Rohr Report

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Overview

This week has brought mild further improvement to the equities, while fixed income and the US dollar have come under pressure. The strength of both the ECB outlook for Europe and their subsequent economic data are ample cause for all of that. Given that the US equities led the way up in the first instance, it is not surprising that they also remain strong while the European markets take over the lead. This is especially true in light of the fact that as time goes by ECB President Trichet looks more accurate in his assessment that interest rates remain accommodative overall in light of the robust economic growth.

This is exacerbated by the derivatives driven low cost of funds for takeover and leveraged buyout activity, which remains centered on the Japanese yen 'carry trade' to some degree. Yet, the degree to which any reversal of the yen trend is capable of triggering a crisis in the financial markets remains dubious in our opinion (which is admittedly a bit contrarian at this juncture.) Our previous review of that is available in last week's *Capital Markets Observer* III-6 on the Sample Reports page of our website. Further thoughts on yet another likely overblown alleged source of extreme disruption is reviewed in Market Mayhem?, below.

Yet, now it's time to spin one of the markets' favorite potentially trend decisive Oldies but Goodies: "Gettin' Ready for Benny." The received wisdom is that Mr. Bernanke's Senate and House testimony today and tomorrow (respectively) will of necessity need to be very upbeat on the US economy. In the wake of the stronger than expected Q4 Advance GDP, strength of the equity markets and earnings, and much more constructive FOMC statement there is a sense in some quarters he will need to focus on the US economy at large recovering faster than expected in the wake of housing and domestic auto sector weakness. This has been one of the primary factors which has influenced the continued erosion of the US fixed income in the wake of cross currents elsewhere (weaker Europe and more resilient UK.)

Somehow we get the feeling that he may not fulfill the bears' hopes in that regard. In the first instance, Mr. Bernanke is now legend for not necessarily leaning into the markets as such, yet certainly leaning into the 'received wisdom' on what he is going to say. That alone brings forward the expectation that he might concentrate more than a bit of his chat on the potential weak factors which could still plague the economy and equity markets. And there are quite a few aspects which are ample fodder for discussion in those areas. Recent guidance from some of the US home builders has highlighted not only stagnant conditions dominated by purchase cancellations; there has also finally been talk of prices slipping again. The latter is just the sort of thing which could instill a real chill into consumer spending across time.

There is also the degree to which the stock market buoyancy continues to be reinforced by sporadic buyout and takeover activity whenever the markets dip back to technical support. After the selloff of the previous several sessions, that was the case for the US markets yesterday, as they surged back initially on buyout talk in the aluminum sector. Which is not to say that the markets are artificial up at these levels. Rather, it points out the degree to which the very attractive cost of funds is a driver for the equities which is ultimately not constructive for fixed income, and the influence of continued higher yields will likely come back to haunt the stock markets at some (unknown) point in the future. Those higher yields are also a drag on the still weak US auto manufacturing sector, with the added influence of the cheap yen being a factor here as well (more on that in Miscellany, below.)

MARKETS

FIXED INCOME

On balance, anything less than very buoyant, hawkish talk from Mr. Bernanke is likely to bring a near term bounce in the fixed income. Yet, as we thoroughly (and disgustingly) expect on historic form, that is all part of the expected choppy erratic nature of the secondary phase of the fixed income bear trend, and may not be worth very much. The March **T-note** recent gaps lower (i.e. above the market) offer ample resistance back into the low- and mid-107-00 area (also previous congestion and failed UP Breaks.) All of which presumes the Chairman does not say anything which would cause a failure back below the 106-19/-16 support already tested two weeks ago; in that case a move down to the 106-00/105-24 major support would be in order, with commensurate weakness in the other fixed income markets.

This is all consistent with the March **Bund** holding on with only minor slippage below its 114.90-.80 support in spite of the strength of the continental European news of the past couple of days. While there is further, more major, support into the 114.55-.46 range, any holding action at present levels which is consistent with a squeeze up in the T-note could foment a push back up into the low 115.00 area. Yet, as even a move back into the recent failure levels in the mid 115.00s would be no more than a minor correction of the down trend.

EQUITIES

The equities are likely to remain in good shape as long as the **DJIA** holds no worse than the upwardly revised near term support in the 12,500-12,475 range. That would set up a test of the 12,750-80 extended oscillator and topping line resistance, above which there is not much until the 13,000 area; in other words, a re-Acceleration of the equities is possible above the 12,750-80 range in the DJIA. On recent form this is also consistent with current upside leader **DAX** not reversing trend back below the UP Runaway Gap left back on the first of the month in the already critical 6,800 area. In fact, after recent pullbacks to no worse than the mid-6,800 area, the DAX is right back up challenging its 6,920 interim resistance. Into next week its major psychological resistance is aligned with weekly oscillator resistance into the 7,000 area, with next interim resistance above that at 7,200, yet with the next major resistance not until 7,500. All of which reinforces the critical nature of the next push up in the equities in general; extreme strength might be a significant drag on the fixed income as well.

FOREIGN EXCHANGE

The US dollar seems quite a bit in jeopardy on the current weakness. Yet that is only back to the sorts of support that were always going to be more critical in spite of the markets not reaching them in the past several weeks. Ever since **EUR/USD** slipped back below the

1.3120-00 support, it was reinstated resistance that was likely to be retested at some point once the market was unable to break the major support at the 1.2950-00 (with a Tolerance to 1.2850.) Various considerations (congestion, Fibonacci levels and weekly MACD still being DOWN) point to a need to EUR/USD to sustain activity above the 1.3150 level prior to any convincing violation of the overall down trend (i.e. US dollar up trend.)

Similar indications are prevalent elsewhere as well. Previous strong sister British pound has weakened against the Euro in the wake of the weaker UK economic and inflation news of the past couple of weeks. While the equivalent **GBP/USD** drop below 1.9550-00 was a violation of congestion support, the intermediate term trend support (reinforced by congestion, Fibonacci and trend channel projections) is in the 1.9250-00 range. Higher resistance remains in the 1.9750 area.

USD/CHF even remains above its resistance in the 1.2325-1.2400 range that has held on all recent setbacks, yet must still overcome telling congestion in the 1.2500-50 range. Only above that does it become liberated for a move fully back to mid-upper 1.2700 area early October highs. As noted previous, the last much lower than expected Australian CPI numbers fomented an **AUD/USD** break right back down into the .7800-.7765 support after a failed test of the .7900-30 resistance. In spite of its recent recovery, it is also only back challenging the top end of .7765-.7800, with weekly MA resistance that extends up to the .7820 area.

Meanwhile, the buck is still at its best against weak sisters, as **USD/JPY** holding its support previous in the 118.00 area in early January led to it surging right back up through the 119.70 high, and recent sharp breaks have all held down into the 120.00 area. However, there is more formidable weekly oscillator and congestion resistance into mid-upper 121.00 area that was being challenged again early this week. While the obvious manifestation of that is the 121.40 previous high (December 2005) of the current bull run, the actual historic resistance is into March 2003 121.68-.87 Weekly Area Gap and trading high (respectively.) Much above that the next historic congestion and weekly oscillator resistances are not until the 123.00 and 126.00 areas.

USD/CAD has failed to push out through the top end of upper 1.1700-1.1800 area resistance, above which there is not much until the upper 1.1900-low 1.2000 area (also major Fibonacci resistance.) Yet, even considering the sharpness of the current sharp setback, it is only back down testing lower support in the mid 1.1600 area (congestion, Fibonacci, trend channel and weekly MA 13.) Only a failure below that area will foment a further selloff into the heavier 1.1500 area support, or portend a potential DOWNturn in weekly MACD.

And, as always, all of this averages out in the **US Dollar Index** where the buck has now succeeded in keeping the bid against the recent mid-.8400 trading low in spite of the more overt US dollar weakness against the strong economy driven Euro. As some of the cross rate activity would suggest, that is moreso about secular strength in the Euro than any extreme US dollar weakness. The most important lower supports are .8450-40, .8400 and .8330 congestion; next resistance above remains in the .8570 and .8730 interim levels, with the next major one in the low .9000 area.

ENERGY
The weather finally had enough of an effect to put **Crude Oil** up onto a Close through the upper 55.00 Tolerance of the 55.00-54.50 range resistance. This pointed to a surge to higher resistances at 58.00 and as high as 60.00-61.00 congestion and gaps (both now achieved.) It also reinstates 55.00-54.50 as support on the next selloff, and possibly overall. Yet, that has not had any discernable effect on trends elsewhere as yet, possibly due to the seasonal turning very soon in spite of current storms. We shall see.

Reports & Events

The major reports and emanations from financial luminaries are all that we are interested in for the balance of what is a somewhat heavy light reporting week. So far this week has brought the very strong European economic indications that were presaged by the comments from ECB President Trichet at the post rate decision press conference last week, and the more benign UK inflation indications which are reinforced in this morning's Bank of England Quarterly Inflation Report. Yet, the really decisive influences are yet to come.

While this morning's Advance Retail Sales (JAN) were extremely robust, markets shrugged them off as fixed income kept its modest near term bid. That may also be due to the more significant near term influence by far will surely be from Mr. Bernanke's Senate monetary policy testimony today. Tomorrow brings more of the same at the House of Representatives. Yet, that is preceded by Australian Consumer Inflation Expectations (FEB), and Japanese Gross Domestic Product (Q4 Preliminary), which might be very interesting number in light of recent extensive concerns about the fate of the yen and its influence on the 'carry trade.' That is also followed by the Japanese Machine Tool Orders (JAN Final.)

However, tomorrow will likely be moreso influenced by other important factors, such as the ECB February Monthly Report, UK Retail Sales (JAN), the European Central Bank's Trichet speaking in Amsterdam, and the US Import Price Index and Empire State Manufacturing Index (both FEB), Industrial Production and Capacity Utilization (JAN), Philadelphia Fed Index (FEB), and the NAHB Housing Market Index (also FEB.)

Friday brings the Japanese Coincident and Leading Economic Indices (DEC Final), and more importantly the German Consumer Price Index (JAN Final) and French Non-Farm Payrolls and Wages (Q4 Preliminary), as well as US Producer Prices, Housing Starts and Building Permits (all JAN), and Michigan Consumer Sentiment (FEB Preliminary.) And for the first Friday in recent memory, there are no talking heads on Friday afternoon. We will have had our fill of them prior to that, and it is an early Close in the US in any event at the start of the President's Day holiday weekend which leaves all US exchanges closed on Monday.

French Toast?

First of all, let's clarify that there's no French Toast in France; it's an American name for bread that is soaked in egg and fried; sort of a poor man's Croque Monsieur without the sandwich fillings. Maybe the guy who invented it couldn't afford the ham and cheese.

Of course, there is a question of whether the French will be able to afford anything other than their tax bill if Socialist Party candidate Ségolène Royal is successful, and institutes any significant portion of what can only be described as a major lurch back to the left after the more capital friendly Chirac administration rescued the French economy from the predations of Ms. Royals' Socialist predecessor, Lionel Jospin.

Sounding the call for a return to a more interventionist and individual rights and services economic vision, she outlined a 100-point program for returning France to the social support model which most of the world has jettisoned in the past couple of decades. Yet, in her zeal to also establish herself as more than just a pretty face, she may just possibly have overstepped the bounds of anything remotely resembling sensible spending, social policy and commercial reality.

Here is a very limited list of her promises excerpted from Monday's Financial Times:

- Increase the monthly minimum wage from €1,250 to €1,500
- Five per cent increase in lowest level of pensions
- Abolish labour laws that currently make it easier for small companies to hire and fire
- Renationalise and merge the utilities EDF and Gaz de France
- Tax firms more on dividends, less on reinvested profits
- Make state aid to companies conditional on a promise not to shed staff when a company is making substantial profits. Aid would be repaid if a company relocated abroad
- Boost public housing and introduce caps on housing costs for low-income families to no more than 25 per cent of income
- Make growth and employment an objective for the European Central Bank
- Increased free healthcare for the young, including free contraceptives for women under 25
- Change school catchment system to "suppress school ghettos" and guarantee more socially mixed education
- Create "participative" democracy in all forms of public life, including citizens' juries to oversee parliamentarians

That does not even begin to broach the other very aggressive plans, such as (once again from the Financial Times): "Young people are at the heart of her programme. They would be given a €10,000 interest-free loan to start their own companies and the state would create 500,000 subsidised jobs for young people. First-time house buyers would get interest-free loans for their mortgage deposit.

"Renewable energy would account for 20 per cent of electricity by 2020, creating 70,000 jobs and reducing the reliance on nuclear and fossil fuel energies. Power utilities EDF and Gaz de France would be merged in a nationalised group.

"Education and research featured prominently in her plans. Research spending would be increased by 10 per cent a year, Ms Royal said, while school class sizes would be reduced to 17 in poorer areas. Many classrooms would get a second adult to supervise children."

Viva la Revolution. Does she actually appear serious in the scope of this program, or was her over-reaching attempt to *appear* serious by seeming aggressive on so many issues all at once actually self-defeating? As opposed to just a plain Croque Monsieur, Chef Royal served up a five course *tour de force* of leftist comfort food; nothing more than Chirac's head would be a fitting just dessert for the Left after such a feast. We have a feeling that while *rigor mortis* undoubtedly set in well over a century ago, somehow Karl Marx is managing a smile. Can Robespierre be far behind? Aside from any of the outrageous levels of expense, does anyone actually consider "citizens' juries to oversee parliamentarians" a good idea? Or that strengthening labor market restrictions and company sanctions will help young people?

While there are some serious questions about the manner in which her right wing opponent will make his supply-side economic program affordable, the overt levels of expanse and return to draconian forms of social and labor market control which Ms. Royal has proposed have left her looking every bit the dilettante that she was seemingly so strenuously attempting to avoid. Obviously in thrall to very statist advisors, she has either seriously mis-stepped, or we are completely out of touch with the fact that the French people are ready to move backward into an unsustainable model.

We have quite a bit of concern for them in that regard. The siren song of Chef Royal may mean that the empty Croque Monsieur the Americans refer to as French Toast will be on the menu, as the French economy will likely be toast (i.e. of the burnt variety) if she succeeds in her election bid and honors even a modest portion of her platform. We are sure that many on the left loved her Socialist Party predecessor, and feel his abandonment of leftist positions allowed President Chirac to steal the election. Yet, as in the case of American ex-President Jimmy Carter, history is often viewed through rose tinted glasses. How many would opt for the condition of the now buoyant French economy returning to the Jospin years?

Market Mayhem?

In addition to the extensive 'carry trade' concerns expressed by so many that we countered in last week's *Capital Markets Observer* III-6 (available on our website Sample Reports page), the other great potential source of market mayhem is the stated intent of the Chinese to diversify investment of their huge foreign exchange reserves. At one trillion US dollars and growing, that's quite a potential move of funds. Consideration that the developed world pension funds and other investors along with the Chinese have thrown so much money at the US treasury bond market is one of the key factors which has helped to keep yields low. As such, the Chinese diversification is seen as a potential source of risk to the long dated yields in the US (and elsewhere due to comparative yield pressures) spiking up, with commensurate weakness in the bond markets.

Why does this sound vaguely familiar? Oh, that's right! Because the Japanese economic juggernaut running into rough seas in the early 1990's was supposed to create a similar massive disintermediation of the US bond market. The Chinese and the rest of the world are about to relearn the lesson of massive investment in a single entity, government or otherwise. The old saying goes that while it's better to be a guy who has a million dollars, the next best thing is to be a guy who owes a million dollars. That's because his bank will be rue to recognize such a major loss, and will continue to float the guy who owes a million in the hope he will make it back on some future venture, rather than write off the loan as non-performing.

The same applies in greater degree to major developed economy sovereign debt. Not only do the Chinese (as the Japanese before them) not want to admit that all of those very secure US government bonds were possibly not such a great investment at what retrospectively may appear to be very low yields across the cycle. The inscrutable Chinese will need to employ every bit of a strong façade as they engage in a time honored government exercise that we always strenuously caution individual investors and firms against attempting in any fashion: scale down investing. While they may have second thoughts about their US government debt holding, both the Chinese authorities and everyone else knows that any attempt to exit would be even more devastating, as disposition of even a small portion of their portfolio would destroy the market, significantly devaluing the balance of the portfolio.

Miscellany

NASCAR Driven Yen

One of the more interesting aspects of the current concerns about the 'carry trade' concerns which are a focal point for the Japanese yen is the degree to which finance ministers seem very reticent to force any revaluation or participate in an intervention on behalf of the yen while their political cohorts in the US (and to a lesser degree elsewhere in the developed world) are howling for some significant upward revaluation. Recently empowered Democrats in the House of Representatives are pressing the Bush administration to pressure Tokyo into strengthening the yen, while Treasury Secretary Paulson is rightfully asserting that the weakness of its currency only reflects the economic fundamentals of the Japanese economy.

As such, while an intervention might bring some temporary (and not completely unwarranted) smoothing to what has become mindless further weakness in the yen, it would seem that the only way to bring about a sustained reversal is more economic strength that would also both encourage and be assisted by significant inward investment. So, here's the obvious solution: US auto makers who are burdened by high costs and weak work ethic in their aging plants and workers should be required by law to make significant investments in plants in Japan. Hey, if you can't beat 'em (i.e. Toyota), join 'em.

It is also significant that Toyota expressed their concerns that discussion of the weakness of the yen is in part just a backlash against their success in the American market, especially their recent eclipse of General motors as the world's largest carmaker. Yet, we think it's another source as well: Toyota's plan to compete in the US NASCAR auto racing circuit. They can grab all of the jobs and market share they want, and it only becomes an issue once they get to the really important stuff: NASCAR.

However, the actual participants seem pretty sanguine about that prospect. A driver for Team Ford said that we should appreciate how many Americans make a good living building and selling Toyota products. A cohort from Team Chevy said that he thought all of the brouhaha was only so much of the press and political classes making more of this for their own purposes than anything the average folks out in the hinterland actually care about. While that may mean the average folks are not clear on the implications of the manufacturing base being owned by foreign interests, it seems that the average NASCAR driver has a more well-informed and global view than a lot of the people in Washington D.C. Interesting.

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

-Rohr
(www.rohrintl.com)
