchers from Purdue University succinctly related memory, context and forgetting quite some time ago in a paper which concluded,...

“Forgetting was viewed here as a failure of performance resulting from the cues at test retrieving a memory other than the target memory or retrieving no memory at all. According to this view, memory involves discrimination learning. Essentially, memories are stored in the presence of an elaborate set of interoceptive and exteroceptive stimuli, a context. Whether at test the target memory is retrieved depends on how well the cues at test discriminate between the target memory and other memories.”²

¹ Cold Spring Harbor Press, **LEARNING & MEMORY**, 14:368-375, “Neurogenesis and the spacing effect: Learning over time enhances memory and the survival of new neurons”, Helene M. Sisti, Arnold L. Glass, and Tracey J. Shors, Department of Psychology and Center for Collaborative Neuroscience, Rutgers University, Piscataway, New Jersey, May 10, 2007

² Ibid., 2:107-132. “Remembering and forgetting as context discrimination”, E. J. Capaldi and I. Neath, Department of Psychological Sciences, Purdue University, West Lafayette, Indiana USA, 1995

It is interesting that forgetting has to do with context. That reference to “interoceptive and exteroceptive stimuli” is especially interesting regarding market experiences and the learning process for trend analysis. It means that the retention of the lesson has to do with both how the analyst or funds manager felt at the time of involvement in the situation, as well as the external information which they were processing. It would seem that in order to segregate market decision lessons from the personal experiential context, it is likely best to pursue some historic studies of price trends and the background information impacting them.

It is possible that even the most intelligent analysts and observers are too influenced by the current context to make real-time learning alone an effective path. That seems to reinforce either individual study of extensive histories, or especially some type of formal courses or mentoring as the best way to absorb the lessons for future application.

That is possibly a reason why some analysts and traders can extrapolate the broader lesson of a market situation to future variations of that same overall context, and others can not. Especially as quite a few short term traders learn their craft on the job, their ‘massed’ incident experience leaves a good deal of their emotion and the specific news and information that was available during each situation intertwined with any specific lesson learned from the independent experience of the sheer short term price activity.

Of course the same can be said to a goodly degree of the longer term analyst or funds manager who is attempting to learn by experience alone. Their emotion and their minimal experience of previous market activity under similar conditions are impediments to making informed and successful risk-adjusted portfolio decisions. Significant review of more broadly ‘spaced’ examples of previous market activity in a structured analysis learning experience seems necessary for effective development of investment decision skills.

Yet, as Mr. Bernanke is an acknowledged academic expert in the history of the Federal Reserve, it seems quite a failure on the part of his Fed to continue to advocate the specious position of his predecessor that the deflation of bubbles is not a problem it should address in the wake of the failure to restrain the Dot.Com Bubble by applying some pressure to the general economy. The point is that while the context was seemingly different, at various times even the Fed’s own members acknowledged the excesses that seemed to be developing in credit markets.

The idea expressed previous that it was a mistake to allow anything not specifically another overvaluation of the equities market must be okay because it was not that nasty old Dot.Com Bubble returning once again applies here. It is another variation of the Twain observation, “History doesn’t repeat itself, but it rhymes.” It is as if the Fed is now following the failed path of old generals who are too narrowly focused on past policies and tradition (such as it is.) The Fed seems to have been very busy implementing the tactics which won the last war (transparency and equity market valuation monitoring), and missed the opportunity to demonstrate that they understood the battle had shifted, and required altered tactics.

The consequence is that the credit bubble has won, and can be a burden to the system for some time to come. It seems that the financial authorities’ ‘target memory’ failed to relate a previous occurrence to the lesson to be drawn over the recent cycle. One would hope at the very least recent credit market exuberance recalled the potential for problems from the 1994 mortgage-backed securities market meltdown that plagued the securities firms and banks.

Yet, in that context it would appear that the authorities failed to include in their logic what would happen if those firms had (cleverly) evolved their business model to be less exposed to proprietary risk (which they attempted to shove off of their books with the LTCM investments.) They had become true 'intermediaries': packagers of risk which was passed on to others.

As noted previous, the 1998 combined LTCM and Russian problem was a walk in the park compared to the current dilemma. In that case a select number of large banks needed some additional liquidity to margin their extended investment in essentially viable 'convergence trade' positions that had merely been under margined. In this case, credit was extended to fund the acquisition of assets which did not have a sustainable value. So, anyone who got it wrong can at least take some comfort from that notion that the Fed likely did as well. It looks like the central bank forgot that the failure to stop faulty loan practices and masking of risk in complex instruments can lead to trouble.

Yet, even beyond the obvious failure of the central banks to understand the longer term lessons of past failures, real learning and intelligent assessment of current conditions requires study of the broader historic examples and contexts. The successful application of any form of knowledge requires maintaining the vision inferred from the lesson beyond near term influences and distractions. Many folks have now been drawn into an assumption the current situation can be extended into knowledge of the future. That represents an excellent example of the tendency discussed above for 'massed trials' to be less than effective in providing the best sort of learning, and is related to the modern information culture. It has quite a bit to do with the nature of news and analysis communication across the Worldwide Web.

Media & Markets

Of course, one of the other major changes that seems to accelerate at an ever faster pace is the amount and velocity of information that we are offered through our broadband internet access to various forms of business and financial news. The ability of the exponentially expanding volume and frequency of communication to overwhelm the perspective of all but the most effectively grounded analysts is glaringly apparent.

There was a very interesting article in today's Financial Times that holds some lessons about the current nature of things, and possibly what to look for in the future. In its way it is also confirmation of the high velocity news and data environment to skew assessment of the economy and markets to a relatively short term view.

The headline of the article by New York FT reporter Francesco Guerrera is "Economic haze baffles bosses." It is quite interesting that they are so unsure. The old adage is that the stock market dislikes nothing quite so much as uncertainty. Evidently the market and the chief executives are kindred spirits in that regard.

The article goes on to note variously, "US chief executives say the economic outlook has not been so difficult to read since the last recession in 2000-01 and warn that, in spite of signs of a pick-up, the threat of an economic contraction is still alive." "The economic environment is uncertain because over the summer the economy was thrown a number of curve balls and it is unclear what the long-term impact of that is going to be," said Jim Tisch, chief executive of Loews, the hotels-to-pipelines conglomerate."

That all sounds pretty sensible, if a bit scary in its capacity to affect corporate capital investment and other things that can actually have a sustained impact on the US economy; and by extension the rest of the global economy. Yet, the article also repeatedly cites what appear to be some fairly short term perspectives, such as, "They said they would watch the third quarter earnings reporting season, which begins this week, to gauge whether companies had managed to cushion the twin blows from the housing crisis and liquidity squeeze." And, "I don't think anybody knows for sure exactly what the consumer is going to do this fall," Ken Hicks, president of JCPenney, the department store chain, recently told investors."

Rear view mirror assessment of third quarter earnings as a guidepost to what to expect in future? How consumers act this fall as a measure of overall prospects? It all seems to illustrate the degree to which the captains of industry are captives of the extended news cycle. In their defense, they do need to keep an eye on quarterly tendencies for the purpose of near term management geared to earnings reports and the like.

Yet, what they see in previous quarterly results seems a bit less than, well, forward looking. What the consumer does over the next couple of months also does not have much to do with how things are going to evolve under the weight of a problem that will only begin to bite into the end of the first quarter of next year. This is another sign of the degree to which the near term and intermediate term economic influences are so disjointed as to defy drawing a firm conclusion for the economy and markets from any near term market trends. Media's influence is also apparent in the degree to which near term news has grabbed the decision framework of even the strategic thinkers at the top of the corporate pyramid.

Yet, even those higher up in the financial hierarchy are having problems dealing with the media influences. There was another excellent FT article at the end of last week that pointed out the significant changes in the central banks' operating environment due to the rapid evolution of media from 'broadcast' to 'broadband.' Gillian Tett is the Financial Times head of global financial markets coverage. Holding a Cambridge PhD in social anthropology affords her (and her readers) the luxury of analysis which goes beyond sheer finance background into understanding mass effects that sometimes occur in markets. The FT was an early skeptic on the efficacy of blended debt instrument securitization, and we revisit that aspect in the 'Structure and Function' sub-topic below.

Her recent observations have also explored the specific changes in the media that have impacted the ability of the Bank of England (and other central banks) to implement 'discreet' solutions for banking problems. As she notes in her excellent column from last Friday (attached for your direct review), "...a couple of decades ago, the authorities could usually assume that they had several days - if not months - to sort out a financial crisis before it hit the headlines." "Back in 1991, the Bank of England managed to organise a furtive bank rescue that remained secret for an entire 18 months,..."

What a difference a decade makes! As she goes on to observe, "But in the modern, BlackBerry-toting, YouTube-addicted world, news tends to flash across the world in seconds. That is what occurred when the European Central Bank intervened in the money markets in early August. As news of this intervention cropped up in media headlines around the world, what supposedly started as a "fine tuning", calming exercise ended up creating a massive shock of its own.

“Meanwhile, in the Northern Rock saga, it was the BBC, not the Bank, that broke the news of those woes, late at night. The shock was compounded by the fact that the government stayed silent on the issue for the next 12 hours, by which time panicked consumers had started emptying their accounts.”

That highlights the problems the authorities have with highly active and open communications structures that now dominate the world. The early philosopher and proponent of the power of media forms to alter society was Marshall McLuhan. The 1960's guru of media influence was the author of the then ubiquitous “Understanding Media: The Extensions of Man”³, with its closely related cliché, “The medium is the message.” All of that seems ever more compelling as instantaneous communication and open source information access continue to expand.

One of his primary themes was the degree to which ‘cool’ electronic media like television were having the effect of ‘atomizing’ mass culture, whereas previous ‘hot’ mass broadcast media like radio and newsprint had the more aggressive unifying tendency upon which nations states and accompanying mass xenophobia could be built. ‘Atomize’ refers to the way in which media that can be highly selective and customized by individual users have the effect of liberating those users to pursue their narrow interests. There are also some aspects of how the ‘cool’ (i.e. involving) television image draws users into the experience, versus ‘hot’ print and aural (radio) media that directs messages ‘at’ them.

Yet, that secondary aspect pales in importance to the atomization factor. What is astounding about McLuhan’s vision is that it was based on assumptions that only went as far the advent of cable television. That worked in conjunction with the move from unifying central city hot beds of political and cultural conformity to suburban expansion into separate communities for folks with selective interests and social standing. What even a genius like McLuhan could not envision was the explosion personal computer use; nobody had even built one at the point of his greatest theoretical postulation and popularity. Computer usage back then was still the exclusive domain of Fortune 100 companies, university research departments, the Rand Corporation and the Defense Department.

Yet, the omnipresent use of the personal computer (and other personal interactive devices) along with the evolution of the original university research Arpanet into the Internet only reinforced and extended all of McLuhan’s theories. What has been more atomizing of mass culture and personally liberating into diverse realms of research and entertainment than the radical shift from ‘broadcast’ to ‘broadband’? Whether or not the content people choose to view are anything anyone else would care to see is beside the point.

The ‘viewer as contributor’ aspect of the electronic culture is among its most interesting radical features. *Cinéma vérité* (quasi documentary reality video) has become the hobby of a major portion of the population at large, often used to promote or publicize (literally) a bit of insight or information that they find important. Such has been the case with every personal view on important news developments from Hurricane Katrina, to the occasional excessive use of police tactics, to the depositor lines out in front of various banking institutions, such as the Countrywide episode in the US, and Northern Rock in the UK.

³ MIT Press, Cambridge, Massachusetts USA and London, England: first MIT Press edition 1994; Copyright Corinne McLuhan 1964, 1994

One of McLuhan's major themes was the significant problems authority structures have in dealing with rapid societal change engendered by major shifts in media. Just as up close, right in your living room coverage of the Vietnam War and hippie communes contributed to splintering of societal norms of the American culture in the 1960's, the ability to disseminate images and video of all manner of events is driving changes in the establishment responses in the current era.

One of the most telling is the manner in which the individual (or a limited class of individuals) can apply pressure to the power structure in various areas. The rapid official review of the combined UK financial authorities' response to the Northern Rock situation was no doubt driven in part by the political forces unleashed by the spectre of pensioners and working class depositors worrying about their savings being wiped out. Their compelling need to be reassured in the circumstances seemed reasonable and attracted a lot of sympathy. These are just the sort of things which the government used to be able to address with post-event remedies, yet now require proactive management.

At the end of her analysis Ms. Tett offers a couple of suggestions with which we mostly agree. To wit, "Thus, to my mind there are two media lessons from the summer's events. Firstly, the government needs to do more to adapt to the pressures of a YouTube media world. After all, we cannot disinvent the internet.

"But secondly, the financial world must become more transparent, and the media raise its own game. Right now, in other words, we need far more reporting of finance, not less."

The first is easier said than done, yet is likely to be incrementally accomplished through the political pressure noted above. Effective oversight must allow for more proactive intervention to prevent harm to the end-users of financial products. The authorities who fail to do so will reap a well-deserved harvest of opprobrium. It can only be hoped that inclination to seek solutions to the weakness of the coordinated UK oversight and regulation migrate back over to the US as well.

If the media are going to be conduits for the suffering of the uninformed, then they should also use their position to question the specious policies of the financial authorities. The Financial Times was extremely aggressive in its skepticism toward the efficacy of blended credit derivatives actually mitigating risk. It duly noted the 'Cov-lite' easing of credit covenants standards for major borrowers was a potential indication that the cycle had reached its endpoint, as the easy credit phenomenon had finally passed totally through the looking glass.

On the second point, transparency is certainly desirable up to a point. Possibly more of it regarding the true nature of risks attendant to complex financial instruments would be a blessing, especially the frank acknowledgement not provided earlier in this cycle that while theories are fine, nobody really knows if complex instruments are actually less risky in times of financial stress. The one thing which we have noted repeatedly is not of any use is more extensive transparency by central banks that have already taken that effort beyond the point of diminishing returns. With the notable exception of the Bank of England, central bankers have already devolved from 'inscrutable' to 'insufferable.' Why ask for more?

³ MIT Press, Cambridge, Massachusetts USA and London, England: first MIT Press edition 1994; Copyright Corinne McLuhan 1964, 1994

Structure and Function

Much more important would be a useful bit of 'transparency' on the buy-side. That's right, the final purchasers of these complex instruments are at least as much to blame as the issuer's and repackager's. Some might consider that a rather harsh variation of *caveat emptor*. However, if the *emptors* would exercise a few more *caveats*, perhaps they would not look so foolish after the fact. If the portfolio managers and investment officers at public and private funds were to have a code of acceptable standards for investment features and minimum quality that are consistent with their risk management parameters, then they could avoid a good deal of the pain associated with the system's cyclical excesses.

It all has to do with those memory and forgetting functions reviewed previous. The simple bottom line is that the investment 'herd' instinct is based upon selective memory. The ability of the mind to maintain its focus on the cautionary lessons of the last market debacle diminishes substantially as the next boom presents ample 'massed' instances of those who are achieving premium yields from what are specious assumptions. As those continue across time, the promulgation of some form of 'received wisdom' that seems to keep rewarding those who invest in it over the intermediate term diminishes respect for the institutional memory that cautions against investment in less than solid opportunities.

Fallacious 'logic reinforcement loops' based upon near term financial success are built on new theories of individual industry expansion (Dot.Com Boom) or the degree to which a premium yield can indeed be made 'risk free' (blended credit derivatives.) Somehow the axiom that higher return always entails higher risk in some form gets suppressed in fancy articulations of why it is 'different this time.'

A good bit of that greater 'transparent reasoning' which must make sense even if extrapolated into assumption of the most unexpected economic and financial conditions (the proverbial 'worst case scenario') is not so very hard to achieve. It seems a bit smug to resurrect the old adage that 'a chain is only as strong as its weakest link' in 20/20 hindsight for the obvious flaws in the blended debt securities fiasco; but that was all it would have taken.

The Financial Times LEX column (a clever play on the lexicographer being one who explains the meaning of words) specializes in aggressive review of the logic underlying assumptions for either individual companies or broader market tendencies. Today they had a comment on 'Mortgage hedge funds' (also attached for your direct review.) In a parody of a T. S. Eliot poem stanza, LEX notes, "Between the mark and the price (of a mortgage-backed security) falls, well, something quite scary." "The problem of how to value securities when liquidity has evaporated was highlighted again recently." And "...a hedge fund can get valuations from dealers on its positions. The issue is: do these valuations mean much? They are not executable –" "The current rethink on the role of credit ratings accentuates the uncertainty."

That would seem to reinforce the very questionable nature of any improvement in the credit markets, as we noted previous was inherent in Mr. Paulson's admission that serial meetings with top bankers had failed to achieve any meaningful address of the problem of valuing credit derivatives which contained a subprime component. What if someone had offered those investors a load of varying grades of beef of instead of debt instruments? They were duly informed that the blend was between A Prime and some meat which had a potential to develop toxic levels of *e coli* bacteria, and as such it was being given a blended USDA Grade B+ rating. How many would consider that an acceptable proposition?

Bubbles: Inflation/Deflation/Burst

The other very interesting recent article in the Financial Times which plays right into this extensive overview is Mr. Tony Jackson's clearly titled, "Commodities bull story relies heavily on guesswork" (also attached for your convenience.) With all due respect, we presume all market projections rely on some degree of conjecture. Yet, on Monday Mr. Jackson brought forth some of the very telling aspects of commodity bull market bubbles that actually apply to all such aberrant phases, and are just more readily observed in the 'physicals.'

He opens his analysis with the at first prescient and then precarious predictions for gold prices from the Aden sisters in the 1980's. He then notes that in the wake of the FOMC surprisingly sizable easing last month, "Most commodities, gold among them, have been racing away again. But in judging such things we no longer rely on a couple of weird sisters in Costa Rica. We go by logic and fundamentals."

"Well, sort of." He then goes on to explain that the rush into all manner of inflation hedge 'received wisdom' is not reinforced by facts, or action of other markets and price indications. It is quite a bubble bursting *tour de force*, as in, "Since the start of this year, the gold price has risen 15 per cent, while the TIPS spread has not risen at all." "When the Aden sisters were on the case it hit \$875. Adjusted for US inflation, the price has fallen 60 per cent." "At a Commodities Week conference in London last week, I heard various fund managers talking up commodities as an asset class. Most of their logic seemed pretty flaky as well."

After which he went on to point out a whole range of specious assumptions regarding whether the rest of the world will be immune to a slowdown if the US lapses in weakness next year, or even if it does not (for which I refer you to back the OECD Composite Leading Indicator report, and our review of it in last Friday's [TRENDVIEW GENERAL UPDATE](#).) He also points out the degree to which there is potentially a strong element of sheer diversification momentum shifting money into something other than "what cost them money in the past", as well as a very good question of whether the general metals strength is structural or cyclical.

However, one of the key advantages a physical commodity has once the fallacious 'logic reinforcement loop' develops is the ability of most folks along the supply chain to hoard just a bit of it, as it must be the right thing to do. Everyone wants in on any game that looks good across time. One of the areas where that has historically been a fact of life is the boom cycles in the sugar market. All of the middle men have some sort of storage capacity for such a non-perishable commodity. Once there is a feeling the harvest is going to be diminished for some reason, it is easy enough to stash a bit of the white granules away. Because it is a world commodity, the tracking of storage stocks is a bit nebulous as well. Of course, once the bubble bursts it is always fascinating how storage stocks in deliverable positions seem to expand to approximately three times the amount of sugar that anyone knew existed!

While it is much more subtle, the same function applies to more ethereal financial instruments as well. While CITI's Mr. Prince is being criticized for his frank assessment of the nature of the securities business, he mostly articulated what everyone in the business acknowledges in private, "...as long as the music is playing, you've got to get up and dance." That his timing was bad does not negate the basic sentiment, and it is shared by his competitors. Nobody in the securities business shuts down business units while there is deal flow. Do some become more circumspect than others? Probably; but nobody throws the 'off' switch.

And that ability to understand when it might be time to become more circumspect would be much better facilitated by clear fulfillment of central bank mandates. It is the central bank's failure if a slowdown to cool things is not pursued, as opposed to waiting for the rather more capricious and wholly unpredictable bursting of a bubble. If the central banks would kindly take control once again (as in lead from the front instead of the rear), properly telegraphed moves toward economic restraint would allow participants to rein in excesses. If not, then it is reasonable for everyone to keep dancing.

The current long term cycle answer to date (i.e. since the late 1990's bubble) from the central bankers that they can just let the party get out of hand by not pulling the punchbowl, and then balm the pain later with easy credit has been discredited. If the chaperone charged with pulling punchbowl soon enough to prevent excess spikes it instead, and then takes up the band leader's baton, repetitive bubbles are the shape of things to come.

That is because 'investment' in 'received wisdom' is inevitably psychological prior to financial; it is the insult to injury that leaves everyone feeling so 'burned' as faulty investment or trend 'logic' disintegrates. Yet, what if the ultimate received wisdom is that the central bank will not act to derail any specious assumptions through stress testing them with the classical method of cooling the economy? It would then make sense to be among the first to invest in a popular misconception, and exit timely so that only the 'greater fool' who bought you out is left with the losses and frustration.

That indeed is (and always has been) the logic behind intelligent gaming of most bubbles, and also why they occurred so infrequently until recent history. Ideas and investment vehicles which had to withstand the test of a less buoyant economic situation were less likely to gain extensive adherents if proven to not perform under stressed conditions. The past decade is an anomaly in supporting two very extensive bubbles that drew in securities firms and investment professionals as well as the public. As Mr. Jackson's article and other indications suggest, there may indeed be a third bubble forming in the wake of the aggressive easing by which the Fed is attempting to mitigate the last one.

This used to take much longer. As noted early on in our March 2005 report **1970's Redux: Son of Stagflation**, "...whole cultures do not learn the lessons of financial history, because each generation's formative experience of necessity cannot include the previous thirty year (more or less) economic and investment cycle. They get to put their hand on the hot burner of long term cyclical economic and investment bubbles, just like the previous generation. In the most cynical sense, about every thirty years or so the market has a new batch of suckers willing to invest (emotionally as well) in the idea that it is "different this time," prior to relieving them of a significant portion of their net worth."

The recent rapid repetition of bubble development gets back to central bank abandonment of their traditional mandate to deter financial excess by whatever means are appropriate under the circumstances. It seems to us that it is no more coincidence that the recent bubbles have been allowed to develop in the wake of the Fed's lack of desire to tackle them since 1996 than the previous 1970's commodities and energy bubble occurred during the similarly ineffectual G. William Miller Fed. As we have noted previous, current Fed Governor Mishkin's notions that it may create too much pain for the economy to tackle various forms of financial excess are distinctly similar to the mentality of the Miller Fed.

This all relates back to the general public's view of investments or trading logic. The more sanguine a central bank becomes regarding excesses, the more it seems acceptable to the investing public that they should try their hand at exotic, unproven investment approaches that they see benefiting others over a multi-year horizon. Investors buy a specious 'logic' such as a 'blended' rating for a mixed security, and regulators and raters seem unable to question the worth of complex instruments created by securities firms. While some in the securities firms' research and product development areas might have been influential in proposing some sort of advanced logic in the first instance, once the appetite for specific types of instruments becomes robust, they effectively lead from the rear. While the securities firms are burdened with the lion's share of the opprobrium once the bubbles burst, at the end of the day they are often just as swept up in the need to supply a hungry beast as creating any of the actual demand in the late phase of the cycle.

There is a perspective in some quarters of the international drug abuse debate that if the developed world did not create so many junkies, the developing world would not have so many narcotics traffickers getting rich off of the drug trade. There is something to be said for that, and it relates back to the need many financial managers feel to 'outperform' their peers. Yet, in the boom times they seem to conveniently forget what is essentially the physical law of 'equal and opposite reaction' as it applies to finance: achieving higher gains always involves greater risks in one form or another.

Just because the times are driving a particular trend which makes everyone look good for awhile, it does not mean that the underlying assumptions behind every investment that is temporarily performing well is basically sound under all conditions. As the old Wall Street adage goes, "Don't confuse brains with a bull market."

Current Frame of Reference Conclusions

There is a real problem looming for the US economy from continued and likely expanding housing sector weakness. Yet the foreclosure process being regulated at the individual US state level means there are understandable safeguards against summary eviction of the current subprime loan plagued home owners. That means the defaulting home owners are able to delay vacating their homes for many months by simply challenging the process at the typical inflection points (hearings, filings, and the like.)

They certainly have most folks' sympathy, and the looming US general election next fall means there will also be no small amount of politicking around the issue. Yet, as noted previous, even if it did want to encourage the moral hazard involved, no government entity has the budget to actually prevent the foreclosures. And unless the Fed can find reason to drop the Fed Funds target rate by several full percentage points, it will not do much to prevent the HARM interest rate resets from creating much higher monthly payments that many HARM borrowers can afford.

As such, we are now stuck in a market where a 'transparency' and 'data driven' Fed can not ease currently, especially with the media trumpeting the return of the strong economy and equities bull market that has most folks in a temporarily more upbeat mood. Yet, that is a significant restraint on the potential for the Fed to timely apply what may well be the requisite anticipatory accommodation for a problem which will likely cause actual 2008 growth to significantly undershoot even the recent downward revisions from the Fed staff.

Market Implications

EQUITIES

The implications for the markets go a long way toward explaining why they are acting as they are at present. The recent Fed over-reaction to the financial scare leaves the markets in a misguided state as well. Equities are likely to remain in a grudging up trend while they are also headed for a top once the more pernicious aspects of the housing problems loom large into next year. Yet, in spite of some temporary setbacks as they churn higher, if the equities can get past the early November release of the US Employment report for October while maintaining any sort of strength near the all-time high (i.e. anywhere above **DJIA 14,000**) into mid-November, that will likely foment a sustained bid into the end of the year.

That is because portfolio managers with any cash reserves will want to be fully invested prior to the calendar year end, and will commit them to the market into mid-December at the latest. While it is easy to say that's just a theory, we encourage you to review it yourself. It has been very rare for any market which was near either the high of a rally or especially near an all-time high into the end of November to experience any significant setback during December.

In technical terms that means the interim support in the DJIA is 14,000-13,900, yet the really significant support is not until down in the 13,700-650 range; only below that does the DJIA potentially lapse back into more sustained weakness. While the other equity markets may lead or lag at times, the DJIA has been the prime mover for the overall trends elsewhere, and we surmise that will continue in the near term.

FIXED INCOME

The long dated fixed income has been a bit more buoyant than the short money of late, yet still remains vulnerable when equities maintain the bid across time. Their greater resilience is related to the underlying sense that they remain intermediate bull trends from the June-July cycle low. As such, while we are going to remain skeptical of the long ends while the equities experience the return of FOMC rate cut inspired exuberance, it is likely if equities are actually headed for a top that the long ends will bottom out sometime between the later part of this year and early next year as well.

To put things into perspective, the rally from that June-July intermediate term cycle low was sharply accelerated by the August equity market debacle. The **T-note** is strongest due to the likelihood the US economy will lead any future economic and market weakness. Its rally from the 104-00 area May-June 2006 low took six months to mostly only rally to 108-00. On the other hand, the early-July to early-September T-note rally this year (also from roughly the 104-00 area) made it up to the 111-00 area in 60 days.

As we noted in the 'Long End Equalization' topical discussion last month, the significant near term rally in all of the long ends was based upon the potential for a full blown debacle in the equity markets. The FOMC removal of that potential has caused the long ends to revert to some weakness. Yet what is most interesting about the selloff is not that they are weak, but rather how resilient they remain in spite of the sustained equity market resurgence since September 18th. That is likely related to the degree to which the fixed income markets still believe that the equities rally is based on less than sustainable assumptions. If the fixed income markets believed the equities rally was convincing, they would be much further back down near their lows. They were also resilient into the new equity highs in July.

What does all of that mean? While we can not really be certain, the DJIA has now pushed to a sustained new high, and the T-note has only sagged into the low 108-00 area. That is a good sign that even if the DJIA should extend to higher resistance in the 14,350 area (which shifts up to 14,500 by late next month), the T-note may well hold the 107-16/-00 support.

Equally as interesting is the degree to which weak sister **Bund** (due to the presumed strength of the European economy) did less well than the T-note on the rally, yet remains around its 112.00-111.65 support, with lower support in the 111.00-110.50 range. Even that is above the 109.66 June low into historic congestion.

Even more impressive in that regard is the resilience of the UK **Gilt**, which was also not quite as strong as the T-note back on the rally in July-September (from 103.00 to 108.50.) Yet, even with the **FTSE** finally outperforming the DAX on the rally, and nearing its June-July Double Top in the 5,750 area, the Gilt is holding up in the 106.50 area on recent selloffs. While failing so far from higher resistance in the 107.50 area, lower support is as nearby as 106.00, albeit with not much below that until the 105.00-104.50 range. However, with the FTSE basically back up to its high that is all still well above the 103.00 area lows seen as recently as early July.

The long end activity is one of the best reflections of the disjointed frame of reference the Fed has instituted by cutting so sharply as to strengthen the equity markets in a way that makes it hard to ease any further in the near term. Yet, if the broader housing problems weigh on home prices next year along with associated subprime debt portfolio problems plaguing the securities and interbank lending markets, then the Fed should be easing much further now to have any chance at meaningful mitigation of the problems.

Instead their overly accommodative action leaves the equities passingly confident in spite of the looming dilemmas, while long dated fixed income remains more resilient than resurgent equities suggests should be possible. As we noted previous, the long dated fixed income held up very well during the mid-July new high in the equities, only reacting back modestly after its initial rally from the mid-June cycle lows. In that case the fixed income had a much better idea of what was coming next than a misguided equity market. Does that mean it must be right this time? Of course not. Yet, it is interesting that the equity market new highs are once again not being taken very seriously by the long ends.

As we have noted on recent short term trading swings, the short money is much more bothered by the equities weakness. That is because their upside surge this summer was also predicated on a debacle in the equities that is not now a reasonable possibility. In fact, every equity market surge has more so brought immediate weakness to the short money forwards, while the long ends have not been pressured until the equities kept the bid for quite some time, and we suspect that will continue.

Unless and until the equities actually begin to crack once again, there is not much of a rationale for a sustained short money rally. The specific contingencies of the trends in the short money forwards are further convoluted by the influence of the interbank market liquidity disruption sustaining premium yields. As such, we will leave the technical discussion for the more extensive technical sections of our reports.

While the **US Dollar Index** remains very vulnerable, as noted in the 'Dollar Debacle?' review (also at the end of last month) that is likely to be moreso as a slow motion, eroding bear. Considerable weakness already experienced, the G7 meeting later this month likely issuing a *de rigueur* "stabilize disorderly markets" statement, near term strength of the equity markets, and the technical support around the .7700 area (even though that's a new all-time low) all mitigate against any sharp weakness in the near term. Only below the .7650 level would the buck look vulnerable to extensive near term weakness to possibly as low as the .7500 area right away. In the meantime, resistances above the market are in the .7875, .7900-50, and the .8000 area, with support back in the .7820-00 and .7760 areas.

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

-Rohr
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