

ROHR REPORT

CAPITAL MARKETS OBSERVER

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

...‘Neutron Bomb’ Lessons, Ready for Prime (Mover) Time?

Key Views

- While the equity market selloff and fixed income strength last Friday was due in good measure to concerns about weak earnings, there seems to also have been another shift in the ‘frame of reference’ by financial authorities. Mr. Bernanke’s speech last Friday contained some statements regarding important academic research that is counter to the ‘Bernanke Put’ psychology previously supporting the equity markets.
- The DJIA fell below serial supports at 13,900-850 and (more critically) 13,700-650. The spillover Monday morning left it into 13,450-350 support, below which there is not much until the 13,000 area. December S&P 500 equivalents are 1,485 and 1,450 areas.
- Fixed income markets only strengthened moderately further early Monday, and we ascribe this to their understanding that those next significant equities’ supports will need to fail in order to signal sustained further weakness. December T-note above 109-00/-06 and 110-00/-06 still has meaningful resistance into the 111-00/-12 historic resistance last tested when the equity markets were still suspect into early September. Much above that the next major resistance is in the 113-16/114-00 area.
- The US dollar weakness back below the historic .7820 low had been reversed a bit due to G7 focus on China, holding .7700 area as expected. Equity market weakness is bringing a bid back into the Japanese yen on a degree of ‘carry trade’ liquidation, with next interim supports at EUR/JPY 159.00 and GBP/JPY 228.00. However, major lower supports remain much lower (150 and 220), consistent with lower equities support.
- Energy markets remain strong, yet Crude Oil backed off its push above mid-upper 88.00 area resistance; rollover to discounted December contract will also weaken it.

REPORT RELEASE CORRECTION: Due to errors some of our calendars, we previously misstated important report release dates for this week. In fact, the US Existing Home Sales is Wednesday (not Thursday), and New Homes Sales will be released on Thursday.

Overview

Once again the ‘frame of reference’ is shifting, as Mr. Bernanke completes the full cycle from data driven incrementalism to market responsive active Fed stance, and now seemingly back again to incrementalism. The operative term there is ‘seemingly’, as it is still hard to separate what he is providing as strictly academic background and what represents his preference as the Chairman of the Federal Reserve. In that regard, we find it easy to understand why the equities psychology has shifted back to such weakness.

The old adage is that “the stock markets dislike nothing so much as uncertainty”, and Mr. Bernanke managed to provide chapter and verse on ‘uncertainty’ in his speech last Friday. As we will have more to say on that in the ‘Not Ready for Prime Time’ topical discussion below suffice for now to say that his brilliance is significantly canceled out by bad timing.

It was a week where shifts in market psychology were significantly influenced by a shift in the US financial authorities' communication, as a reversal from previous economic cheerleading centered on the 'maintain moderate growth' mantra had already weighed on equity markets. Friday's views from Mr. Bernanke on academic theories on the effectiveness of active central bank influence over the financial markets were not at all what the equities wanted to hear. That was also very constructive for the fixed income markets and a bit of a burden on the already suspect US dollar.

The bottom line is that while there are quite a few theories which propound more activist positions by central banks in light of the significant lead times for monetary policy to take effect, there is also a particular key theory which advocates much more restraint in any reaction to near term market turmoil or anticipated major economic changes. It has been our sentiment for some time that Mr. Bernanke has had a hard time making the change from beloved professor to potent prime mover.

His exposition on Friday seems a retreat into the review of balanced considerations of degrees of uncertainty only exacerbated the uncertainty the stock market was already having quite a bit of trouble handling due to the unknown extent of the increased housing and credit market pressures which are due to impact the US economy next year. It may have been good insight; yet, in terms of what the equity markets needed to hear, it was bad timing.

The DJIA remains the prime mover for the trend decisions elsewhere. As noted previous, this is due to its status as strong sister, substantially due to the degree to which the major US multinational corporations will benefit from the weakness of the US dollar regardless of the overall trend of the economy and equity markets. As such, the DJIA is the ultimate indication of whether the equity markets have actually failed any particular general levels of support.

Similar, if indeed in reverse perspective, is the strength of the fixed income markets. The US is rightfully leading the way up. As noted previous, the country where the housing problems are the key to weakness that will only then spill over into the balance of the world is entitled to see the strongest fixed income activity. That is currently followed by strength elsewhere, albeit the degree to which the UK also has a long term housing bubble makes it the second most likely weak economy. If any of that becomes more apparent, the Gilt and Short Sterling are likely to become more bullish, with Europe lagging due to the (possibly erroneous) assumption it will not be affected as strongly or as soon by any US weakness.

Yet, concern that US economic weakness might indeed leak into Europe more quickly than expected is affecting the euro and British pound against the US dollar, as short term interest rates in Europe may not continue to rise against falling US rates if that is the case. As we had noted previous, the 'Bernanke Put' support for the US economy and equity market was very pernicious for the US dollar, due to the degree it would (as the Fed and other US officials put it) 'forestall' the impact of the US housing weakness on the balance of the US economy.

As such, it would also slow the pace at which US weakness spreads to the balance of the global economy. If the Bernanke Fed is indeed stepping back from this highly proactive anticipatory accommodation, then it will possibly mean more weakness sooner elsewhere. The key issue is whether the Fed is indeed moving back to a more incremental approach. While the conclusion of Mr. Bernanke's speech last Friday seemed to indicate this, was it a policy directive, or just so much quickly reversible academic insight? Therein lies the rub.

Markets Summary

EQUITIES

That the **DJIA** remains the prime mover for the trend decisions elsewhere is apparent at present in the more radical selloff to its recent lows in the December S&P 500 future once it broke 1,500-45 trend support and the 1,520 Tolerance of its 1,530-25 support on Friday, in line with DJIA dropping below its 13,900-850 trend support (below the 14,000 area), as well as 13,700-650 near term support (all now resistance.) At 1,495 the December **S&P 500 future** was nearly an additional full percent lower relative to its recent 1,586.50 all-time high than the DJIA at 13,500 is below its recent 14,198.10 all-time high. As noted above, next DJIA support is into the 13,450-350 area, below which there is not much until the 13,000 area, with December S&P 500 equivalents in the 1,485 and 1,450 areas.

However, major supports are quite a bit lower, around the DJIA mid-August trading low in the 12,500 area, and even more major trend support down in the 12,000 area, with a Tolerance to the old 11,750 January 2000 all-time high. The S&P 500 future major support equivalents are into the 1,400, 1,375 and 1,350-30 areas.

The European equivalents of the near term supports are in the **DAX** at the 7,750-00 and 7,500-7,400 areas, with more major supports into the 7,000 and 6,500 areas. Similarly, recent strong sister **FTSE** has near term supports at 6,400-6,350 and 6,200-low 6,100 areas, with more major supports into the 5,800-5,750, and 5,500 areas. Weak sister **NIKKEI** was back below support in roughly the 16,700 area as well as more major support in the 16,500 area as well. Its next support is in the 16,100-15,900 area, yet with more major levels not until back in the 15,600-500 area, 15,250 and the ultimate support back in the 14,400-14,000 range last seen on the sharp downside reaction into June of last year.

LONG DATED FIXED INCOME

December **T-note** recovering quickly back above the 109-06/-00 congestion from the middle of last week when the more downbeat outlook from US officials finally took hold also pushed straight above the 110-00/-06 resistance. Along the way it Negated its previous daily up channel 109-22 DOWN Break, and that leaves the 109-23/-18 daily gap higher from last Thursday as a buffer of support back below the 110-00 area, if the market can even break that far.

The reason we are questioning its ability to do so is the reluctance of the DJIA recovery to push back above its failure below the 13,700-650 area. Based on recent trading form, unless the DJIA does indeed demonstrate some strength back above that area, it is not likely the fixed income which sees overall trouble in the equities will selloff below the pullback lows of the past couple of sessions. Conversely, if any DJIA failure to get recover above the 13,700 area leads to a failure of 13,450-350 (on the way down to at least 13,000, if not lower), then it is likely the T-note will retest the 111-12.5 trading high Tolerance of the important low 111-00 area historic congestion resistance.

That high is important on several levels. It was made by the September contract in early September while the perception was still that the equity markets were bad on the recovery in spite of the mid-August Discount Rate reduction, prior to the Fed ostensibly rescuing the equities with the sharp easing at the last FOMC meeting. As back then, the low 111-00 area is the last significant resistance this side of the more major 113-16-low 114-00 area, and its violation would allow the T-note to lead the weak sisters higher in the near term.

As such, it will be very interesting to see what the T-note does if there is indeed a DJIA failure below the low end of the 13,450-350. Does that just inspire a vigorous test of the 111-12.5 high current high of the overall T-note rally since the intermediate term June-July fixed income cycle low? Or is that all it takes to put the T-note above it in light of the fixed income having a better idea on recent form of the trouble for the US (and ultimately global) economy even when the equities have pushed to their various new highs in July and again last month?

The bottom line is that any equity market failure (DJIA either below 13,350 or not) which leads to a weekly T-note Close above the 111-12.5 level is likely to inspire further strength there, and have the T-note leadership assist the weaker sisters. Speaking of which the key technical levels in the European long ends are **Bund** lower supports at 113.50, 113.15 and 112.90-.65, and resistances at 114.00, 114.45-.55 and 115.00, above which it can gain another full point-and-a-half to two points. Similarly in the **Gilt**, lower supports at 107.50, 107.00 and 106.60-.45, and resistances at 108.00, 108.45-.60 and 108.80-109.00, above which it can gain another full point-and-a-half to two points.

SHORT MONEY

There was similar strength in the short money from the middle of last week when the more downbeat outlook from US officials finally took hold, also naturally led by the US. Even though the March **Eurodollar** was quite weak into the equity market recovery into the early part of last week, the negative comments culminating with Mr. Paulson's exposition on the housing and subprime problems last Tuesday finally turned the trend.

That left the Eurodollar on a recovery from its test of 95.25-.20 congestion back above the previously violated 95.365 pre-FOMC trading low and on a 95.40 down channel (from the early September 95.72 high) UP Break above the associated congestion resistance. It is once again near that 95.65-.72 resistance, and may well swing above it if the equities fail, and the T-note can lead the way up above the 111-12.5 high. Yet, next daily oscillator resistance is as nearby as the 95.75-.80 area, albeit with a chance to see the low 96.00 area (i.e. around the 96.025 June 2005 contract high) if the market pushes through that area.

Once again, European instruments are that much weaker due to the perception that any economic weakness will spill out from the US leading the way down. The key technical levels in the European short money are March **Short Sterling** lower supports at 94.20-.17 and the 94.05-.00 area that just held, and resistances at 95.35, 94.45 and 94.55. Similarly, albeit that much weaker for the alleged stronger economy in Europe, the March **Euribor** lower supports are a minor level at 95.65 and the more major 95.60-.55 which just held a vigorous test, with resistances at 95.78-.80 and 95.88-.92.

FOREIGN EXCHANGE

The US dollar picture remains fairly consistent with previous views, where the key question is whether there will indeed still be a US dollar debacle? In a word, "yes." However, in a phrase, "Yes, yet only in slow motion." The bottom line is 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 not an environment conducive to any interest rate differential rationale to convert to US dollars for a sustained period, and will not foster 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. Indeed, the bounce came from the .7700 area, as projected.

While getting no help from the G7 meeting this weekend not issuing a typical “joint action to stabilize disorderly markets” decree, the weakness of the US equity markets assisted the buck against Europe. That may seem a bit perverse for a currency which will suffer from the US economy leading the way down into weakness. However, the seeming watering down of the full ‘Bernanke Put’ implicit in Mr. Bernanke’s speech last Friday means that the more aggressive weakness in the US economy may spill over into Europe that much faster than if US weakness is significantly ‘forestalled’, as promised previous.

That in turn may weaken Europe enough in the near term to both weaken their economy and prevent any further tightening by the ECB or Bank of England which might have further softened the US dollar against those two. However, just to be clear, the US Dollar Index rally from an oversold condition should not be misconstrued to represent a bottom; especially at it has failed so far right back at .7800-20. That seems more a technical correction in an eroding bear market from an oversold condition than a trend reversal.

That is likely to remain the case for the overall US dollar down trend from here. Below the .7650 Tolerance of the .7700 support 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 .7800-20, .7875-.7890, .7930-50, and .8000 areas, with minor support at Monday’s minor daily UP Closing Price Reversal and Tolerance at .7740-34.

Speaking of Closing Price Reversals, quite a bit of comment has been made regarding the rather sharp DOWN CPR in the **EUR/USD** on Monday from the 1.4300 area. However, even though that was a rather impressive looking ‘outside day’ with a somewhat significant lower Close, and is reinforced to a modest degree by the US Dollar Index UP CPR, it was not evident in any other currencies except the euro. That makes it fairly suspect as a *bona fide* indication of a bottom in the buck. Next lower support is back in the 1.4000-1.3900 area, and unless that is violated timely, it is more likely that the US dollar will come back under pressure for another new low (albeit remain choppy overall.)

The one currency which has seen a rather more extensive response is, not surprisingly, the **Japanese yen**. Yet, the major trend decisive relationship is not with the co-weak sister US dollar so much as the more active carry trade relationships elsewhere. **USD/JPY** has had trouble so far failing even the obvious support back in the 113.50-112.50 area (with a Tolerance to the 112.00 area.) Nominal resistances are back into the technical levels at 115.00, 117.50-118.00, and the more major resistance in the 120.00 area. One of the key problems for the USD/JPY bears is that the yen remains the co-weak sister to the US dollar. The overall weakness of Japan’s economy and their recent lapse back into political malaise does not leave much room to imagine Japan will prosper enough to markedly strengthen the yen against the US dollar, much less against the stronger cross-rate currencies in a global slowdown, even though they may sag during equity market weakness.

That is why we noted in the Key Views that equity market weakness is bringing a bid back into the Japanese yen on a degree of 'carry trade' liquidation. However, the somewhat weaker euro along with the British pound have not even dropped to their next interim supports against the yen at EUR/JPY 159.00 and GBP/JPY 228.00. Even if those are violated, the major lower supports remain much lower, in the EUR/JPY 150.00 area and GBP/JPY 220.00 area, even though they will have broken their major up channel supports (from the late 2003 consolidation pullback lows in each case) somewhat above those (*de facto* Tolerance) levels; those lower levels also remain major Fibonacci 0.50 retracement supports.

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. The weekly oscillator pointed to the 80.00 area that the market has now shot back above, with next resistances in the 83.00-.50 area that has also been exceeded (now support.) Much above that there were some weekly topping lines into the 85.50 area (up from the mid-83.00s a month ago.)

Yet our next major resistance is not until the August 2005-July 2006 topping line that projects to the mid-upper 88.00s, which is just where the lead contract November stalled last week prior to this week's rollover to the somewhat discounted December contract. While that may have seemed a bit aggressive, above the 83.00-50 area the lead contract was escaping the intermediate term weekly oscillator resistance. Yet, the December contract has indeed stalled there, and the upward drift of the topping line means that resistance is now up in the 89.00 area.

Reports & Events

In case you did not see the notice on page one, we have corrected previous misimpressions that the US Existing Home Sales and New Homes Sales will both be released Thursday. That is only true for New Homes Sales (SEP), which will be preceded by the release of New Homes Sales (also SEP) data on Wednesday. We apologize for any confusion arising from errors in the reporting calendars which we reference, and have now confirmed the New Homes Sales release schedule on the US National Association of Realtors' official calendar.

While we assume everybody appreciates definitive reporting dates, German Consumer Price Index (OCT Preliminary) seems forever destined to be released in stages. This month that means from late this week into early next. Of course, even though the inflation data has not been all that trend decisive of late, it still bears watching.

While it is a comparatively light reporting week, what is provided might be very trend decisive due to the influence of US housing figures and financial luminaries' comments. In both their volume and scheduled topics, the exposition from all manner of global finance officials sustains the "Onslaught of the Talking Heads." (Oh Joy.)

While there has been some interesting input from financial luminaries early this week, it has been a fairly uneventful economic release period heading into the more important reports from tomorrow onward. Yesterday only brought the Australian Producer Price Index (Q3), and Japanese Supermarket and Store Sales (SEP).

After that the Fed's Kroszner spoke on financial markets in Washington, as did the Bank of France's Landau at a conference in New York, and later the ECB's Trichet gave brief remarks on the 40th anniversary of Institutional Investor in New York, followed by new Chicago Fed President Charles Evans reinforcing the downbeat economic outlook in the evening.

Today was also a light reporting day, with strongish French Consumer Spending (SEP) and Italian Consumer Confidence (OCT) and Retail Sales (AUG), being offset by the much weaker than expected Euro-zone Industrial New Orders (AUG) and UK CBI Quarterly Industrial Trends (OCT.) Then there was an interesting exposition by the Bank of England's MPC member Kate Barker on the influence of the world economy on UK monetary policy, especially as it relates to heightened housing risk in the UK's own heavily appreciated market. Yet, there was no immediate indication other than heightened downside economic risks that had not actually been triggered as yet. That was followed by ECB Council Member Liikanen speaking in Helsinki, and only the Richmond Fed Manufacturing Index (OCT) in the US, with the typical late day release of ABC Consumer Confidence (for the week ending OCT 21.)

Wednesday commences with Japan's Merchandise Trade Balance (SEP) and Australian DEWR Skilled Vacancies (OCT) and their extensive quarterly Consumer Price Indices (Q3) that include the RBA Trimmed Mean and Weighted Median Mean figures. That is followed by the ECB's Gonzalez-Paramo and Spain's Vegara speaking at a conference, Italian Business Confidence (OCT) and Trade Balance (SEP), along with Euro-zone Current Account (AUG) and their PMI Manufacturing, PMI Services, and PMI Composite (OCT Advance). In the US it's the next weekly MBA Mortgage Applications (for the week ending OCT 19) and those important Existing Home Sales (SEP), followed by the ECB's Trichet and Garganas speaking in Frankfurt at the Cultural Days of the ECB (whatever they may be.)

All of which is followed by the doves' favorite Fed Governor, Frederick Mishkin speaking in New York on (of all things) "*Financial Instability and the Federal Reserve as a Provider of Liquidity.*" Now that ought to be interesting. Yet, as with so much else of the potentially critical communications from financial luminaries this week, it is provided after the markets close; in this instance, fifteen minutes after the closing bell at the New York Stock Exchange. Are they trying to foster volatility? Later on in the evening, the ECB's Mario Draghi attends a meeting in Milan

Thursday begins with the Japanese Ministry of Finance Foreign Net Stock and Bond Investment (for the week ending OCT 19) and Corp Service Price Index (SEP) with quite a bit of data from Europe to follow, including the German Import Price Index (SEP), various French sentiment indicators from the Business Confidence Indicator to Production Outlook Indicator and Own-Company Production Outlook (OCT), and Italian Services Survey and Retailers' General Confidence (both OCT) along with their Hourly Wages (SEP), followed by German IFO Composite Business Climate including the Expectations and Current Assessment (OCT), and the UK BBA Loans for House Purchase (SEP), and the BoE's Financial stability report with Chancellor Darling at the Treasury Committee.

In the US it's the always wonderfully erratic Durable Goods Orders, Initial Jobless Claims (for the week ending OCT 20), the sometimes suspicious New Home Sales (SEP) and Help Wanted Index (also SEP), along with the Fed's Consumer Advisory Council discussion of mortgage rules.

Friday is another light reporting day, with only the Tokyo CPI (OCT) and Japanese National CPI (SEP) and Industrial Production (SEP Preliminary), Australian Conference Board Leading Index (AUG), German GfK Consumer Confidence (NOV) and Euro-zone M3 (SEP) scheduled prior to the US University of Michigan Consumer Sentiment Index (OCT Final.) Of course, there is a possibility we will also see those German CPI numbers (OCT Preliminary) by then as well, for whatever that is worth.

'Neutron Bomb' Lessons

In last week's 'Sleight of Hand' discussion we had already noted the degree to which there might be some deft adjustment of values likely in the workings of the M-LEC. Subsequent calls for a high degree of transparency should not really represent a problem, as the fund is indeed set up to deal with the highest rated of the debt derivative components locked up in instruments which include some less desirable securities.

However, even allowing for a bit of legerdemain, the extensive negative attitude directed at the M-LEC effort by savvy observers is a bit surprising. There has been consistent immediate comparison is to the late 19980's US Resolution Trust Corporation's successful liquidation of undesirable property. Everyone from Private Citizen Greenspan to the other banks not included initially in the project to the financial press has criticized the plan. Much of that has revolved around a key issue we suggested in our citation last week of the balanced view from the Financial Times' Gillian Tett, "The RTC helped to solve the S&L mess because it auctioned off the assets it acquired - initially at ultra-low prices - believing that the US needed to create a true "clearing price" of S&L assets in order to rebuild market confidence." (Full column attached once again for your ease of review.)

Yet the causes, crisis phase, market participants and nature of the underlying assets are wholly different. And applying that model to current credit market problems does not guarantee a constructive outcome. Comparative assessment highlights the inconsistencies between this phase of the credit crunch and the RTC effort. The bottom line is that RTC was the endgame of a multiphase devolution. I was in a related business at the time, and watched it all unfold.

The crises are in fact similar in the overvaluation of assets. In the case of the late 1980's it was excessive US property valuations created by tax sheltered investments. The US Tax Reform Act (TRA) of 1986 eliminated all real estate tax shelter benefits for new and even existing property investment vehicles. That stopped cold any new real estate purchases by investors who already had more than enough in their portfolios. The fallout was a rapid drop in prices of both commercial and multi-unit residential properties. That may not seem unreasonable for a market which had been overvalued for years.

Yet, as most tax shelter vehicles were structured with a minimum of equity, it wiped out many of the vehicles' equity, and brought pressure onto their extensive debt funding. That was due to debt holders substantially being S&L's and other institutions required to liquidate loans based upon failed underlying assets. The reason only two actual crooks were prosecuted for the 1980's S&L crisis is that the US Congress's poorly thought 1986 TRA was the actual trigger for liquidation of assets to which the S&L's were exposed. Sardonic financial services wags quipped it was a 'Neutron Bomb Real Estate Market': the buildings still stood, but all the investors got killed.

However, after initial sharp markdowns, 'vultures' were able to find bargains among high quality properties into 1998-1999. Those properties were the equivalent of the AAA and AA debt which M-LEC is offering to restructure in its attempt to 're-liquefy' the market for the most attractive parts of blended debt instruments. Just as there was a rump of undesirable properties back in the late 1980's, nobody is suggesting M-LEC is a panacea for all debt derivatives. Yet, another difference is almost anybody can participate in real estate auctions in a way that is not likely for complex debt.

That said, there are indeed questions regarding M-LEC. The functional issues are compounded by the question of whether funding is sufficient. Key technical details still need to be worked out among the participants, who are thankfully not requesting a handout from public coffers (which RTC did in a major way.) If more funding is required, then at least a mechanism will be in place.

There is also the rightful concern articulated by the FT's Ms. Tett, "...that some banks apparently want to avoid asset sales because they fear they would depress prices and hurt balance sheets." Yet, real world implications for a bargain basement blowout auction of complex blended debt instruments are significantly unknown. While 'clean slate' solutions sound attractive, the banks may be prudent to temper the process with a bit of legerdemain. If the radical cure is a trigger for more aggressive than expected balance sheet contraction, it may prove worse than the disease. An anonymous source at the Federal Reserve now seems to have (belatedly) reinforced that view (see attached CNBC.com Reuters citation.)

Even Mr. Paulson's multi-day meetings with top bankers did not yield a definitive approach to valuing the complex instruments. That should be respected, especially in light of the looming Basel-II banking regulations' risk-adjusted capital requirements. This remains the early phase of a crisis that is likely to worsen. M-LEC is an enlightened effort to deal with addressable aspects rather than wait for them to be subsumed into the more daunting phase *ad hoc*.

As Mr. Bernanke just noted, uncertainty requires a measured response. That applies to separating the fungible portions of derivatives from the detritus of toxic subprime debt that is most likely to fail. The other major difference with the RTC is the underlying assets in that case were real property with a reasonable residual value. The residual value of a goodly portion of failed subprime debt is... ..(effectively) zero.

That may sound a bit alarmist. Yet, in addition to the worthless nature of failed company debt, anyone who doubts the likelihood of extensive weakness in resale values for the least desirable repossessed properties in overbuilt regions should refer to the attached Wall Street Journal article on tighter lending standards for housing in the weakest markets. That will most probably further reduce any value that can be retrieved from repossessed homes, and the debt securities created from their mortgages.

It may be more probable than currently acknowledged that we may well get another RTC to clear the real estate overhang; but this time it will be moreso residential than commercial. Regular contributing columnist John Dizard nicely sums up the *real politik* of the situation in today's Financial Times' Wealth page when he notes, "Profits will be privatised, and losses socialised, just like they were in the last cycle."

Indeed, everyone now referring to it as a very good pricing model forgets what a very deep drawdown from the public purse was necessary to fund Resolution Trust Corporation. That is all the more reason to allow the banks some time to sort this out as best they can while avoiding unnecessary balance sheet pressure. We should not risk a 'Neutron Bomb Banking Sector' where the property is left standing, but all the banks get killed.

Ready for Prime (Mover) Time?

We have spent quite a bit of time reviewing the manner in which the changes in attitude by central bankers and other government financial officials have been swiftly shifting the overall 'frame of reference' for financial markets. Generally speaking this is not the optimal manner for them to inspire confidence in the economy, and that relates to their credibility as well as producing confused notions of what the public and business community can expect.

One area we stressed in the major review of the overall context of the 'Frame of Reference' topical discussion from a couple of weeks ago was the subtopic of 'Media and the Markets' regarding how the evolved media environment made it tougher for central bankers to manage situations calmly. It seems they need to respond more actively in the fully evolved and extensively public media environment.

Yet, one other aspect of media which often comes to mind is the assessment in traditional broadcast circles of whether a particular act is ready to be aired in front of the most important audience in the early evening hours. The ones that were considered even a bit deficient for that major advertising revenue space are deemed, "Not ready for prime time." In light of his speech last Friday, we wonder whether Mr. Bernanke is indeed 'ready for prime time' in the wake of an exposition which was very weak and vacillating right at a moment when the equity markets needed some psychological support in the wake of the US financial authorities' very downbeat assessment of the housing impact on the balance of the economy early last week (abetted by Private Citizen Greenspan.)

Let us say first that we have quite a bit of sympathy for Mr. Bernanke in his attempt to make the transition from academia to the pinnacle of US financial leadership. As we have noted many times previous, he seems to be struggling with the shift from beloved professor to potent prime mover. That first surfaced in his overly open and premature discussion of the Fed's potential to pause in their tightening cycle in May 2006, and was (in our view) extremely apparent in his lack of leadership to return to tightening to head off the excessive exuberance that would ensue from the new all-time high in the DJIA a year ago.

While nobody can know for certain, we still feel that pulling the punchbowl back then would have left a bit less of a hangover from the credit market bash than the terrible straights the economy and financial markets appear to be entering at present. The ability of the rest of the world to believe that the US consumer would be there to buy their output, and the (since refuted) consideration by financiers that the cheap credit would continue to flow forever might have been mitigated by an early signal from the Fed that excesses would not be tolerated even if equity market valuations were not excessive.

A bit more risk of criticism back then might have saved everyone quite a bit of pain now, for which Mr. Bernanke will take the blame from many quarters. Of course, it did not help that Mr. Greenspan had become a beloved figure by the time he retired. That is another factor which likely diminished further any natural aversion Mr. Bernanke had to attracting criticism.

And none of that is to diminish our respect for Mr. Bernanke's academic brilliance. We have quite a bit of respect for the insights and humor of the man who actually said that if necessary the Fed should go up in helicopters and throw dollar bills into the street if necessary to prevent an economic meltdown. However, while his observations retain all of their excellent research qualities, it seems he is plagued by a lack of understanding of how his remarks and major expositions are received by the markets.

Friday's speech was a case in point. Yet, before we get to a brief specific review of its content it is important to consider the way in which it completes a full cycle of shifts in the frame of reference that has been promulgated by the US financial authorities. Back in early August the FOMC statement accompanying their 'no change' on interest rates seemed to reinforce the degree to which the Fed remained committed to inflation sensitive, data driven incrementalism. In other words, there would be no sharp responses yet to the possible surfacing of greater housing and subprime problems.

Of course, that policy was shaken when the lack of liquidity in the interbank market left banks refusing to lend to each other due to the fears of portfolio problems. That led to the Fed's inter-meeting reduction in their Discount Rate and major adjustment in Discount Window operations (allowing for more extensive loan periods) that reversed previous incrementalism barely a week after the August FOMC meeting. A major reversal of policy that was necessary to prevent an equity market meltdown after the DJIA had dropped from the 13,500 area to a low near 12,500 in a mere six trading sessions.

While this seemed a more proactive Fed, nobody knew just yet how far that would go, and the focus rightfully shifted to the mid-September FOMC decision and statement. In the event, the FOMC not only cut the Federal Funds Target Rate a more aggressive than expected 50 basis points (to 4.75 percent), the statement made a commitment to "...maintain moderate growth." In light of the problems in both housing and the subprime securities markets, that was quite a shift, and portended continued aggressive anticipatory accommodation from the Fed.

Yet, the US dollar weakened markedly, and even in the current benign environment the Fed (and the fixed income markets) had some concerns about inflation. The 'Bernanke Put' which that cut and language seemingly implemented also raised concerns about the further erosion of the US dollar. That would occur if the Fed was indeed successful in its attempt to 'forestall' (as they and others continued to state in the following weeks) the impact of that US housing weakness, as it would also delay spillover into the balance of the world economy. As such, it encouraged visions of a Fed that would be forced to ease, while the ECB either would not, or might indeed still raise rates if the European economy remained strong.

However, at the beginning of last week US authorities became far more negative regarding the effect of housing problems for the balance of the economy. While we considered this a confirmation of what we had been saying would be the case across time into early next year, their timing was a bit of a surprise. Then, as they say, it all came out: specifically the Fed's Beige Book that was still projecting growth, yet very much weaker than previous.

It was obvious that Mr. Bernanke and Mr. Paulson and company did not want to appear out of touch with such a weak view of the US economy that they had attempted to assure folks previous they could encourage to maintain moderate growth. Even that might have been a less than daunting problem for the equity markets insofar as it encouraged a view that they were preparing the financial community for a further easing of any dimension necessary to offset the combined housing and subprime burden on the economy. It was not surprising that the fixed income markets continued to rally in spite of only modest further equity market slippage last Wednesday in the wake of Beige Book.

While we have already allowed that the equity market selloff and fixed income strength last Friday was due in good measure to concerns about weak earnings, there seems to also have been that additional shift in the 'frame of reference', and that was due to the content of the speech by Mr. Bernanke. While seemingly regarding important academic research, it also contained some aspects which are counter to the 'Bernanke Put' psychology previously supporting the equity markets.

In the first instance, the very title of the speech and overall thrust of the content were not reassuring for the equities. Considering that the market was already technically burdened with weakness from early week through Thursday, and was back below DJIA 13,750 support from early morning weak corporate earnings and guidance releases, it didn't need any further negative influences after the early week expositions from the US financial authorities.

And the title of Mr. Bernanke's speech? "Monetary Policy under Uncertainty." Great. However, the content is even more interesting, and we have attached it for your direct review. It is very thorough and interesting comparative analysis of a whole range of differing theories and broad historic experience of the effectiveness of central bank policy, especially whether activist or more passive approaches work best. Our warning is that it is very complex in its discussion of extensive theories that call for some further exploration by all but the most academically aware on theories of modern finance.

That said, there is quite a bit that can be inferred from the context of the discussion of those wide ranging theories and practical experience. There are two key points which stand out. The first is that the Chairman of the Federal Reserve Bank of the United States of America is actually explaining that the job is very hard because the data is so unreliable. Well, as the old adage is that "the stock markets dislike nothing so much as uncertainty", and Mr. Bernanke managed to provide chapter and verse on 'uncertainty' in his speech last Friday, is there much doubt he threw the equities an anchor after early session weakness at new lows for the week where they had been down all week. It makes one wonder.

On other levels the speech was even more disturbing. The analysis of the unreliability of the data did not just relate to the current era, and was indeed interesting in its discussion of how this is an ongoing problem. Yet, one could not shake the sense that this was in some ways an attempt to explain away the degree to which the 50 basis point easing by the FOMC may have been a misstep in light of the major upward revision to the US Non-farm Payrolls data released in early October. (That was after the Fed was operating under the influence of the erroneously weak data that was released in early September, prior to the mid-month FOMC meeting.) That would amount to the Fed Chairman attempting to make excuses for what many perceived as overly aggressive action. It is the equivalent of a comedian attempting to explain the punchline of a joke; neither gains any credibility from the effort.

However, the most disconcerting part of the Chairman's exposition related to some of the theories he discussed, and especially the conclusion of the speech that seemed to imply that one of them now had his support. As we questioned in the Overview, was it a policy directive, or just so much quickly reversible academic insight? A review of some of the specifics is in order, and we will leave any extensive review of the speech to you.

The specific theory he alludes to approximately halfway through (lower half of page two) is that of the estimable Bill Brainard's 1967 paper (which Mr. Bernanke describes as elegant.) The overall thrust of Brainard's analysis is that "...uncertainty about the effect of policy on the economy may imply that policy should respond more cautiously to shocks than would be the case if this uncertainty did not exist. Brainard's analysis has often been cited as providing a theoretical basis for the gradual adjustment of policy rates of most central banks."

That's certainly a very nice bit of insight, and Mr. Bernanke's provided both previous and subsequent exposition on other theories that run counter to this position; in other words, they articulate many reasons why the central banks must, at times, be much more proactive in their approach. In fact, mention in the speech of those more proactive approaches were the grounds since last Friday for the strength of the short money forwards. So, if he noted quite a few theories advocating active responses from central banks to near term influences, why did the equity market not respond more constructively to his speech?

That likely has much to do with the conclusion of all of this extensive academic background. In the final paragraph, indeed in the penultimate sentence prior to a final mention of the need for humility in applying his craft, he said, "...the public economic sentiment formation based upon central bank announcements and actions) provides a reason for the central bank to strive for predictability and transparency, avoid overreacting to current economic information, and recognize the challenges of making real-time assessments of the sustainable level of real economic activity and employment."

That "...avoid overreacting to current economic information,..." would seem to disallow the radically aggressive anticipatory accommodation which had been implicit in the Fed's previous commitment to "maintain moderate growth." The cumulative response of the equity markets by later in the day was about the same as our own: "*Whhhatt??!*"

That was about the last thing the equity market had wanted to hear after the authorities' early week dissertations on just how bad housing and subprime were going to be, likely spilling over into an influence on the balance of the US (and likely global) economy. While it was a brilliantly concise and highly informative academic view, Mr. Bernanke's speech was also another of the recent *ad hoc* shifts in the frame of reference that the equity markets and investing classes do not particularly like.

We can not say we blame them. Last week's communications from the 'powers that be' brings forward the problems which we felt were going to be daunting into next year, while reducing the degree of anticipatory accommodation that the Fed is going to provide. Which is not to say the Fed is not in an accommodative mood; we thoroughly expect they will provide another 25 basis point easing at the FOMC meeting next week, and possibly more if the equity market gets into trouble (i.e. DJIA dropping below 13,000 once again.) Yet, it speaks of a return to an incremental form of accommodation from what had been assumed after the sharp September FOMC easing to be a much more aggressive mode of accommodation.

Yet, as we have noted previous with Mr. Bernanke, his commitment to transparency was likely an exercise in futility at a juncture in the economic and interest rate cycle where it was just not going to be as effective as in the preceding clearly restrictive period. It has led to serial shifts in the frame of reference which are more pernicious than positive, as he continues to speak plainly (as he promised), yet vacillates between perceptive professor and anything resembling a potent prime mover.

On current form, he is as yet 'not ready for prime (mover) time.' Unless he can cure his penchant for delivering academically accurate assessments at times where the economic and market environment means they will not be well-received, he might end up the worst Fed Chairman since G. William Miller (the ineffectual Carter era Fed head) in spite of his prodigious intellectual prowess.

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

-Rohr

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