Rohr Report

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Overview, Markets Summary,…
…Not Ready For Prime Time, Flailing, RTC-2008, Political Calculation

Key Views

- **As we noted prior to the FOMC meeting last week, the overall decision was not so much about their overt action as the ensuing market activity; which was abysmal. However, beyond any weakness from disappointment with the extent of the Fed Funds easing only being 25 basis points, the nebulous, lackluster nature of the statement which followed was very disturbing; it did not seem to communicate very much at all about any forward view. Even more disturbing was the coordinated central bank money market liquidity injection plan announced less than 24 hours later.**
- **While there should have been relief that central banks were finally taking concerted action to alleviate the congestion in the interbank lending market, the manner in which it was handled left everyone feeling bad. The reasonable return to incrementalism that Mr. Bernanke laid out in his *Monetary Policy under Uncertainty* speech on October 19th had now been diluted by the degree to which the Fed had 'ambushed' the markets, which created more of the very disruption that they should be attempting to mitigate.**
- **We will have more to say on that below, as well as the other key issue of whether the Bush-Paulson adjustable rate borrower rescue plan has any chance to alleviate the real problem: US housing asset value destruction at the core of the derivative debt securities dilemma, which is the 'cause' behind the interbank lending 'symptoms.'**
- **As we suspected, the DJIA dropped back from 13,750-800 resistance to violate supports at 13,500 and now 13,250. That leaves the door open to a test of either 13,000 or more likely the 12,800-12,724 support unless it can Close back above 13,350 soon.**
- **The difference this time is that the fixed income market began breaking well ahead of the FOMC, and has sold off more aggressively than previous. Yet, the March T-note has recovered back into the area of the lead contract (which it becomes today) weekly channel UP Break at 113-05. As such, it may rally into upper 113-00s if equities break. Yet, the European long ends are far more challenged. Any further easing forced by equities weakness may be bad for the long ends yet good for short money.**
- **All of which gets back to the renewed importance last week's US inflation indications, which have temporarily buoyed the US Dollar Index into a .7670 UP Break from its weekly aggressive down channel, yet to only near the .7820 major 1992 all-time low, with USD/JPY also struggling into the heavy resistance in the 112.50-113.50 area.**
- **As noted previous, January Crude Oil was so orderly below 89.00 (still support) it was likely to spring back, yet resistance remains in the 93.50 and 95.00 areas.**

Overview

Quite a bit of our topical discussion today summarizes factors analyzed previous, some of it as far back as last year in the case of the lack of Bernanke Fed credibility. Yet, that has now seen certain key market issues compound that feeling since we noted interbank market problems were not just a technical dilemma in the banking system back on September 7th (*Capital Markets Observer* III-28); even though the Fed (and other central banks) would have us all believe different. While we will be as brief as possible in our review, these factors now intertwine in a way that requires somewhat substantial exploration.

This is all the more important after another relatively light US reporting day today leads into tomorrow and Friday's last major US reports being released prior to the end of the year (save US November New and Existing Homes Sales at the end of the month, when almost nobody will be around to react.) Once again, it is not so much the economic releases will be trend decisive for the markets so much as getting them out of the way will allow for decisive equity market activity into the end of this week, or the very thin holiday period into New Years Day.

Of course, the markets may just quietly churn into the end of the year in spite of the continued interbank lending dislocations. Yet, the reason that any volatile equity market activity is so important is that it has been a very strong driver of trends elsewhere, especially fixed income. While that relationship is evolving markedly in the wake of last week's US inflation numbers, in one way or another the near term equities activity will be telling; possibly still supportive across the entire curve at first, yet potentially destructive of the long ends if the central banks (i.e. the Fed and possibly even the Bank of England) are forced into any immediate easing to alleviate disorderly weakness in the stock markets. Key technical perspectives are noted in the Markets Summary below, and remain considerably consistent with the previous views on the DJIA violation of 13,350-250 support as a key indication of extensive vulnerability.

However, the really major change over the past several months that has intensified over just the past couple of weeks is the continued weak performance of the Bernanke Fed potentially evolving into an overall lack of confidence. That is due to a seeming lack of appreciation of the Fed's impact on markets. This raises concerns over the shift from adept Mr. Greenspan to a far more academic approach, which either does not comprehend or for some strange reason fails to reflect fine points of the central bank's role in market psychology. To a lesser degree this is also true of Bank of England Governor King's succession after the very market savvy Eddie George regime. Monsieur Trichet is not expected to contribute anything more than continued hawkishness regardless of economic conditions. While that is in part due to the one-sided ECB mandate, we sense that it also just suits their parochial view.

As such, if there is confidence when the Fed acts, it encourages the investment community and public to feel it has a clear view and productive plan. That is likely more important at this juncture than any of the actions from the other central banks. That is also due to the degree US housing problems are at the core of the securitized debt crisis. There is a rightful view both are due to lax regulation and supervision in the US, and it will ultimately need to provide the cure. And that gets back to the major theme we first explicitly expressed yesterday that a Resolution Trust Corporation-style bailout is likely sometime next year. As it stands, current government programs do not seem sufficient to the task at hand, and the massive central bank liquidity infusions will not be effective until the underlying assets are stabilized.

Markets Summary

EQUITIES

As we have been over this ground quite a few times of late (as the equities have continued to trade in ranges with resistance restraining them at the high side), we will be brief. The **DJIA** remains the prime mover for the trend decisions elsewhere, yet it is apparent that it is not necessarily the most aggressive at all times. That is especially true when the DAX decides to rally in the context of a European economy the ECB tells us is still robust in spite of some loss of confidence due to the global financial concerns. While the OECD disagrees with upbeat ECB opinion, (as we have noted previous) the ECB has the far more active and high visibility platform from which to shape market perceptions.

However, the trend influence still flows substantially from the US, and it will continue to dictate the trend elsewhere, if not always commensurate trend momentum and percentage changes. The DJIA led a pre-FOMC anticipatory recovery after extreme emotional weakness into the 12,800 area on November 26th (in the wake of Senator Schumer's critical letter to the Atlanta Federal Home Loan Bank) that left the now critical Tolerance low at 12,724. That strength lapsed after the 1,000 point rally ended in disappointment (as expected) from the extended resistance in the 12,750-12,800 area. Once FOMC only provided a 25 basis point easing and vacuously noncommittal statement, the DJIA slipped back below the 12,500 area, with only a temporary reprieve on last Wednesday's announcement of the coordinated central bank money market liquidity injection program.

What seems important about that now is the extended slippage back below the low end of the 13,350-250 congestion. While that does not represent failure of major lower support (such as a break below 12,800-12,724 would represent), it does highlight the degree to which the weak sisters in the US are very influential for the trends elsewhere. While we have focused on it previous, how equity market trend indications are evolving remains very interesting.

Considerably greater strength in the DAX and to a lesser degree in FTSE meant that all of the daily MACD's turned UP on the sustained recovery from the minor (yet ugly) new lows in the US back on November 26th. However, even with DAX re-approaching the summer rally highs, the best the European weekly MACD's could accomplish was to improve into critical balance (from DOWN), and they did not even firm much at all in the US and Japan. The recent selloff has prevented strong sister weekly MACD's from turning UP, and now all of the daily MACD's have come back into a critical balance (from UP.) That threatens to turn into a coordinated DOWN signal if the equities slip further.

In fact, with the exception of the DAX, they are all already in modest DOWN signals, and that highlights the requirement for the DJIA to recover back above the top of the 13,350-250 range to reverse the current weakness. The bottom line is that in spite of the equities not breaking any critical low end supports so far, the burden of proof is on the longs to create a near term recovery, or suffer further weakness if they cannot. That is consistent with the skepticism that the central banks massive liquidity infusions and the Bush-Paulson adjustable rate mortgage rescue plan have addressed the broader problems which afflict the outlook into next year.

The exact same psychology applies to the **March S&P 500** future, which fell right back to reestablished supports in the 1,451-44 area in spite of becoming official lead contract at a ten dollar premium when the December contract expires late this week. While there is further extended continuation and contract support into the 1,435-32 area, the post-FOMC failure from the gap in the 1,525 area right back below important continuation and contract support in the 1,485 and 1,495 areas leaves the same sort of burden of proof on the bulls here as in the DJIA; in both cases that is also back below some key daily and weekly moving averages.

For now it is enough to note that while the **DAX** did recover temporarily above next resistance in the 8,025-40 area, the 8,100 area stopped it cold after the poor US market response to the FOMC, well prior to even reaching the 8,151 high of the up trend from back in July. Lower support remains the recently reinstated 7,750-00 range and in the 7,600 area, with extended support not until the 7,400 area that was neared on the recent selloff. Similarly, recently weaker sister **FTSE** had a DOWN Break below the 6,550 area, and unlike DAX had trouble remaining above it. It is also now back below the previously violated 6,400-6,350 support, with major supports in the mid-6,100 area into 6,040 that held on the last break. Below there is can fall back as far as the 5,821 mid-August low, which is far more similar to the US than anything which is going on in Europe.

It is not necessarily a surprise in light of Japan's return to economic weakness exacerbated by political malaise that weak sister **NIKKEI** fell back below support on a serial basis below the 16,700 area as well as more major support in the 16,500 area back in early November when the other markets weakened. At that time it also violated supports at 16,100-15,900 that we suspected would remain resistance on the way back up as the US market exhausted its upside potential into the FOMC meeting. Even though it Closed just above 16,100 at the top of the pre-FOMC rally, it has now (not surprisingly) fallen all the way below major levels in the 15,600-500 area and 15,250 mid-August low once again (the only equity market to do that in the first place back in November as well.) While not quite yet reaching its ultimate support back in the 14,400-14,000 range last seen on the sharp downside reaction in June 2006, any further weakness elsewhere will surely burden this ultimate weak sister.

LONG DATED FIXED INCOME

What a difference an FOMC meeting makes. In the wake of the temporary equity market post-FOMC strength back on October 31st, (as well as their tacit mention of inflation) the December **T-note** had slipped back from a test of its low-mid 111-00 resistance to just about its previously Negated 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, and that was only the most temporary of dips prior to putting on a much more extensive rally once it became clear form the equity market weakness that the Fed had not done nearly enough.

Sustained weakness of DJIA back below 13,500-350 (now somewhat critical once again with the slippage below 13,250) was sufficient to have the T-note Close convincingly above the 111-12.5 Tolerance of the low 111-00 historic congestion; yet another reason the mid 111-00 area is critical to the March contract. Yet, the immediate concern is just how well the March can rally from its recovery back into the 113-05 weekly down channel UP Break area.

That also ties in with whether it can still maintain support at no lower than the 112-24/-20 area to leave a chance that any equity market weakness will allow it to recover back above that major weekly down channel UP Break for a potential move back up to the upper 113-00 area gap and congestion resistance (even if Europe remains quite a bit weaker.) That said, after the weekly DOWN CPR two weeks ago, there is a question over whether the T-note can once again attempt to escape the low-to-mid 114-00 resistance. The negative influence is of course last week's US PPI and CPI (NOV) releases, and those have corrupted the underlying bid in the long ends.

That will be even moreso the case if the Fed is forced into any further near term easing by the need to counteract a disorderly selloff in the equities. As noted previous, the sense the central banks remain a bit behind the easing curve into the anticipated US economic weakness next year has been quite a tonic for the long ends. Even if they are only seen to catch up with the easing requirements in a forced manner, it will undermine the previous buoyant psychology of the long dated fixed income.

If the March contract generally fails the 113-00 area, there are quite a few interim supports along the way. Those include the old mid-low 111-00 area, with various gaps, congestion and Fibonacci support into the upper-mid 110-00 area. Yet, any sustained failure back below 113-00 would actually indicate the likelihood of a move fully back to the 110-00/109-16 range across time. That would also be consistent with retesting lower major congestion, as well as weekly MA 41 and the major weekly oscillator thresholds that were overrun on the violent uptrend since the mid-June lows.

And if US long dated fixed income is weak, it leaves that much more room for weakness in the European long ends, as we have seen since the middle of last week. The ECB (albeit not the OECD) tells us the European economy can remain robust in spite of US economic weakness, and that raises the spectre of further inflation. The key technical levels in the similarly recovered European long ends were the differentially weaker levels for the **Bund** that shattered lower supports in the 115.00 and 114.45-.55 areas. The latter of those was a weekly down channel UP Break as well (albeit of a much different scope than the one in the T-note.) Its failure is a very bad sign for the Bund, and leaves the mid 114.00 area as major resistance; if the market can even rally that far on equities weakness. Lower support held into the 113.00 area, and there is more of the same every 50 points down into the 111.75-.50 area (which is also the major weekly up channel support from the summer lows.)

Moreso similar than previous for what was the strong sister **Gilt** that overran lower 108.83-.66 resistance and sprinted above 109.50 initially to test its 110.50-.84 resistance, it fell apart after the Bund came under pressure into the later part of that week. Quickly back below the 109.50 level, it also slipped below the 109.20-.00 support (both now key resistances.) Yet it did hold next major lower support in the low 108.00 area, which also has a buffer to 107.50, below which there may not be much support until the 106.00 area. While extreme weakness in the equities may cause the fickle betwixt and between Gilt to reestablish a strong bid back into the mid 109.00 area, as there is really not much to suggest it can return to a sustained bull trend unless it can also avoid any fallout from a central bank easing in the face of a sharp break in the equities; a highly problematic assumption.

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 while being constrained at the same time by the continued disruption in the interbank market and continued buoyant comments from the ECB on Europe. Those proved to be very telling in the past two weeks, as even the Short Sterling did not respond very well to the 25 basis point easing from the Bank of England once it became apparent that the interbank lending rates were going to remain elevated. However, it is less burdened than a Euribor saddled with the hawkish views of the ECB into what is an extreme lack of short term funds that is exacerbated by normal late year liquidity needs. While more forward contracts also present some interesting implications, we continue to analyze the March contracts for now in light of the rather critical decisions which are likely from the various central banks.

The March **Eurodollar** recovery from its early October test of 95.25-.20 congestion left it quickly back above the previously violated September 18th 95.365 pre-FOMC trading low once it was clear more accommodation from the FOMC would be forthcoming at their late October meeting. While that left a 95.40 UP Break above the associated congestion resistance, the holding action against higher 96.50 congestion into early November indicated a strong bid, and that likely remains support on any near-term selloff, as seen in the past couple of sessions. While it once again pushed above 95.65-.72 resistance recently, it has also stalled repeatedly into 96.75-.80 area oscillator resistance. If it escapes on the back of any equity market failure, it will likely be in the wake of an inter-meeting easing. Further resistance remains into the low 96.00 area (i.e. around the June 2005 contract high.)

Once again, European instruments were that much weaker due to the perception that any economic weakness will spill out from the US leading the way down. Yet, the UK is more buoyant in the wake of the weak economic outlook contained in the BoE Quarterly Inflation Report and other weaker economic indications along with the recent rate cut. The key technical levels in European short money are March **Short Sterling** holding the washout below support in the 94.20-.17 range (now reinstated), with lower support remaining in the 94.05-.00 area. Resistances remain at 94.40-45 and 94.55.

Similarly, albeit very much weaker due to the allegedly stronger economy in Europe, the March **Euribor** finally violated the supports in the interim level at 95.65 and major 95.60-.55 area from which it was having trouble rallying very far from due to ECB hawkishness. The higher resistances remain in the 95.78-.80 and 95.88-.92 areas, with next lower supports below recent multiple 95.52 trading lows (since mid-October) are 95.40 that is currently being tested, and again into the 95.32-.26 range.

FOREIGN EXCHANGE

The US dollar picture has evolved from previous views, as pressure from everything from strongish Euro-zone economic indications to the pronouncements from various quarters that they may be becoming less partial to the US dollar have kept it under pressure below the previous anticipated support **US Dollar Index** in the .7650-00 range. Yet, it has now recovered back above the previous recent recovery highs in the .7615-20 area, which leaves a buffer of support into the .7570 area.

It had even rallied through directional trend resistance (weekly MA 13 and aggressive down channel) by leaving an UP Break last week above the .7670 area. That is now near term support, yet with the more significant intermediate term trend resistance is into the upper .7700-low .7800 area this week. That includes the.7820 previous all-time low from 1992 where it failed so badly on a sharp late-October rally.

As noted previous, near term strength still appears an extended upside reaction built on a specious rationale. We will hopefully be pardoned for old fashioned 'trend logic', but to believe that US headline inflation ramping up above four percent is a wonderful reason to own US dollars seems the height of folly. After last week's US PPI and CPI that is based on the idea that inflation is too high for the Fed to possibly consider easing.

Yet, if equity markets get into deep trouble this week or into the first of next year, the Fed will have little choice but to put through an inter-meeting easing. The alternative is unthinkable in the context of an already fragile economic and financial environment which has evolved since the US equities made their last all-time highs back in July. We can only hope that the Fed appreciates and acts on our previously expressed Rohr International *Number One Rule for Central Bankers*: In order to manage an economy, first you need an economy to manage.

The hope is that the Fed will not repeat the early 1990's mistake of the Bank of Japan, and let confidence slip to where it can not be revived. Of course, any forced aggressive easing in the face of what are indeed already elevated inflation levels will completely reverse the near term faulty logic for the US dollar bid.

In any event, the greater focus right now seems to be on the weakness of the British pound, which had been rekindled by its relatively weaker performance against the euro today in spite of the euro remaining somewhat weak against the US dollar in the near term (although not likely to be maintained overall.) The pound had already become a co-weak sister with the US dollar and Japanese yen after the Bank of England Quarterly Inflation Report pointed out the fragility of the UK economy. That resulted in a failure of **GBP/USD** below the entire 2.07-2.10 resistance range, as well a drop back below 2.0550-00 congestion.

While that was mitigated to some degree by a temporary recovery back above the 2.0550 DOWN Break last month, subsequent failure below that area and now 2.0250 support leaves GBP/USD headed for its more major critical support in the 2.00-1.99 area. Much below that the market would violate important interim weekly channel support (from the November 2005 low) and weekly MA 41 (which is actually up in the 2.0050 area.) The next support would then be the full channel trend support and major congestion in the 1.9650-00 range.

Of course, what remains more telling is pound weakness against remaining European strong sister euro. As we noted in our early November *TrendView* **MARKET ALERT**: **FOREX**, **EUR/GBP** Closing above the .6980 down Break Tolerance at .7000 was likely the trigger for more extensive strength. That was the case, as it demonstrated timely technical follow through above previous .7020-50 recent and historic congestion (recent strong congestion and daily MA support, as well as critical near term resistance in the .7120-50 area. While it washed out below that two weeks ago, it held back at that area this week, with next obvious resistance is at the .7254 May 2003 high (also oscillator resistance.)

Much above that extended targets for the overall trend are not until the extended congestion and Fibonacci levels as well as weekly oscillator thresholds at .7350, .7550 and .7700-.7800 (the latter of which are also consistent with extended weekly oscillator thresholds at MA 41 plus 0.0750 and 0.0900.)

EUR/USD also attempted a failure on a DOWN CPR a month ago, yet acted as expected in violating it by returning to and overrunning the 1.4300 area in short order. It has recently pulled back near that area and held, and would even have lower support into the mid 1.4200 area. Previous violation of the 1.4300 area resistance left the market up through its historic 1995 all-time *de facto* all-time high for the 'synthetic' basket of the component currencies. The inferred level of that high is 1.4535. However, 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 recent H&S DOWN Break from the 1.4525 level. Much back above that EUR/USD would recover from the washout back below that major historic area, as well as potentially Negate the recent topping action. That likely requires a Close back above the 1.4600 area. If it can accomplish that it would prevent weekly MACD from turning DOWN (from recently back in balance after being UP), and also indicate that the mid-November 1.4966 all-time high was not going to remain so. Oscillator projections suggest an extension to the at least modestly above the 1.5000 area.

As also noted in our early November ***TrendView*** **MARKET ALERT**: **FOREX**, the US dollar finally failed against the yen on the violation of the 112.00 Tolerance of the previous major weekly H&S UP Break and lower congestion in the 113.50-112.50 range. That leaves those levels as formidable resistance, after the market washed out below next support at the May 2006 110.00-109.30 weekly Up Closing Price Reversal (also very important Fibonacci 0.618 support.) Lower support remains in the 107.00-106.50 range that the market neared on the selloff three weeks ago prior to a weekly UP CPR above the previous week's 108.30 Close.

However, in considering whether this has any implications for the long anticipated carry trade 'crisis' it is evident from the relative activity of **EUR/JPY** and **GBP/JPY** that the extensive technical pressure on USD/JPY below previously tenacious key support was just another manifestation of secular US dollar weakness. That is even still true in light of the British pound, even though it has demonstrated weakness against the euro. Which is not to say there was no emotional buying in the yen on the back of such an obvious previous failure of the US dollar against it, as well as the equity market weakness.

As we have also noted in the past regarding the selloff in the European currencies against the Japanese yen, EUR/JPY has support at 159.00 and GBP/JPY 228.00 support was violated, with slippage below secondary support at 225.00 congestion for what is now the weak sister. In the event, EUR/JPY is still held 159.00 support, even though it failed on initial recoveries back into fresh resistance in the 164.00 area, with extended resistance is as early as 165.00 and 167-168. That is even moreso the case for the British pound, as GBP/JPY first holding into 225.00 left it weak into interim resistance in the 132.00 area, and it still feels challenged on rallies. Extended resistance is back in the 235.00 area, and every 2.50 up from there.

However, even if recent supports are violated in each case, the major lower supports remain in the EUR/JPY 150.00 area, with GBP/JPY (not surprisingly) much closer in the 220.00 area. While 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 levels also remain major Fibonacci 0.50 retracement and congestion supports. Any extensive US equity market weakness could once again be a driver for further weakness in the yen, yet with progressively lower odds that any carry trade 'crisis' would develop with the Japanese economy lapsing back into a state which will fail to attract sustained yen buying, and many speculative carry trade borrowings now unwound in an orderly fashion.

ENERGY

January **Crude Oil** had been so orderly below 89.00, we were not surprised that it rebounded smartly from the top of the lower support at 86.50-.00, even though it could have dropped to as low as 85.00-83.50, 82.00, or even the major support in the 79.00-78.00 in the context of an overall intermediate term up trend. Yet, even with that contract expiring and leaving the **February** contract as the leader, the technical parameters remain exactly the same due to the lack of much of a discount in the second month leading up to the expiration. As such, all of those support levels still apply, as does the resistance in the 93.50 and 95.00 areas, with extended resistance into 97.00, 98.00 and the 100.00 area.

Not Ready For Prime Time

While we felt the Fed over-reacted in providing the September 18th half point cut, it seemed they were getting back on track with Mr. Bernanke's *Monetary Policy under Uncertainty* speech on October 19th. He prominently alluded to Bill Brainard's idea that central banks should not 'overreact' to any near term shocks. We felt that created at least enough of a sensible balance to leave a question over whether his Fed was moving toward flexible incrementalism (***CMO*** III-35, [**Ready for Prime (Mover) Time?**, Tuesday, October 23, 2007.]

In that same speech, Mr. Bernanke also reviewed many other theories of effective central bank management of the economy and the markets. Quite a few of those focused upon the advantage, indeed the need at times, for central banks to act in a way which surprises the markets. That left the door open to additional Federal Reserve activity if necessary into the pre-holiday period. On balance, a good idea. Yet, as in so many things, it's not what you do, it's how you do it. And the announcement of the coordinated central bank money market liquidity infusion program could hardly have been more poorly handled. It leaves us removing the question mark over whether the Bernanke Fed is 'Ready for Prime Time.' It is not.

With such a bland FOMC statement and no indication anything was afoot prior to the actual announcement of such a major program, the Fed caught the market participants completely off guard. It is one thing to surprise the markets, and totally another to needlessly disrupt them; something the central bank is supposed to be working to eliminate in an effort to keep risk takers interested in providing liquidity. In the event it had just the opposite effect into an already unsettled market entering a typically thin holiday period. There were all sorts of lame excuses about how they could not finalize the package until sitting together at the actual FOMC meeting, and how they needed to announce it while Europe was open for business.

While the latter does have some merit, the idea that they could not decide prior to sitting together in a room is a bit ludicrous. In the age of modern communications where so much other important business is regularly settled on conference calls we would hope they could have made this enough of a priority to complete it in advance of the FOMC meeting, and either announce it first, or in conjunction with the statement. We certainly would like to think that if the equity markets dissolve into a disorderly downside debacle while they are out on their holiday next week, the voting members of the FOMC can find their collective way to a telephone and agree on an inter-meeting easing (and any other useful steps) to underpin the markets if necessary.

Even if the agreement on the liquidity injection program did require them to all sit together, or possibly was not fully agreed with the Europeans until just before the FOMC meeting, ideally they might have considered a 'pre-announcement' to warn everyone that they had something special to say. That way the faint of heart might have had a chance to move to the sidelines prior to the actual press release.

The Bernanke Fed has repeatedly moved toward a more professional approach for awhile, and then managed to do something to impugn their credibility. It leaves us feeling a lot like the aging Michael Corleone in the movie Godfather III. There is that wonderful scene where he has just about completed extracting himself from unsavory gangland businesses, and something comes along to require him to remain involved in those enterprises. In a fit of pique he says, "Just when I thought I was out, they pull me back in."

It's kind of like that waiting for the Bernanke Fed to establish steady, professional, forward looking management of the economy and financial markets. As noted above, they always seem to find a way to either misread the context or mis-communicate their intentions. All of which would not be so bad if it were Mr. Bernanke's first few months in office; the proverbial 'settling in' period for such a lofty role. But this is a well-established syndrome that goes back to his off-the-cuff conversation with CNBC's Maria Bartiromo last April about the meaning of his 'pause' comment. All of this continues to be a drag on the Fed's credibility.

To repeat a concern we've expressed before, Mr. Bernanke seems more comfortable with professorial pontification and *ad hoc* pronouncements than applying his ample intellect to the role of prescient prime mover who understands how markets are going to respond to his actions. What will be most interesting is whether the FOMC minutes release on January 2nd show any discussion of the liquidity infusion program; and if not, why not?

Flailing

One of the truly vexing problems is the degree to which others are now voicing concerns about the lack of effectiveness at the Fed. This raises the prospect of more political influence or outright loss of autonomy if things get bad enough and there is no better leadership from Bernanke & Company. That's still a long way off, and regardless of anyone's sentiment about the current Fed head, it is a thoroughly bad idea in the long run. Yet, just today the New York Times ran a lead editorial castigating the Fed for past mismanagement of their role as the head banking regulator at a time when such blatant abuses were occurring in consumer lending that the Fed did nothing to stop. Let us say first that the New York Times is not our cup of newsprint; in fact, quite a bit too Bolshie for our taste.

Yet, we can add their litany of regulatory failure to our strong admonitions that the Fed was letting various forms of irrational exuberance become ingrained once again by not tightening as the DJIA pushed above the old 11,750 all-time high (even thought equity prices were not specifically a bubble on the basis of price/earnings ratios.) Their editorial outlines the ways in which the Fed (even back in the later phase of the Greenspan era) was consistently aware of abuses, yet said it was not its job to rein in such lending practices. As the Editor of the New York Times said, that is nonsense. (The editorial is attached for your review.)

It parallels the nonsense that it is not the Federal Reserve's job to deflate bubbles. As noted in the "**Bubbles: Inflation/Deflation/Burst**" section of our extensive exploration of **Frame of Reference** in ***CMO*** III-33 (Wednesday, October 10, 2007), if it is not the central banks' job to deflate bubbles, then who?

That was a convenient canard invented by Mr. Greenspan after he failed to deflate the Dot.Com Bubble timely to avoid the worst excesses. It is a pernicious pox on the credibility of all central banks, and someone in authority should refute it as soon as possible to avoid the political meddling that will only be that much worse. If central bank policy is to let bubbles inflate, and only be there with the salve for the investors' third degree financial burns when they burst, what do we need them for? It is now more obvious than ever the central bank needs to be the chaperone that pulls the punchbowl when the party gets too raucous, or cede that role to the politicians. Of course, the lack of reliable and prudent leadership in this sort of endeavor is exactly why central banks were created in the first place.

And in this case the Fed let the worst excesses of the credit bubble continue to roll when some cooling of the economy late last year might have at least deterred the worst of the late phase shenanigans; both specious business models based on endless rollovers of very short term funding, and the general good cheer that encouraged unqualified buyers to feel they should attempt to own homes. While ample problems had already developed, there is more than adequate documentation for the worst of it coming near the end (as binge imbibement always does) into this summer.

As that concerns the housing and Hybrid Adjustable Rate Mortgage (HARM) bubbles, a source as impressive as US Treasury Secretary Paulson has verified that there are many borrowers from the late phase who have not even bothered to pay the initial 'tickler rate' payments on their mortgages. Is it possible that some of these folks are treating the later phase lunacy of 'no-doc (i.e. documents)' 'no income' 'no dough (as in down payment)' loans as a very good way to achieve rent-free living in a house until they are evicted? We suppose there are a limited number of cases where the home owner should not be pitied, but rather admired for their ability to fleece an out of control system.

Yet, the sad truth is that there are many more who sincerely wanted to own a house, had every good intention of making it their long term home, and were sold a literal bill of goods under false pretenses by an unscrupulous salesperson. And those are the poor souls who will be put out of their houses because they can not afford to pay even a renegotiated lower monthly payment. In fact, it is very interesting that in his communication on the HOPE NOW program, Mr. Paulson always refers to the number as 'some' of the 1.8 million homes at risk. Is it possible that the government really does not know enough about the financial state of these folks to provide a more accurate assessment of the number at risk than 'some'?

Our guess is that they do not. In fact, other aspects of his laudable attempt to mitigate the damage also leave us less than comfortable. For one thing, he keeps repeating the same things in slightly different form. There is something to be said for the Treasury Secretary doing a good PR job by getting the message out. Yet, if this is a crisis which it is truly in the interest of the lenders to address (which we agree it is), and it is solvable (which is far more problematic), why does it take so many repeated efforts to move the ball forward?

Let us presume for a moment that this is due to the hesitance he has noted on the part of the borrowers to come forward. Fair enough; possibly the public who is a little less financially sophisticated needs some additional encouragement. Yet, he keeps saying that roughly half of all home foreclosures occur without the borrower even bothering to call the lender to work things out. Think about that. If you were in a house, and you only had to call your lender to significantly improve your chances of remaining in it instead of being evicted, wouldn't you make the call?!

As we noted last week, comedian George Carlin once famously quipped, "Every silver lining has a dark cloud." Mr. Paulson would have us believe that a simple lack of motivation and awareness has resulted in a major number of foreclosures occurring in the past; and if we can just get through to those folks we can significantly mitigate this major housing problem that is attributed to the adjustable rate mortgage reset monster. Possibly just the opposite is true. Maybe the reason that so many foreclosures proceed without so much as a phone call from the borrower to the lender is that the borrower is sophisticated enough to appreciate that they can not possibly make the monthly mortgage payments even with a major reduction.

What does all of this have to do with 'flailing'? Simple; all of the money that central banks are throwing at the interbank lending market illiquidity is an exercise in futility. As we mentioned in ***Capital Markets Observer*** III-28 back as early as September 7th (in the topical discussion of **Interbank Indications**) the problems were not some typical, temporary, technical banking system dislocation. To wit, "…while this week's lack of interest rate hikes from central banks in strong economies anywhere from Australia to the UK was ascribed to a desire to avoid further turmoil in the interbank market, it may prove a convenient excuse to end the tightening cycle in the face of what may be enough asset destruction from the dual subprime and US housing mess to foment the first real bout of economic weakness in awhile."

And now quite a few other folks have realized the same thing. The most recent example is a very pointed column that explored various aspects of the current crisis in the FT Comment page on Monday. Wolfgang Munchau is one of those folks in financial trends analysis who really knows how to connect the dots. In his "Hold tight, the central banks have no plan" (Monday, December 17th), he notes that "…market participants are not infinitely stupid. They know by now that this is not a liquidity crisis at its core. If it had been, it would be over by now. It is a fully fledged solvency crisis that has arisen because two giant and interlinked bubbles burst simultaneously – one in property, one in credit – leaving banks and investors on the brink of bankruptcy,…" (The full column is attached for your review.)

His further conclusion is one way to mitigate it will possibly be effective in the short term, yet so destructive overall as to be less than truly successful: "This raises the question of whether central banks, or governments, should consider raising their inflation targets. That would be a huge mistake, in my view, but I expect such a debate to hit us next year." "…an annual inflation rate of about 4 per cent would take care of the problem. Nominal houses prices would then not have to fall.

"This is an experiment I would dearly love to watch, though preferably from outer space. A hypothetical increase in inflation targets would, I think, turn the current episode of turmoil into an uncontrolled financial crisis. Bonds would become the next asset class to crash and we could also expect violent adjustments in global exchange rates."

And that is consistent with our analyses of the past several weeks that while central banks (i.e. the Fed in the first instance) may be forced to ease in the face of disorderly weakness in the equity markets, that will be moreso destructive for the long ends than any seal of approval for their cyclical rally from the summer lows. And a further need for massive liquidity is likely the case whether the central banks accomplish that by cutting base rates aggressively or continue to throw massive liquidity injections at the interbank lending market.

It is very interesting that while various observers take some comfort from the modest reversal of strength in interbank lending interest rates, the massive central bank liquidity injections which it took to accomplish this give us pause. The Financial Times' Gillian Tett noted in their 'The Short View' column today that "…the bad news is that there is no guarantee that rates will stay low. The key reason why money market tensions have risen is not a lack of cash in the system per se - but widespread mistrust about the health of banks." "…(banks hoarding cash) partly reflects "technical" factors, such as the turn of the year. But it begs questions whether the banks know something nasty that the rest of us do not." (Her full column is attached for you ease of review.)

With due respect for the very astute Ms. Tett, we think the lady posed a quasi-rhetorical question with that observation. At least some of the banks that employ some of the best analysts in the world surely know what quite a few of the rest of us have worked out. Yet, as it happens they are being viewed as the prime movers behind the problem, and they dare not mention what for them is an unspeakable solution.

Yet until a real solution is applied to the core problem, all of the central bank liquidity provision is still just so much flailing at symptoms; and those will continue to worsen across time unless the core problem is addressed. Welcome to…

RTC-2008

As we noted in Tuesday's *TrendView* **BRIEF UPDATE**, if the governments had a solution to this problem we would have heard about it already. All of the US mortgage problems will continue to create commensurate problems with instruments based upon their securitization. As we have noted previous, this is like termites armed with hand grenades, and will only worsen into next year unless a 'fix' is found.

That potential 'fix' will be very distasteful, yet will be viewed as a necessary evil. Sometime in 2008 we will see proposals for a Resolution Trust Corporation-style bailout of the HARM interest rate reset-driven housing crisis. That fix will be rightfully criticized as a bailout which creates the 'moral hazard' of encouraging risky financial behavior while penalizing those who were more prudent.

Yet, the same was said of the RTC back in the late 1980's. The political pressure in the US election campaigns next year will be too great for leading candidates to ignore, as *vox populi* screams for a solution to a problem that seems to be eroding the US economic foundation. Without a broad resolution, it is only a matter of time before the confidence in the markets falls to dangerously low levels for both professionals and the public. Once the situation deteriorates sufficiently for Americans to be faced with a choice between the risk of reliving the Great Depression and providing funds that will ultimately underpin wealth they've accumulated in their homes, they'll write the checks. They will hold their collective nose, ask the amount, and write the checks; just like 1989-1995 (with trailing interest expense.)

And that is exactly why Mr. Paulson has been hammering away so hard at any chance the HARM interest rate reset problem can be solved through a free market solution. If interbank market illiquidity is the primary problem, why is one of the best minds in Washington and Wall Street so completely engaged elsewhere? He is a smart and experienced enough participant to know that until the underlying assets that are the problem with the securities causing banking system turmoil are stabilized, there is no real solution. The banks do not have enough good paper to pledge for loans from the central banks unless the latter are willing to begin taking truly suspect collateral. Which will not happen, because it is not their role, and they are clever enough to avoid becoming the culprits seen to be picking the public's pocket.

It will ultimately need to be legislated, as was the case with RTC. If the public is going to pay, they also do not want the impugned central banks which let the problem develop be the ones to administrate a bailout. The politicians will also want credit for 'solving' the problem. This is going to create some delays; and also some great demagoguery moments in the US election campaigns into next year. We can hardly wait.

As opposed to being self-righteous about not assisting those who made bad bets, the rest of the American populace will assist them in a clear case of enlightened self interest: No joy in watching the other guy crash and burn if you're set alight by the fireball. If that sounds a bit alarmist, consider the evidence of how extensive the fallout from the related US housing and HARM problems have become. The Treasurer of the state of Arizona was on television news the other day. What did he have to say? That the abandonment of homes had become widespread, and the complete disappearance of some communities was a fact of life in his fair state. That would mean that anticipated tax revenue would not at all meet projections; Arizona is predicting a $1.8 billion shortfall in a $10 billion budget.

Consider how that fits in with S&P downgrading one bond insurer and saying five others could lose their top ratings. It downgraded ACA Financial Guaranty from A to CCC, the lowest junk rating. That was due to their assessment that its capital would be wholly inadequate to withstand projected losses of over $2 billion under stress tests. That relates back to the ability of places like Arizona to issue municipal bonds to fund operations.

And all of that does not even begin to address the issue of the various state and local governments everywhere from Australia to Europe that have invested in what are now significantly downgraded investment instruments, or failed trading funds. In some limited cases they will possibly be made whole on their invested funds if the issuing bank feels their marketing folks had indeed not been forthright enough about the risks. But that will not make up for the extensive revenue they had been expecting from the accelerated interest rates on those securities.

This goes way beyond housing and a few securities firms and banks which have portfolio problems. However, even more daunting is the idea that the more extensive HARM interest rate resets that began this fall are not even due to begin creating actual foreclosures until the later part of the first quarter of next year. While the markets have already discounted some of that prospect with the selloff since the perceptions became apparent in August, the reality has probably not been fully discounted in the markets at current levels.

Admittedly, the rating agencies (very belatedly) adjusting the credit rating of many of the instruments has probably anticipated a goodly degree of problems to follow. Yet, everyone is still dealing with unknowns, and the actual value of the homes that back so many of the suspect securities is still likely to face further extensive weakness. Until the degree of that weakness is clearly established and seen to have reached its nadir, problems will expand.

Of course, all of the arguments about moral hazard and rewarding financial bad behavior are true, and exacerbated by one more factor: the degree to which any major bailout will also be inflationary, as it is a major capital infusion that will add to the already out of control US government deficit. Yet, the acceptance of these sorts of things tends to only seep into the public psyche across time. Mr. Greenspan cracked the lid on this particular Pandora's Box when he noted that the only way to alleviate the pressure was to provide direct, transparent assistance to individual homeowners having mortgage interest rate reset problems.

There was also a very brief and interesting last paragraph to that New York Times editorial referenced above. As noted, the bulk of the opinion was related to the failures of the Fed (and other select culprits) to prevent the current crisis and personal suffering brought on by ineffective bank regulation. Yet, its final missive was not about apportioning blame; it rather provided a suggestion for how this would likely be addressed: "This crisis didn't appear unexpectedly. And it won't go quickly away. Congress and the next administration will have a lot of work ahead to clean up the subprime mess — once and for all." We find it telling that they are already looking for a government fix; and quaint that they feel it can wait for the next administration to take office and gets its programs in gear into mid-2009.

Another bit of completely isolated anecdotal evidence is a bit of feedback from someone in a unique position to appreciate the nature of the problems. This individual is neither a financial services wizard, nor even a highly involved investor. While out to dinner with a good friend who is a well-regarded bankruptcy specialist, I responded to his question of what I thought of the whole situation at present by simply telling him that the American taxpayer would end up picking up the tab for excesses. His response was a shrug and very simple, "That's a given." And that was the end of it. Isn't it interesting how someone who deals with insolvency all of the time has no doubt, and no qualms, about where this ends up?

Political Calculation

Not that it will make a difference to the near term market trends, yet one of the most intriguing aspects of this likely political 'fix' for a deeply ingrained financial problem is just who is the first to formally propose it. There is a simple bit of 'Devil's Arithmetic' attached to when and how that occurs. In case it is not apparent from all of our previous discussion on when the actual foreclosures will occur, and markets can no longer think interbank disruptions are distended end of year concerns, the more intense focus on an RTC-style bailout will likely hit in the later part of the first quarter of next year, or possibly not even until mid-year.

As we were mentioning this will not be a serious consideration next week, or next month, or possibly even next quarter, one of our more astute clients noted that it will not become real until the Americans are "staring down the barrel of the gun." And that's pretty much it for one very good reason: the massive price tag to underwrite the deficiency in monthly affordability on so very many mortgage payments.

The political conundrum is therefore daunting, especially for the US presidential candidates as the problems persist and worsen into next year. There will be a tipping point in public perception where the fallout from the extended problems ballooning out from the HARM interest rate reset mess will seem far more pernicious than the Pyrrhic solution. However, due to the huge burden on the public purse (i.e. taxpayers' wallets) attached to that 'cure', nobody will want to be the first presidential candidate to propose it.

Yet, there is only on thing that those candidates will want even less: to NOT be the first to propose it. The first one to move forward does so at extreme risk. Yet, once it is already a 'given' (as our insolvency specialist friend already understands), the candidate who proposes it will be lauded for their honesty and financial and economic savvy. None of the others will want to be 'me too' endorsers of the prime mover's brave assessment of the situation.

So, in addition to all of the talk on other major issues like Iraq, the trade deficit, poverty and healthcare and America's standing in the world, the US federal budget will represent a unique sort of opportunity and risk for the candidates. They will all need to continue to take rightful stands that the budget deficit needs to be brought down considerably. That will continue right up to the moment when the most astute and tuned-in of them senses the gun barrel rotating around right into the face of the American public. At that moment all of that budget rectitude talk becomes irrelevant compared to the fear of major economic recession or depression.

While we do not normally recommend market positions (as opposed to research on technical trends and overviews on fundamental background), this case is an exception. If you notice any candidates who still cling to budget rectitude, and abhor the potential to 'fix' the problem with funds from public coffers, get ye directly to Las Vegas, and book all of the bets of those who still feel that candidate has any chance of becoming the President of the United States.

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

-Rohr
(www.rohrintl.com)
