ROHR REPORT

CAPITAL MARKETS OBSERVER

Volume III Number 8

Wednesday, February 21, 2007

Overview, Reports & Events,…
…Report Reactions, Frank Bernanke, The Cycle,…
… Carry 'Tirade' Cassandras' Quixotic Qualms

Overview

This week has brought further improvement to the equities, and a sense of stability to fixed income and the US dollar. That said, the fixed income may be vulnerable once again after the US CPI (JAN) came in a bit hotter than expected, and that is lending a bit of further strength to the US dollar as well. In fact, even though this morning's BoJ 25 basis point interest rate hike was not necessarily expected by some informed observers, we get back to our key question from yesterday, "What if they throw a crisis and nobody shows up?" Included in yesterday's ***TrendView* BRIEF UPDATE** preview of today's report, it is also the theme of the last topic noted above.

There are those who felt that any firming of yen interest rates or a continued signal of liquidity withdrawal by the BoJ would foment a crisis in the form of massive liquidation of low interest expense 'carry trade' yen borrowings. Yet the equity markets seemed quite a bit more responsive to the prospect of a less accommodative US interest rate environment which might be engendered by the hotter than expected CPI than the earlier move by the BoJ. Certainly the BoJ gave ample indications that (whatever the pace) they are more likely to firm rates further than stop at current levels: "…our economy is likely to continue its moderate expansion…" "…Uncertainties over the future course of overseas economies, including that of the United States, are abating, and this is likely to reinforce the prospects of continued increase in corporate profits and business fixed investment." "From a longer-term perspective, however, consumer prices are likely to increase as a trend,…"

There were also earlier opening remarks from Reserve Bank of Australia Governor Glenn Stevens prior to his Parliamentary Economics and Finance Committee. While he was duly circumspect on inflation which he suspected could ease further in the short run, he also noted, "After a long period of solid economic growth, we have approached what for practical purposes can be called full capacity, at least for the moment. The evidence for this is quite widespread." "Looking abroad, the world economy continues to post a strong performance, led by the US and China." "While prices for some commodities have retreated from their peaks, others have remained very high." All of which reinforces the notion in the February 12 Statement on Monetary policy, "The Australian economy has continued to benefit from strong global commodity prices."

Add to that the Bank of England minutes of the February 7-8 MPC meeting articulating the sustained concern about inflation prospects centered on a lack of spare capacity. Of course, the fact that Messrs. Besley and Sentance dissented from the 'no action' in favor of a rate hike also leaves the balance of risk sentiment on inflation concerns.

Why all of this focus on central bank perspective? Because it seems that they are all very content to highlight the degree to which they have already moved to substantially head off any inflation threat, yet allow that the global economy (led by a US which has significantly dodged the spillover effects of selective sharp regional weakness in housing) remains very strong overall. This includes strong ex-energy commodity prices. The one exception is the ever vigilant ECB. Their strong outlook for Europe and expectations for global economic data are ample cause for concern that the equity market strength is not just the net result of financial engineering, but moreso significant of continued strong growth. The technical parameters related to that concern are noted in the final paragraph of this section.

For now, the markets seem to be respecting parameters discussed previous that include the inability of the Bund to put in the requisite UP Breakouts through the recent 115.68 high, which is well calibrated to the resistance in the mid 107-00s for the T-note, and low 107.00s for the Gilt. That is in spite of what has been some weak economic releases and quite benign inflation indications of late, prior to this morning's slightly stronger than expected US CPI. (More on that below as well.) Similarly in the foreign exchange, the EUR/USD inability to push above the 1.3150 Tolerance of the 1.3100-20 resistance, and the US Dollar Index ability to hold secondary support in the .8400 area after dropping below the .8450 congestion both signal the attempt of the buck to defend its nominal early year up trend in spite of recent weakness against other currencies, which does not seem to include the yen.

While we have noted that it remains early days for the influences which might ultimately signal any reversal out of the carry trade, the key sign so far that this will be evolutionary instead of revolutionary is the lack of any secular strength in the Japanese currency after today's BoJ hike. While the received wisdom is that this is due to the BoJ not signaling any appetite for serial rate increases, the foundation for that indication is certainly that their economy continues to expand more slowly than competing world economies. On current form, EUR/JPY pushing to new highs into the 159.00 area does not even hit major historic congestion until the 162.00-.50 range, and the recently weaker British pound has already hit and reacted from its equivalent area at GBP/JPY 240.00-241.00, yet now has room to recover if it can surmount 235.00-236.50 resistance, as with the USD/JPY 122.00 area.

This all returns us to our previous observations (cited again below) that short of a more radical strengthening of the Japanese economy or sharp reversal of economic strength elsewhere, the economic fundamentals do not support enough convergence between Japanese rates and other global rates to foment a sharp reversal of the carry trade. In fact, in the near term this more likely remains an attractive proposition.

That will also have quite a bit to do with the future path of rates. The strength of the equity markets point to continued growth possibly reinvigorating inflation pressures elsewhere prior to any significant impact in the still relatively weak Japanese economy. The question for not just the yen but a whole series of assumptions rests with how much strength is signaled by the equity markets from here. The resistances above the key strong sisters remain in the DJIA in the 12,750-90 range, and DAX in the 7,000 area. Above those levels each of those markets are likely to accelerate up at least another 200-250 points, and we still feel that would be good for the US dollar and a questionable environment at best for fixed income. While it is a bit brief, that review covers the most telling aspects of the trends, and we refer you to last week's ***CMO*** III-7 on the **Sample Reports** page of our website for more details.

Reports & Events

In spite of having seen many reports so far this week, the fun and games just begin in earnest with this afternoon's release of the FOMC minutes from January 30-31. The reason for this is in part that in spite of the short month February calendar and holidays leaving CPI until this week and the release of the FOMC minutes today, we are basically in the back half of the US mid-month reporting vacuum this week. The short month also means this is a brief window of calm after the minutes release through the end of this week; next week brings the veritable late month and early month data tsunami once again. Yet, for some reason the US BLS has decided to delay release of the US Employment report until March 9th, and that will ease the crunch next week.

Yet, that means the balance of this week's economic influences after the FOMC minutes are centered in Europe. However, as the last bit of US input this week, that leaves the minutes more influential, not less. Especially as their statement accompanying the 'no action' on rates was significantly more upbeat than anything previous (or what any market observers we are aware of expected), the potential impact from that release in the wake of the hotter than expected US January CPI this morning.

While they have a penchant for not accurately reflecting all of their deliberations in the statement, they would need to provide quite a surprise to defuse the upbeat nature of the January 31st statement. Changes from previous statements were striking, especially mention of "firmer economic growth" and "signs of stabilization… …in the housing market." Each of those was in stark contrast to previous statements. All of which should assist the equity markets in shaking off the rate concerns engendered by this morning's inflation numbers.

Even after release of the FOMC minutes, the Fed's Yellen speaks on the economic outlook. Yet, outside of that, tomorrow morning influences rotate around to the Australian Conference Board Leading Index (DEC) and Average Weekly Wages (NOV), along with the Japanese Merchandise Trade Balance (JAN) and Supermarket Sales (JAN.) After that it's on to what is likely to no adjustments to the German Gross Domestic Product (Q4 Final), along with all of the typical government and private spending totals and Import/Export figures. This followed by the French Business Confidence Indicator, Production Outlook and Own-Company Production Outlook (all FEB), Italian Business Confidence (FEB) and Retail Sales (DEC), UK Total Business Investment (Q4 Preliminary), and Euro-zone Industrial New Orders (DEC.) Final influences from the typical weekly US Jobless Claims and EIA Crude Oil Stocks (for last week), as well as the Help Wanted Index (JAN) are likely to be muted.

Friday is once again centered on Europe, albeit starting with the Japanese All Industry Activity Index and Corporate Service Price Index (JAN.) Then it's on to French Consumer Spending and the Italian Trade Balance (both JAN.) The more important German IFO and UK GDP (Q4 Preliminary) follow, with the Private Consumption component of the latter expected to take a jump from Q3. The UK Index of Services (rolling quarterly figures for DEC) and Car Production (rolling quarterly figures for JAN) are also released. And then it's back to something which was suspended at the end of last week, yet has become a very typical end of each week: a central banker gets the last word. This week it is the Fed's Yellen speaking on the economic outlook in Sacramento after the fixed income markets are closed, and shortly prior to the close of the equity markets. How nice.

Report Reactions

Last week saw some very interesting price activity in fixed income markets. The extension of the recovery in strong sister US markets was exceeded by the first really sharp recovery for some time in previous weak sister UK markets, with the residual weakness in what is now the new weak sister Bund and Euribor leaving them stalling no better than the previous week's reaction highs. A certain amount of the residual weakness on the continent can be ascribed to the continued predations of the ever-hawkish ECB. Yet, that does not explain the curious phenomena occurring elsewhere.

The weak US and European economic news encouraging a reaction back up to some fairly important resistances was not really much of a surprise in markets which had been in sustained down trends. The UK Gilt had Closed lower nine weeks in a row between early December and the first of this month, leading the way down through the summer 2006 lows which the Bund and T-note have yet to violate. Given the weakness of the UK news, it was entitled to make up some of the ground lost to the strong sister T-note and previously more resilient Bund. Yet, as these markets had already achieved a test of their higher resistance levels by last Wednesday, and had the weak news from early in the week as background, why did they fail to knock out those key higher resistances they were already testing into continued weak news late last week?

The combination of across the board benign UK and Euro-zone inflation news and weak economic indications that included a weak German ZEW Survey (FEB), French Non-farm Payrolls (Q4 Preliminary), and very weak US Housing Starts (JAN) and Michigan Consumer Sentiment index (FEB Preliminary) why were the T-note, Bund and Gilt unable to breach the resistances noted in the Overview (above)? That would have led to further improvement in the short money instruments as well, as violation of those resistances (which may still occur in the wake of the FOMC minutes release or other news later this week) holds the prospect of roughly another full point higher in each of the long ends.

However, that is the very reason those resistances are critical enough that the markets are likely hesitant to attempt violating them unless they are clear that the news will continue weak enough to enable that sort of further improvement. The fly in the ointment remains strength in the equity markets which seems to be reinforcing expectations of further economic growth that is in fact inconsistent with the lower inflation expectations. In line with our consistent theme of reporting cycle oscillation, was this morning's US CPI overshoot just an anomaly in a benign situation, or the first shift in a reporting cycle oscillation back to stronger, more inflationary news? If the FOMC minutes reflect a sentiment that is anywhere near as buoyant as the January 31st statement, then it will likely supersede the recent benign comments from Mr. Bernanke, and may just assist the equities in shaking off the concerns generated by this morning's US inflation numbers.

Frank Bernanke

While he was certainly entitled to the kudos he received during Congressional testimony last week for seeming to have had a very prescient outlook to date and also very 'frank' in his assessments, that also allowed Mr. Bernanke to avoid the need to say "I told you so." However classy and low key that would have been expressed, it would have been unseemly for a Fed Chairman. That said, one of the most interesting and telling exchanges of the two day testimony was a response to the somewhat more pointed (as always) remarks and questions from irrepressible House Financial Services Committee Chairman Barney Frank.

The Right Honorable Chairman Frank's inquiry was on the Fed's and Mr. Bernanke's forecast calling for the economy to slip back to (or just below) trend growth, and for inflation to slide back further toward or below the Federal Reserve's preferred comfort zone of between one and two percent. His specific inquiry was that if the current relatively full employment was both desirable and also a very important part of the Fed's mandate, shouldn't that warrant a strong bias toward cutting rates instead of the residual inflation risk focus of the central bank?

Mr. Bernanke was very 'frank' once again. He simply noted that all of those views were just forecasts, and the Fed might be wrong. Certainly sensible, and candid. Yet, it also continues to highlight the degree to which all of the major developed economy central banks (save the ECB) are tending to view their own inflation improvement as a good thing which leaves them room to be a bit circumspect while highlighting the continued strong growth in the global economy (which was recently reinforced by the OECD Composite Leading indicator projections for December.)

The Cycle

All of this tends to reinforce our sentiment that the equity markets still need to be watched for signs of accelerating economic growth. While it is by no means a direct or clear correlation, especially in this distended a trend, and upward acceleration in the equity markets is likely to exert some very strong psychological influences elsewhere. As noted above, the current key levels (i.e. this week, and rising incrementally across time) are DJIA 12,790 and DAX 7,000. Sustained price activity above those levels would likely lead to DJIA 13,000 plus, and the DAX at least hitting incremental interim resistance in the 7,200-50 range, with major historic congestion and oscillator resistance not until the 7,500 area.

Of course, as we have noted many times, there is no hard and fast rule that major extensions of equity market up trends necessarily dictate significant selloffs in the fixed income markets. While that sort of extreme counterpoint was in evidence in early 2006, there were phases prior to that when the equities and fixed income rallied together. The most notable of these was the major anticipatory rally in European equities in 2004-2005, as they both followed the US equity markets, and then began to reflect the return to strength on the continent. All of which occurred with the Bund remaining a full blown bull market even though the US long end had been consistently bearish after the mid-2003 peak.

The difference between then and now? The phase of the cycle. Equity market up trends in their early phase allow that it will take some time for economic turnover will take some time to reach the point where inflation pressures will surface. However, later in the cycle potential pressures are much more likely to be triggered by concrete influences such as commodity prices from strong demand (especially global demand after a long period of growth) or the psychological second round inflation expectations from wage pressures.

While it took a sharp reaction back down after first breaching the 400 level in December, the CRB Index is now back above that level after not violating trend support to the down side; and that is with still very much lower energy prices since the August 2006 peak. Gold is back on the march toward the $728 lead futures contract May 2006 high, having just surpassed the $669 July 2006 reaction high subsequent to that May 2006 high. Energy prices may be stalled into the Crude Oil resistance at 60.00-61.00, yet are keeping the bid overall, and this all points to the degree there is just not very much slack in the price situation if the global economy experiences any greater than expected growth: Watch the equities.

Carry 'Tirade' Cassandras' Quixotic Qualms

We can only respond to the ever more strident warnings from various quarters on the likely demise of the world financial system due to the imminent unwinding of the 'carry trade' by inquiring, "What if they throw a crisis and nobody shows up?" While that might appear a bit flip on the surface, there are good reasons for the extreme concerns of the carry trade Cassandra's being misguided.

There are also compelling reasons to take a more global view at this time. Not the least of which is the likelihood of BoJ firming in the wake of renewed economic strength that includes domestic Japanese demand. Misplaced notions about the implications of any BoJ action are more likely to trigger the very market disruptions which concerned commentators feel they are attempting to avoid, encouraging more near term volatility than warranted by any actual fundamental shift.

Some sage observations in a letter to the Financial Times from Brown Brothers Harriman's Marc Chandler ("These two factors should lessen concerns over yen carry trade", February 17, attached) were a partial address of the factors noted in previous major analyses by that estimable financial journal (among many others.) In fact, the FT and other business news and opinion sources have relied heavily on the views of highly concerned parties, and those analysts views were neither nearly broad based nor comprehensive enough in our view. Any reasonable assessment calls for integrated review of four related aspects of this situation.

These include the relative economic fundamentals, central bank activity, the position of offshore issuers and other participants in this extended bit of financial engineering, and dynamics of the trend across the broader horizon. The harbingers of doom failing to include some or all of these factors in their analysis has led to the current acute anxiety. While very possibly improving faster than expected previous, the relative economic fundamentals in Japan will still leave it lagging the rest of the world for at least some time to come. This also means that any adjustment in its interest rates is more likely to remain evolutionary than revolutionary. Some participants may have placed their short term bets on assets which can react sharply to any sense the cost of funds in yen is rising. Yet, baring a major fundamental shift, that is a short term factor.

As Mr. Chandler noted, the rather significant unwinding of yen speculative positions last fall did not have much effect on the major equity markets. That has been reinforced by the recent rally in the yen leaving all of the major stock indices at their highs of the current rally. Our analysis is long term enough to appreciate it is early days, and no assumptions should be made on the basis of such a modest yen rally. Yet, at least initially, there does not seem to be much cause for concern.

Regarding the central banks, their lack of activity has been characterized by some as a dread of precipitating a crisis. While they are likely duly concerned about not distorting the natural trend of the yen, their attitude is likely moreso *laissez faire* than caught in the headlights. As they successfully engineered a bottom in the Euro in 2000 when it had allegedly entered a phase of endless decline, any smoothing of the yen is also unlikely to cause a significant crisis; as long as it is timely to continued economic improvement.

There has also been much made of late about the degree to which offshore issuers are driving the appetite for yen borrowings. Yet, the dynamics of the trend across time is that speculative interests which have been pursing the carry trade for the past several years now have very large buffers of profits. It is inconceivable that more substantial entities are going to panic because the favorable carry trade interest rate spread contracts between 25 and 75 basis points. Only once there is a prospect of Japanese inflation and growth pushing base rates above one percent will there likely be appreciable pressure on carry trades.

Even allowing that comparisons to 1997 and 1998 are relevant in their consideration of volatility, after those sharp bouts of strength, the yen returned to either sustained secular weakness or stability. And those sharp fluctuations had no lasting effect on the equities, which were in much more distended bull trends than today. As such, the worries surrounding worst case scenarios are moreso centered on the potential for a collapse of other developed and rapidly developing world economies than anything to do with Japanese growth alone. Only a trigger independent of carry trade 'trimming' that brings other major short term rates plummeting down toward Japanese levels could possibly provide the spark for the "vicious circle" scenario some fear will be the case.

While always vigilant on technical and psychological signs that a sharp trend reversal has been triggered, there do not seem to be any such indications at present. And this is after the relatively softer US economy absorbed significant weakness in the housing and auto sectors. The warnings of highly professional analysts who remain very concerned about carry trade excesses should certainly be factored into risk potentials. Yet, unless and until economic factors bring other major economies moreso in line with Japanese performance, concerns over a crisis might be a bit overwrought. The shift back from extensive, and in fact most probably excessive yen borrowing is more likely to be evolutionary than revolutionary for the foreseeable future. Of course, the markets have already passed the first test in the form of this morning's BoJ meeting.

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

-Rohr
(www.rohrintl.com)
