Rohr Report

Capital Markets Observer

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Overview, Markets Summary,…
…Uncertainty, Anchoring, Balance(?), A Streetcar Named Defunded

Key Views

- **As noted in Monday's *Weekly Preview*, there are several Fed heads speaking today, and the Richmond Fed's Jeffrey Lacker has already opined on *The Role of Central Banks in Credit Markets*. Yet, that proved to be more of a justification of the Fed's provision of liquidity and most recent FOMC easing; and that's from one of the hawks. No wonder the US dollar continues to suffer, also under the influence of Chinese comments today. Yet, all of that is still prior to the weightier BoE and ECB rate decisions tomorrow, quickly followed by Mr. Bernanke's Joint Economic Committee testimony.**

- **All technical indications and trend views remain much the same as last Friday's *TrendView* GENERAL UPDATE, and we refer you back to that for further trend views and technical levels. Other than the US dollar continuing its slide, the other market groups continue to set up for the more important influences later this week in spite of interesting economic releases. Those included strong US Productivity (Q3 Prelim.) that has not assisted equities much in the face of further financial services worries.**

- **After a very minor stall, the US Dollar Index slipped more decisively below significant intermediate term channel and oscillator support in the .7650 area, including the .7600 area Tolerance of that support. As noted previous, that opens the door to a more rapid erosion than we expected previous to the broader weekly channel (overall from the major November 2005 high) return line support in the low .7400 area (reinforced by weekly oscillator projections.) EUR/USD pushing up through its own historic price and weekly oscillator resistance in the 1.4535-1.4600 area also opens the door to extension up to at least 1.4800 or even the 1.5000 area, with commensurate levels elsewhere.**

- **DJIA is churning between 13,700-13,650 congestion and high end of lower supports in the 13,500-350 range. December S&P 500 is 1,530-25 area versus 1,495 and 1,485.**

- **T-notes back off from 111-12.5 critical intermediate term resistance, and may actually drop back to low 110-00/upper 109-00 support if the DJIA can squeeze up further. Europe is a bit firmer, but just narrowing the differential with strong sister T-note.**

- **December Crude Oil was clear cut from the middle of last week, up sharply from a test of violated 89.00 resistance (support.) The violation of the 95.00 area as well leaves that as loose support (with a Tolerance to the 93.50 gap.) Next resistance is 100.00!!**

Overview

With the FOMC meeting and subsequent financial services industry concerns prices into the equities and fixed income, the strong economic news assisting the equities late last week have left those areas stabilized from early this week. The next event horizons are additional Fed-speak later today, yet even moreso important decisions and pronouncements from various quarters at the Bank of England, ECB and Federal Reserve tomorrow. As noted previous, whatever transpires there will also need to allow for the influence of the OECD Composite Leading Indicators (SEP) tomorrow. That is some of the only important data other than the US Trade Balance and Import Price Index (OCT) prior to the early holiday Close in the fixed income and foreign exchange markets in deference to Monday's US Veteran's Day holiday (with trading in those same markets closed on Monday as well.)

Yet, the recent themes of central bank communication have reinforced the degree to which the 'frame of reference' remains more important than ever in assessing the market responses to economic releases and official pronouncements. As such, other than exploring the changes to the complexion of the US dollar from an eroding bear into a more aggressive down trend, various observations on the market and analytic 'frame of reference' is the major theme of our topical discussion once again.

If there is one thing for certain, it is that the gods of finance at the pinnacle of the economic data Mount Olympus have now admitted that the degree of uncertainty they deal with is greater than many among the public and even financial services community have been willing to allow. As we have been among the most vocal critics of the degree to which central bank transparency had reached a point of moving from inscrutable to insufferable, we feel a bit vindicated in that.

However, the more important point is what to do about it. In essence, that answer is the old market adage, "Mind your knitting." When markets seem to have no respect for the news, or the news is shifting so fast as to make fundamental analysis even more of a tea leaf reading exercise than usual, 'mind your knitting' relates to understanding key technical junctures and what they mean. Whether that leaves one respecting their lowest form of 'self-fulfilling prophecy', or their highest form of studies in psychology and energy (although we allow that falls short of real science), the only practical approach to risk management is to have some relevant price levels at which to anticipate certain types of trend performance.

Whether the markets indeed perform as expected, of fail to reinforce ones anticipation of trend activity all still holds further lessons on what to expect next. Which is quite a bit more than can be said at present for a purely fundamental analysis that of necessity needs to incorporate some of the somewhat better than expected current US economic news, yet also be sensitive to the more daunting potentials for weight on the economy well into next year. That is of course a rapidly shifting influence in the real world; all but the most committed bulls and bears with very deep wells of capital need to respect near term activity; and that seems subject to the influence of even minor shifts in the influences, as we review in our discussion of the FOMC use of a particular term in 'Balance(?)', and its possible impact on the buck.

Other than that, we leave the rest to the discussion of individual markets that have seen the stabilization of the equities in spite of the continued fears of further bad news (the rest of the proverbial skeletons in the subprime closet.) That has left fixed income still mostly buoyant, yet needing to see further stock market failure prior to another sharp move up such as the recovery from the break last week. It also leaves the poor US dollar still crippled.

Markets Summary

EQUITIES

That the **DJIA** remains the prime mover for the trend decisions elsewhere is still apparent at present in its capitulation late last week on the terrible news continuing to be visited on the markets by US housing and securities firm announcements. The key will rest with whether the equities continue to weaken after below supports. If DJIA not only remains below the interim 13,700-650 already violated last week, but also fails the lower 13,500 and especially critical 13,350 supports, it will drag the rest down with it. The lower level is crucial due to it being the Tolerance of July –September congestion, below which DJIA is likely on the way back down to at least 13,000. Higher resistance remains in the 13,900 and low 14,000 areas.

As noted previous, what is very interesting is the way in which trend indications are evolving, as their more active swings had left the DJIA, **DAX** and **NIKKEI** weekly MACD's slipping into very negative territory on the early August break. While the **S&P 500** and **FTSE** did likewise, their weekly MACD's had turned back UP on the recent recovery, while the others struggled back at roughly in balance. All of which added emphasis to the need for the more telling markets to sustain their friendly response to the FOMC decision, which they did not.

What is even more telling for how that integrates with short term trend indications is that all of the daily MACD's turned DOWN right into the mid-October selloff. They had all based out, and were back in balance into the later part of last week. However, that means any sustained near term weakness is essentially failure of those trend indications to turn UP through their resistances, remaining DOWN. Even the extreme strong sister **NASDAQ 100** future failed to turn its daily MACD on its recent push to a new high, and it remains DOWN.

LONG DATED FIXED INCOME

December **T-note** recovering quickly back above the 109-06/-00 congestion also pushed straight above the 110-00/-06 resistance, and had been having a hard time slipping back down for a retest in spite of some recent bouts of equity market strength. Yet, in the wake of the temporary equity market post-FOMC strength (as well as their tacit mention of inflation) last week, it did manage to slip to just about its Negated its previous daily up channel 109-22 DOWN Break. In fact, even in electronic overnight trade it only made it down to the top of the 109-23/-18 daily gap higher buffer of support back below the 110-00 area.

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 similarly recovered 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 is just not much to say about the short money forwards except that they are subject to all of the same forward looking economic implications of the US equity market activity as the long ends. The relative trend strength differentials, their ability to hold their respective lower supports and recover so sharply, and likelihood that will continue if the equities continue to weaken are all very much the same as the long dated fixed income.

The March **Eurodollar** recovery from its test of 95.25-.20 congestion back above the previously violated 95.365 pre-FOMC trading low left a 95.40 down channel (from the early September 95.72 high) UP Break above the associated congestion resistance; yet its holding 96.50 last week leaves that as more near term support as well. It has once again failed from around 95.65-.72 resistance. Yet, its overall strength tends to reinforce our view that the fixed income still thinks any equities' recovery is misguided in the face of the likely pressures on the US economy next year.

If the equities fail, and the T-note can lead the way up above the 111-12.5 high, next March **Eurodollar** 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. As such, anytime the equities are firm it also maintains instincts that the lack of near term spillover from US economic weakness may allow European central banks to remain (rightfully) more hawkish. The key technical levels in the European short money are March **Short Sterling** supports at the 94.20-.17 range the market has just recovered back into from lower, and the 94.05-.00 area that held two weeks ago. Resistances remain 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 the major 95.60-.55 area which it is having trouble rallying from due to the continued hawkishness of the ECB. Lower supports are 95.42-.40 and the low 95.30's. Resistances remain at the minor 95.65 level, and at 95.78-.80 and 95.88-.92.

FOREIGN EXCHANGE

The US dollar picture has evolved from previous views, as additional pressure from everything from strongish Euro-zone economic indications to the pronouncements from the Chinese that they may be becoming less partial to the US dollar. While we have been committed to the idea that there would indeed be a US dollar debacle, we expected it might occur in slow motion. The current **US Dollar Index** failure below the .7650 bottom (return line) of its interim weekly channel and the .7600 Tolerance of that significant indication point to a greater likelihood of a move to the .7400 area sooner than not, unless the buck can recover markedly back above .7650 in the near term. Extended supports remain in the .7100 area and again at .6900.

EUR/USD recovery from its attempted DOWN CPR last week Monday has acted as we suspected in returning to and overrunning the 1.4300 area in short order. Violation of the 1.4300 area resistance has now left the market up through its historic 1995 all-time high for the 'synthetic' basket of the euro's component currencies. The inferred level of that major high is 1.4535. That is an approximation, as nobody can no for certain if the 'synthetic' history of the trade weighted 'basket' indicates where a true trade would have occurred.

Yet, it's a pretty fair estimate, and works very well with the now violated US Dollar Index projected .7650-00 area support, as the EUR/USD also ran into major weekly oscillator resistance by the 1.4600 area that has now been exceeded, likely on the way to either 1.4800 or even 1.5000 in the near term.

The one currency which quite a few folks have been looking at once again for a rather more extensive response to any equity market weakness, and been very disappointed along the way is the **Japanese yen**. Along with the US dollar shifting into the leading secular bear trend, the situation in Japan reverting to economic weakness and political malaise has not done anything to assist the "Carry 'Tirade' Crisis Cassandra's." Those are the folks looking for an upside explosion in the yen as a forced endgame of speculative 'carry trade' borrowing, that would also cause a asset market implosion. (Kind of like Chicken Little on steroids.)

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), which is being tested again at present. 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. However, the somewhat weaker euro along with the British pound did not even drop fully to their next interim supports against the yen on the recent selloff.

EUR/JPY 159.00 and **GBP/JPY** 228.00 probably should have been tested on interim selloff in the equities on US housing weakness warnings from two weeks ago into last week. Yet, it just did not happen. Even if those were 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.

EUR/JPY is back above interim congestion at 165.00-164.00, albeit stalling into its higher resistance at 167.50, with extended resistances at 169.00 and even any new highs into the 172.00 (oscillator and weekly topping line) area. Somewhat weaker sister GBP/JPY is back above heavy interim congestion at 230.00, as well as higher interim resistance at 235.00, with heavy additional resistance at 240-241 holding it back do far prior to extended resistances at 245, and the 249-250 area.

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. It is almost incredible that less than a month ago the weekly oscillator pointed to the 80.00 area (with a Tolerance to 79.00) as support. There were then serial violations of resistances in the 83.00-.50 area, as well as weekly topping lines into the 85.50 area, and ultimately the next major resistance August 2005-July 2006 topping line at 89.00.

While all that may have seemed a bit aggressive, above the 83.00-50 area the lead contract (now December) was escaping intermediate weekly oscillator resistance that foreshadowed push to the 89.00 area. Above that the weekly oscillator was actually out to a new all-time high, and projected that level as fresh (if highly extended support.) Of course, that indication was vindicated in overnight trade into Wednesday of last week, when the market held the pullback to that area, and pushed up to the 95.00 area later in the day. As noted previous, we can only rely on the psychological 'five dollar' rule that implies resistance at major five dollar increments for this market. Now above 95.00, the 100.00 area is indeed next.

Uncertainty

Recent Central Bank views of uncertainty have been most interesting. We have already reviewed Mr. Bernanke's conclusion of his *Monetary Policy under Uncertainty* speech that for the most part central bankers should strive to "…avoid overreacting to current economic information,…" (substantially the Brainardian approach.) He has substantially fulfilled that indication with last week's more modest easing by the FOMC, as well as their more balanced statement. For now, those factors seem to have assisted with removing some uncertainty and instability from the markets.

Yet, it must be said that Mr. Bernanke's exposition in his speech was every bit the deep and vast theoretical academic survey of research on central bank theory. It was nothing less than panoramic in its survey of the subtle differences between the highly different perspectives of well-established academic research. That is not to diminish its insights; it was just rather complex and extensive.

By comparison, last Wednesday's speech by Bank of England Executive Director and Chief Economist Charles Bean was more of a practical review. It covered both factors attendant to central bank decision making in general, as well as how the current financial turmoil had affected perceptions on how to respond under uncertainty. It was a shame that it was somewhat overshadowed by the FOMC decision and statement last Wednesday, as it was a most definitive yet completely understandable discourse. The Old Lady of Threadneedle Street has been at this a lot longer than her cohorts, and in some ways that shows up in her ability to express herself plainly on sophisticated issues.

What was most compelling was his discussion of some of the more progressive steps the BoE's analysts were taking to address the relative levels of uncertainty; and not just on the current or forecast estimates of various economic indications. They were also applying it to the previously released data, with more latitude for revision applied to the most recently released indications. This is the focus of the discussion on pages three through five, with some interesting graphical representations on page ten of the speech text (which has been attached for our ease of review, along with Mr. Bernanke's speech as a point of comparison.)

We do not really have much to add to those two speeches from such august sources. Yet we would be remiss if we did not highlight our favorite part of Executive Director Bean's speech: the opening where he quotes none other than the acerbic Donald Rumsfeld's various observations on 'unknowns.' While he acknowledges that for this extended observation "…Rumsfeld was awarded the 'Foot in Mouth' award…" he also points out that dealing with 'known unknowns' and 'unknown unknowns' "…represents one of the pithier encapsulations of the economists' distinction between risk and uncertainty of which I am aware."

Good for him. Whatever Rummy may have not had right in his approach to either the overall US Defense Department management or the War in Iraq, he is a highly intelligent individual. As we have also tended to use that description of uncertainties in our assessment of the contingencies facing capital markets participants, it is good to know we are in such good company as the Bank of England's Chief Economist.

One of his most telling observations on the 'known unknowns' is from the later portion of the speech that focuses on the possibilities for the devolution of the subprime problems. To wit, "…if banks are forced to take loans back onto their balance sheets from conduits, then their capital ratios will, other things equal, deteriorate."

He goes on to say that "…banks may be unwilling to tolerate that much erosion of their capital buffers because of the impact it would have on their ratings and their ability to raise funds. So this 'bank capital' channel may also lead to a reduction in the supply of credit."

Of course, he is being charitable when he characterizes that as an "if" as opposed to a matter of degree. Yet, the degree to which all of that weighs on US consumer sentiment, and by extension the US economy is a 'known unknown' affecting all of the markets at present. Considerable anticipation and guesswork are always part of price trend analysis. It is just moreso the case now than for quite some time. Times like these are one of the key reasons that technical projections can be useful signposts along a very misty way to a bigger view.

We always find it fascinating that those who disparage technical analysis as a meaningful tool (either primary, or as an adjunct to fundamental/economic analysis) are also perfectly willing to look at graphical representations of economic indications. As the good Executive Director of the Bank had made clear, in their way the fundamental indications can be just as unreliable as technical indications.

This does not necessarily rise to the level of a *de facto* endorsement (tacit or otherwise) of the modern extensions of the chartist's craft. Yet, it does highlight the need (which has been our real point for quite some time) for employment of all the tools at the disposal of the analyst, dealer or investor in what are admittedly less than conclusive situations most of the time. However much the *lumpen proletariat* puts its faith in them, if the gods of finance at the peak of the economic informational Mount Olympus admit to such high degrees of uncertainty, it certainly speaks of the need for mere mortals dealing in the markets to equip themselves with as many of the relevant tools as are within their grasp.

This all gets back to our recent extensive focus on 'frame of reference', and one of the most powerful psychological aspects of trading and investing: 'anchoring.' Its effective use works for the illuminated, while random perceptions which form the frame of reference for casual observers definitely works against them in the face of the skills of the moreso well prepared.

Anchoring

Anchoring is the psychological tendency by which the most recent experience of a particular situation remains a more considerable influence than extended observations or occurrences. As we noted in our 'The Nature of Memory and Learning' section of the overall 'Frame of Reference' discussion (***CMO*** III-33, Wednesday, October 10,2007), forgetting is part of the process of memory. It has to do with the ability to recall situations (the context) and lessons from them in future. This is where price histories and indicators can be useful; yet most folks prefer to get an impression moreso form the markets' responses to news and events.

That said, most folks the ability to recall situations beyond a certain point in the past is very limited, as so much else has occurred. That's why training in professional trading skills involves repetitious review of similar situations to establish a more definitive understanding of market behavior. Those 'lessons' can then be used to evolve the basic analytic frame of reference to accomplish what is actually a change in perception and response. Short of that, most folks (both outside of and even within the financial services community) never quite understand how to effectively asses the markets across different phases of the overall cycles.

Part of that problem for the public investors is that they only apply a limited degree of their attention to the markets. They have many other aspects of their life, most prominently their primary occupation, which do not allow for full time market observation. They listen to many statistics and opinions, and tend to form impressions which may be randomly useful from time to time. However, on balance, it is hard for even many in the professional trading community to develop more than a passing understanding of the nature of the long term influences and pressures; what chance does the 'public' have in this endeavor.

In dealing with such huge statistical expressions of various economic and financial data, there is a (somewhat rightful) tendency to see how the market responds to the news rather than actually analyze the facts. And why not? When statistics like national debt, trade balance, GDP and the like reach figures in the billions or even trillions of dollars (or other countries' currencies), who really can effectively analyze them?

From Charles Bean's assessment of uncertainties which central banks need to address, it is not even possible to know if they are accurate until some time after the fact. Even assuming accuracy, the sheer size of statistics is mind numbing for all but the most adept economists. The sort of numbers which are released on a regular monthly or quarterly basis remind us of (the seemingly apocryphal) observation on large events from Joseph Stalin, "The death of one man is a tragedy; the death of millions is a statistic."

The numbers get so large that most folks can not really say they understand them. Their best defense, and a phenomena which is often observed in markets, is the degree to which prices moreso react to how a particular bit of data compares to the relative level of the previous data in the series and the pundit's estimates. Which is why there are so often initial price reactions which appear to reflect the headline statistics, and countertrend reactions soon after. Yet this is the best form of anchoring the broad trading community can muster due to its limitations.

In our experience, the average investor or retail trader can probably recall what has occurred over the past eight weeks. That is partly their pure memory in spite of the other event s with which they must deal in their life, as well as a goodly degree of reminders from the media. Any extensive viewing of the online or media financial electronic press or papers (do people still do that?) provides quite a few points of reference which (for example) remind everyone of the previous FOMC (or other central bank) action, and the environmental economic changes since that last situation. Of course, the pundits' views are prominently offered as well.

Those who do their 'homework' might even look back eight months to likely no more than a full year. That is a reasonable horizon within which the past couple of quarters' comparisons are relevant, and the full year history is the 'default' display on most web sites' graphical analysis displays. While the better among those sites affords the ability to expand the view back quite a few years, most untrained observers have a hard time understanding how that extensive history applies to the current trend conditions.

The exception is when there is a major move out of the recent price range. At that point many folks will quickly reference where the previous significant multi-year trading lows or highs might have occurred. Yet, the actual old trading lows or highs are often not the most critical levels in the context of the current trend. The most recent telling example is the ten year US Treasury Note yield pushing up through a multi-year high (from back in May 2002) in June of this year.

That immediately brought out predictions of another 20-30 basis point yield escalation, with some estimates as high as another 40 basis points. Yet, the intermediate technical factors actually highlighted the degree to which yields were already overextended from their immediately previous push up, and they topped out instead. Indeed, that turned out to be a significant intermediate term top prior to a sharp fall.

The other form of anchoring is the anniversaries of major significant events. The most recent was the 20 year anniversary of the equity markets' Black Monday, October 19, 1987. Even in those circumstances the anchoring can yield not much more than a mild influence. That was covered in a most enlightened fashion by Mr. John Authers, one of our favorite Financial Times columnists *cum* analyst. He notes that as everyone was prepared for the worst, some degree of the selloff was completely normal. The degree of it was fairly impressive, yet was not another repeat of the violent debacle by any means.

His attached article ("Metaphors' mixed signals in describing markets", October 27, 2007) goes on to discuss how this is just a particular form of anchoring, with much more active ones affecting perception on a near term basis. It is very interesting to note that market trends which are presented as graphs are more likely to engender a feeling of continued trend momentum than those presented in tabular form. Interesting. Possibly a reason technicians are always so interested in monitoring trends which analysts of statistical structures (such as options analysts) seem more partial to finding delimiters which will leave markets stabilized.

In any event, other than the major anniversaries most market participants have a hard time remembering conditions and the trend evolution going back the most relevant time frame, which is eight years. That is of course a gross approximation. Yet, in our experience, that is roughly the amount of time (i.e. between six and ten years) that most intermediate term market cycles last. In that regard, it is important to recall how and why the various markets bottomed, maintained their up trend, topped out, and sold off. The exception to that is that last phase: as bear markets drop faster than bull markets rally, it is often the case that the top and subsequent bear trend can last a mere several years.

Yet, that remains outside the scope of memory for most public investors, and even quite a few financial services participants. Which is why technical analysis forms a reasonably prominent part of truly professional analyst's or portfolio manager's array of tools. While the degree to which the specific variation of the economic and fundamental influences may be a bit different enough in any instance to fool a goodly number of participants, the price activity doesn't lie.

Among the most telling of those current occurrences is the fact that until just recently quite a few folks had very good theories of why the US dollar was so cheap already they could not imagine it going any further. That was with the US dollar Index still well above .8000 compared to this morning's test of the .7500 area (likely on its way to lower levels.)

Here again John Authers had some very good observations, yet those are from a bit more than one year ago. His ability as a journalist to appreciate the degree to which different schools have merit at times is one of his real assets. In the case of his "Not waving but drowning in financial theories" (Financial Times, October 6, 2006) he was actually responding to feedback to his previous citation of a "paper from researchers at City University in London that showed that Fibonacci sequences… …had no statistically significant role in predicting the troughs and peaks of the Dow Jones Industrial Average over the last century."

He also immediately noted that “Fibonacci ratios are much used by traders”, and that the feedback from analysts who use it was rather aggressive. Of course, this is all part of the contentious and silly acrimonious debate between the most adamant adherents of each school, which we have thoroughly debunked previous (see the “Analytic Balance” discussion in ***CMO*** III-21, Wednesday, May 23, 2007.)

The two schools are of course complementary, and Mr. Authers seems to at least tacitly come around to that view in an observation later in the column, “If enough people behave predictably in the same way, these "anchoring " points become useful. The number of fund managers using behavioural finance is growing. They may be zeroing in on the same phenomena as the chartists, having reached them via a very different route.”

While that still leaves a question as to whether technical analysis is self-fulfilling prophesy, actual relevant psychological analysis or real science (which even we do not believe as it regards either technical or fundamental analysis), he does conclude with the rightful and relevant deduction, “…technical analysis has its uses, when combined with fundamental analysis, and prospect theory supports some of its claims.” As usual the full column is attached for your review.

It is all back to ‘anchoring’ that naturally goes on in everyone’s mind to one degree or another. And while the markets are in their way nothing more than compressed and intense reflections of the rest of life, their propensity for immediate and dramatic reinforcement or refutation of ones views is part of their charm, or offensive nature, depending on one’s most recent views.

All analysts and investors are anchored in some form of orientation. For the most part it is too short term, too grounded in experiences that have not provided durable analytic expertise, or too reliant on economic and fundamental analyses of data that even the Chief Economist of the Bank of England tells us is really not nearly reliable enough upon its initial release.

As such, at least as signposts along the very misty way, anchoring to some relatively longer term (and thereby more likely relevant) technical indications and their associated price levels is likely productive for most folks; if only they take the trouble to learn how to accomplish that analysis in their own right, or seek qualified advice consistent with their individual scope of market analysis.

As Mr. Authers notes, while it is not much better at times than random numbers which come up on a wheel “…traders faced with the welter of complex information embedded in securities markets ‘anchor’ themselves to some chartist measure.” In fact, information is not only voluminous; the output from the most influential sources is also open to interpretation.

That is the case with the FOMC’s altered use of the term ‘balance’ in their most recent rate decision statement. In fact, their specific indication may explain a bit about why the US dollar is so very weak in the aftermath (as opposed to the nominal weakness which was thoroughly expected), and commodities so strong; albeit the latter is indeed part and parcel of their pricing in dollars.

Balance(?)

For those of you who would rather avoid one of our digressions into minutiae, you might want to skip this part of the topical discussion. Yet, after our own initial reading of the FOMC statement last week, several other folks raised the same issue and asked what we thought. While we were sort of impressed with the mutual perception on this fine point, we must admit it is ultimately the difference between something as mundane as the use of a word as the verb transitive versus an adjective.

We are referring of course to the use of the word 'balance' in the fourth paragraph of the statement accompanying the FOMC 25 basis point easing. Previous it had been used as an adjective to characterize the state of the risks: "…sustainable economic growth and price stability roughly in balance." That passive form had been used extensively previous. Yet, it is interesting that the last time it was employed in that manner prior to last week's meeting was at Mr. Bernanke's inaugural FOMC Chairman meeting back in March 2006. Odd.

More curious still was its use as a verb form in the most recent statement. To wit, it indicated that "…upside risks to inflation roughly balance the downside risks to growth." While it may have just been some analyst getting cute with the language, that does allow the inference that the Fed is specifically allowing a sense of upside inflation possibilities as part of the buffer against fears of weaker growth. As we would prefer to presume they do not endorse inflation as a tonic to offset public perceptions of weaker economic conditions, it must be tempting to allow that a bit of price escalation might mask the potential general price weakness possible as the extended effects of the US housing crunch bites harder into next year.

However, with the international purchasing power of the US dollar already crumbling, that will not likely be a perception the Fed wants to encourage. As we noted in our extensive topical discussion 'US dollar Debacle?' back in ***CMO*** III-31 (Wednesday, September 26, 2007), the race to a competitive devaluation bottom is an exercise in futility. The J Curve theory never was confirmed as producing the sort of export market recovery that it predicted.

In any event, in order to benefit a country would need two things the modern US economy lacks. The first is a robust enough manufacturing sector to benefit from earnings on products that can be exported. As the 70% of the US economy is now generated by services, it would not work in this case. Foreign countries have not shown much interest in us exporting our lawyers and tax accountants to their less litigious shores; albeit there are some here who would dearly love to see them off.

The second is a free floating currency. While the US dollar was liberated along with the rest of the developed world's currencies from the Bretton Woods regime back in the early 1970's, there is that issue of some developing countries who insist on pesky US dollar pegs. As we also noted back in ***CMO*** III-31, the ongoing acrimonious debate and occasional bi-lateral flare-ups confirm China as the most important of these.

Yet, the ongoing weakness of the US dollar does speak of a lack of latitude for the Fed to prevent its further fall through near term defensive interest rate hikes into the already fragile US economic situation. In fact, the weakness of the US dollar has even become a bit more pronounced than we had suspected in our previous slow motion' assessment; a five percent drop in sixty days is likely a bit more rapid than 'slow motion.'

The really scary part is that any further US Dollar Index destabilization below .7600 likely points to a near term accelerated swing down to the .7400 area; that would represent a decline of 7.5% within 90 days. Definitely not 'slow motion.'

A Streetcar Named Defunded

Yet, who can blame folks for pulling money out of an economy that is at the center of 'capital destruction' of the magnitude being experienced in the US right now. We first noted that was the case as the interbank problems remained tenacious into early September. That was included in a brief comparison to how much worse the current problem is than the 1998 combined Russian Crisis and LTCM problem. That was a problem of under-margined positions which were still viable in the intermediate term.

As the root of the current problem (albeit extending into more dire portfolio problems) is the resale of foreclosed homes that will entail very aggressive price drops (with the attendant risk of impacting consumer sentiment.) That will be a necessary evil to make them affordable for the sort of buyers who both find them desirable and can qualify (in part due to lower prices) for finance under much tighter lending standards. The impact of continued significant US house price slippage on the popular psyche is the issue, not whether a Fed Funds rate cut can directly address the problem (which it can not.)

One of the best comparisons we have heard of late was on the CNBC morning show Squawk Box from their guest Mr. Richard Bove of the securities analysis firm Punk Ziegel. He quite plainly stated (something to effect of), "It's the same as the S&L crisis. A lot of people who borrowed short and lent long. In this case they also lent against substandard assets."

Well said. The ability to convince themselves that a form of low cost funding which allowed them to expand their business rapidly was also the more isolated case (or so we would hope) in the Northern Rock fiasco in the UK. The mistake in the 1970's was the ready availability of easy tax shelter funding for any piece of real estate which could be leveraged to create low enough capital requirements; that would thereby take advantage of accelerated real estate depreciation rules to harvest tax benefits. In fact, at least S&L's had an excuse: they had a need to earn income from investments in property because they had been 'disintermediated.'

They had been cut off from earning money for a while because they were restricted by some antiquated laws from lending above a certain set interest rate while interest rates escalated in the late 1970's; at least until the laws were changed. Yet, that same law change raised the US government guaranteed level of deposit insurance. It was the infamous Garn-St. Germain Depository Institutions Act of 1982 financial services bill, named for its primary sponsor, Congressman Fernand St. Germain (whose political campaign funding was also heavily supported by the financial services industry.)

In retrospect that bill's significant expansion of deposit insurance caused a massive influx of funds to the previously cashed starved S&L's is broadly acknowledged to have been one of the major contributing factors in the subsequent late 1980's S&L crisis based on… …the major property market debacle caused by the US Congress's Tax Reform Act of 1986, as reviewed in the *CMO* III-31 discussion of 'Neutron Bomb Lessons' (for the subprime crisis.)

Yet, defunding is defunding, whatever form it might take. It seems that the real problem is firms, or at times a major portion of whole industries that believe it is acceptable to rely on a steady stream of unstable funding. Yet, those temporary times when unlimited funding flows always come to an end. It seems that being the Blanche Dubois of the capital markets by always relying on the 'kindness of others' is no substitute for securing stable long term funding, if the business can indeed qualify.

While some in the financial services industry have been very concerned about them to some degree, possibly the Basel II banking reforms are likely more of an answer than many would like to admit. If the risk adjusted nature of the assets which are funded assist in determining if more extensive reserves are necessary to underwrite riskier assets (including those that can not be readily priced), then possibly they will end up a blessing.

The only problem now is that they are coming into force at such an unseemly time in the midst of a crisis. As Bank of England Executive Director Bean noted in his speech we reference above, "…banks find themselves no longer able to securitise loans as expected and anticipate having to fund committed credit lines to conduits. That will reduce the supply of funds for new loans." As with the resulting economic slowdown into the early 1990's, while it may take some time, the capital destruction will take its toll on the general US economy.

Ironically, current signs of economic resilience will prevent the Fed from providing enough additional accommodation soon enough to fully offset those influences. Yet, on balance, it is just a normal part of the cycle. Folks who are anchored in the past eight weeks or eight months are likely to still hope that the equities will find a way to rescue themselves, and ultimately get hurt when the equity markets reflect the slowdown. Those who recall from the last major crunch (which was admittedly more like seventeen years ago) that the uncertainty currently afflicting the near term trends amounts to more a matter of when (and not if) the equities are going to fully reflect that weakness will likely fare better.

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

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