

ROHR REPORT

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Key Views, Overview,...

...“Let ‘em Eat MBS”, Carload of Beef, The Fiddler’s Notion

Key Views

- The Great Delinking R.I.P. It is obvious that what occurred in Europe this week is another vestige of the degree to which the rest of the world was misguided in thinking the US (especially the allegedly ever-buoyant consumer) could come under extensive pressure and it would not make any difference to ‘self-sustained’ economic strength of Europe and the rapidly emerging economies. While the problems up to a point seemed to be substantially in financial services, the US has demonstrated that those can and will migrate to the broader economy through the credit markets. This is also now apparent in various markets we review below, and most prominently the degree to which ‘country’ spreads are now working against US long dated government bonds, as we have been strongly focused upon of late. That this is occurring even as the long ends rally reinforces our expectations of T-note vulnerability once equities bottom.
- As to the machinations in Washington DC, they were also thoroughly (and sadly) predictable for some time. While dissection of the causes is not something we need to revisit here, the end result is as expected. In the same *CAPITAL MARKETS OBSERVER* III-41 (December 19, 2007) where we first noted the that an **RTC-2008** would likely be needed, we shared the response from an insolvency attorney friend of ours when we answered his inquiry on the illiquidity crisis by noting that the American taxpayer was going to foot the bill. In a most matter of fact manner he replied, “That’s a given.” The benefit of his professional perspective was they he knew where the money was. The question is whether a “Let ‘em Eat MBS” mentality is a good idea while the crisis is in progress?
- We also hasten to add that while we disagree with Treasury Secretary Paulson’s lack of support for direct borrower assistance, we are very thankful that he is the head of that critical department at this decisive juncture. That may sound like a bit of a contradiction, especially in light of our recent criticism. Yet, with all due respect for the intelligence and accomplishments of his recent predecessors, we doubt they would have had his sophisticated grasp of the issues at hand, and ability to negotiate as effectively with a restive Congress. There is also the sheer public service aspect of his assuming his current role. He surely needed neither the money nor further professional stature. Indeed, we surmise he had an idea how fraught things were, and the situation would require somebody of his standing. Whatever anyone may believe about tactical financial moves during the earlier phases of the crisis, he deserves full credit for stepping in at a time when he likely knew the challenges were going to be so major as to require that someone with his relationship with Wall Street, strong grasp of the nature of the problem, and *gravitas* to maintain some control was needed.

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- As to further fundamental influences, aside from US housing data this week that we noted in Monday's *Weekly Overview* was going to be some of the little relevant economic data regarding the crisis, the balance of the economic data has been significantly weak on everything from Japanese employment to global Purchasing Managers Indices to UK home prices as well. Now it will be interesting to see whether Monsieur Trichet can finally come around to somewhat supportive language at the post-rate decision press conference this morning, or tosses the credit markets the anchor we fear he might.
- As to the markets, the initial equity market response on Monday afternoon was nothing less than a full blown debacle that was followed by Tuesday's euphoric 'maybe now they'll get it passed' relief rally. Sort of an equity market version of *The Agony and the Ecstasy* (Irving Stone's 1961 novel about Michelangelo's struggles) that we hope ends with a work of inspirational market confidence art. At least so far since then the European equities that were already leading the way down in Monday morning held in while only washing out below key supports on Tuesday prior to rebounding. As noted in Tuesday's *TrendView Brief Update*, it is very interesting that while DJIA had indeed slipped below major 10,700 support with its Tolerance to 10,500-450, it has rebounded to back above 10,500 up into its 10,832 mid-July lows. That still leaves some faint hope that it can stabilize, and not turn in to a more accelerated bear trend once again.
- That said, while we felt previous the other equity markets were very likely to follow the DJIA lead, the S&P 500 future and European stock indices actually led the way down. That points up the heightened risk factors facing all of these markets. Yet even with the banking crisis spilling over into Europe and the UK this week, the DAX drop below 6,000 and 5,875 has so far only washed out below 5,735 and recovered, which is very important with the next support not until the mid-2006 trading range congestion at 5,375 with a low end in the mid 5,200's. It is similar in the FTSE that also dropped below 5,071 mid-July low as well as 5,000-4,960 (congestion as well as 'big penny') and 4,850, yet only washed out somewhat heavily below 4,800-4,775 area (significant April 2005 pullback low and congestion) prior to recovering; below that the next support is not until the 4,600-4,550. And then there is the December S&P 500 future that also overran its 1,201 lead contract mid-July low (also very close to the 1,202 low in the December contract), 1,172-65, 1,145, and 1,137 prior to recovering back above those lower levels in overnight trade. If there is sustained weakness below 1,137, expect an implosion to the 1,096-90 area (from October 2004), or even the August 2004 pre-election trading low at 1,060. Whatever one may think about the others, the NIKKEI obliterating its own (rather more depressed) basing action in the 12,000 area from back in March and only railing back to that area last week prior to falling again remains the weakest of the weak sisters. Really not very surprising in light of it seemingly being the first to go back into a contraction. Lower support at the 11,620 mid-March has been more seriously violated, with major lower support back at the 10,500 low end of the 2004 extended trading range tested, even if there are interim congestion areas at 11,260, 11,000 and 10,800.
- Of course, the long dated fixed income has responded well to this equities weakness, and has had more definitive countervailing swings in the past couple of weeks. Yet, as we have noted more than a few times previous, the extended 'govvies' bid well into negative real yield territory was based upon the fear that other credits were almost all suspect (except for the very most highly rated.) Once it becomes apparent at all that the equities might be bottoming and the other credits might become more liquid and attractive, the government bond markets will become very suspect; especially the T-note.

- As vexing as the full point discount in the December T-note was prior to the September contract expiration, it also continues to illustrate the inability of the contract to escape the 118-00 area resistance (Tolerance at 118-12) that ended up being a key to its weakening markedly when equities recovered. What is notable is the degree to which it had not rebounded much in the face of the initial equities drop two weeks ago, only strengthening markedly once a real crisis atmosphere returned this week. Of course, once that occurred the 'two-way' street psychology we turn to more of the drag racing up and down the block that has characterized the atypically volatile range trading of late. Also of course, there is also the issue of the major increase in bond issuance and inflation implications of the ballooning federal deficit which are weighing on the long dated debt instruments. We suspect that after holding important trend support at 115-00/114-16 (below which the next support is not until the 112-24/-16 area), the recovery on any near term DJIA weakness will feel can just a round the low 116-00 area, and moved to the extended edges of the range in response to counter the ailing equity swings.
- The Bund is more clear cut after temporarily overrunning resistance in the 115.00-.30 area, yet failing once again at higher resistance into the 116.00-.30 area. Lower supports below the 115.00 area are as noted previous at the overrun resistance in the 114.30-.00 area (that has already been overrun once again) and more important trend support at 113.30-.00, with higher resistance into the 117.00-.50 area. Similar tendencies apply to December Gilt in spite of its massive premium to the now expired September contract. As noted previous, that significant premium was a big 'tell' that the long ends were all likely to moreso remain in extended bull trends for the interim unless the equities had performed far better, and that has worked in spite of the sharp selloff at the end of the week two weeks ago. The higher interim resistances at the 112.57 January continuation high and multiple recent trading highs in the 113.05.32 range have indeed restrained the December contract. Extended resistance above that is not until 114.50 and every half-point up from there to the June 2003 all time high at 116.58.
- Technical levels for short money forwards remain geared to March 2009 contracts, and have shifted markedly in the wake of the equities weakness. While there is still a lack of a strong rationale for major easing by central banks in the face of the inflation pressures, recent European and UK expressions of economic weakness have driven the psychology nonetheless, and that has proven to be highly erratic as the implications from weaker equities are not as constructive for the short term credit markets as they had been previous for the long ends. Eurodollar back a round 97.175 early May high resistance (with a Tolerance to 97.20) also failed it reinstated resistance in the 97.40 area with next resistances in the 97.71 that restrained the market before the crunch back down to 96.90 support a couple of weeks ago when the additional credit market tightness hit last week. Lower support remains 96.75 and 96.60.
- Short Sterling had similarly pushed above key resistance at 94.65 and 94.85-.90 as well prior to stalling at next resistance into 95.17 prior to experiencing the same sort of short-term weakness two weeks ago. Yet even at that it managed to hold on against the previously violated resistance in the 94.55-.50 area, and is now back above 95.17 in the wake of much weaker UK economic sentiment, with next resistances as nearby as 95.25 and not again until 95.45-.50. DAX is the western economies' weak sister, and that has fomented some real strength in the Euribor in spite of ECB recalcitrance. While laggard on the recent rally, it has pushed back above the heavy 95.25-.30 congestion and even 95.40 where it stalled previous. Already above additional heavy congestion at 95.55-.60, next resistance is not until 95.75 and the 96.00 area.

- Extensive foreign exchange projections are somewhat the same as previous in spite of the previous extended strength of the US dollar confirming the secular reversal of its down trend into a sustainable up trend against other currencies finally reflecting poorer fundamental economic conditions elsewhere. Yet, the stall out into resistance at US Dollar Index .8000-.8100 brought a reaction all the way back down to support in the .7600 area prior to the recent recovery right back up into the .8000 area. It is interesting that EUR/USD violating supports at 1.5000-1.4850 in August was especially important due to there not being any further support below it until the 1.4540 Objective. Yet, the low end of the previous trading range below the 1.5300 area May-June lows was not until the low 1.4300 area. The rightful implication that we expressed previous was that a weekly Close below the 1.4540 Objective for even a retest of the low 1.4300 area would be more bearish (i.e. bullish for the buck) than it appears due to overrunning the mid 1.4500 Objective into the early part of this month. As such, the drop to the 1.4000-1.3850 was not a big surprise, and the market is right back there now with a secondary critical test. Much below that there is interim support in the 1.3600 area, yet with the next major sport not until the 1.3350-00 area and 1.3000-1.2850.
- It is also important from another perspective, as once EUR/USD held 1.4000-1.3850 support previous (along with other weak currencies holding their commensurate extended levels against the buck) it was time for an extended reaction. All of those (and especially weak sister AUD/USD into its .8000-.7900 support) were more formidable areas that were consistent with the US dollar also stalling out if it was not ready to exhibit a push to the next major levels in the near term. As the markets are now right back at or near those more major US dollar resistances after a somewhat significant correction, the greenback may actually be ready to extend the rally. However, given the two-way street mentality that has set in to so many other areas, we are inclined to wait for the weekly Close to confirm that the dollar has actually escaped those resistances.
- Equivalent trends for the other major US dollar indications have key levels at:
 USD Index: RES: .8000-50; .8100-50 (Fib); .8215-50 SUPP: .7700; .7600; .7530-00
 GBP/USD: RES: 1.8000-1.8100; 1.8300; 1.8650; SUPP: 1.7650; 1.75; 1.7100-1.7050; 1.66
 AUD/USD: RES: .8265-90; .8430-.8500; .8675 SUPP: .8000-.7900; .8675; .7500-.7400
 USD/JPY: RES: 105-106; 107; 108.60; 110.00-.50; SUPP: 103.80-50; 102.50; 100.50-00
 USD/CHF: RES: 1.14; 1.16; 1.1850-1.1900 SUPP: 1.13; 1.1000-50; 1.0860; 1.0600-25; 1.05
 USD/CAD: RES: 1.0675-1.0725; 1.0865-1.0920 SUPP: 1.05; 1.0350-00; 1.02; 1.0050-00
- While the October Crude Oil drop below weekly congestion and Fibonacci support in the 100.00-98.50 area seemed telling previous, it also ran straight up through resistances in the 106.23 and 110-112 areas once it was apparent that there were so many US dollars being splashed around it created an 'stagflation' psychology spike into the commodities in general (look at what gold did!) Unfortunately for the Black Gold bulls, it is not actually Gold. Failing back below the 100.00-98.50 area at the top of this week, November Crude Oil also slipped right back down to the 95.50 support that was violated on the selloff two weeks ago. While it only approached them on that break, extended congestion into interim support remains at the 89.00 late 2007-early 2008 congestion with and major support into the 86.00 area Fibonacci levels and December-February lows.

Overview

There is really not so very much to say in an Overview this week, due to most of what will or will not occur with the markets resting with the US House of Representatives decision on whether to proceed with the massive financial rescue package that the Senate approved yesterday evening.

As noted above, there is a bit of an upside down “**Let ‘em Eat MBS**” mentality right now, as the general populace signals that sentiments about on not caring very much about what happens to mortgage backed securities orphans of very much diminished previous Masters of the Universe. While it may end up back-lashing to hurt even the well-to-do, there is a generally negative sentiment on Main Street toward paying off the previous sins of Wall Street.

While Republicans are resisting from the right on fiscal grounds, the sentiment from the left is that there needs to be more in it for Average Joe and Jane seems sensible in light of the pressure on at-risk borrowers facing foreclosure also being at the core of the mortgage-backed securities portfolio failure problem for the banks. After failure of the rescue package failed in the House on Monday, Rep. Loretta Sanchez (D-CA) summed it up best when she said that it needed more address of failing mortgages, and she could not vote for something that did not provide more relief to the folks who are footing the bill.

“Let ‘em Eat MBS”

It is glaringly apparent that the current financial crisis has assumed a critical political dimension that must be included in any analysis. On the economic front, I have noted for some time that the pure 'just absorb the write-downs' approach of Messrs. Paulson and Bernanke was not going to fully address the illiquidity of the financial markets.

New Jersey Governor Jon Corzine (who has no small amount of experience in the financial services business) also came out in favor of the rescue package. Much like House Financial Services Committee Chair Barney Frank, he was pointing out the degree to which the government taking control of the tainted MBS would facilitate the more rapid renegotiation of loans that the at-risk borrowers cannot afford. Why it took so long for the powers-that-be to get around to explaining this to the general public is a bit of a mystery. Perhaps they could have used some sort of metaphor for the intricacies of creative finance would have been appreciated. And we explore that iteration in **Carload of Beef** below.

As we shall review in **The Fiddler’s Notion** this week there is a current topical bent to apportioning blame to Wall Street, some of the regulators and even the central banks. However one of the greatest risks that now faces elected representatives (and by extension the general public) is making decisions on significant regulatory changes in the midst of a crisis. The question which must be asked is whether it is a case of **Rules Moot in Failure of Will**. As we suspect that is the case, no rush to regulate will solve future problems as well as selecting people for key roles who have the will to rigorously implement any sort of regulations, and provide properly prescient economic management.

It lacked the ability to stem sharply sliding valuations of underlying assets that raised the suspicion of market participants in the first place. It is now the case that their extreme focus on keeping Wall Street whole with no correspondingly aggressive efforts to assist Main Street has left bad feeling in the hinterland; and that may still result in dire consequences.

While the general public rarely understands what goes on in Washington and Wall Street, the lack of direct assistance to the US housing sector during its recent sharp correction has fomented outright rebellion; and of a most ugly sort.

The Treasury Secretary and Fed Chairman have delivered almost no direct solution to the dilemma of sharp US house price slippage being at the core of Wall Street's problems with derivative debt securities portfolios exploding. This has been akin to termites armed with hand grenades, and they failed to tend to the pestilence problem while they were throwing new siding (and business names) on the house.

In addition to the obvious cultivation of some constructive grassroots sentiment from cooperating with (instead of adamantly rejecting) Congress' Hope for Homeowners at-risk borrower program, there is also another benefit that would have been very useful for their current plan.

Had they gone along with reducing home values and interest payments in an orderly manner, we would now have a benchmark for assessing Mr. Bernanke's elusive mark-to-maturity value of distressed homes. Even if that meant only those qualifying for FHA guarantees, it could have furthered the valuation of distressed mortgages, providing an alternative to asking the public to go along with 'reverse auctions' that they do not really understand. Even Messrs. Paulson and Bernanke admit this will require 'opinion' from 'experts' (further impugning their own standing as such.)

At his press conference along with Senator Dodd last Friday morning (September 26) House Majority Leader Harry Reid pulled the covers off an elaborate kabuki dance of cordiality when he explicitly pointed out the vehement opposition of the administration to any foreclosure mitigation.

That included a firm veto threat for the entire first half of this year. He asserted there were ten thousand foreclosures per day during that period.

That seems to move toward Congress demanding highly visible foreclosure mitigation support as their *quid pro quo* for approval of any rescue plan. It may well also provide at least part of the political cover recalcitrant Republicans now seem to need to play along.

While it is reasonable for esteemed economists to question its efficacy, that's what is now necessary to regain any grass roots support that the administration's Wall Street-centric 'just absorb the write-downs' approach has almost completely crushed. On the economic front it addresses the relevant issue of stemming the seemingly endless further destruction of bank balance sheets, and associated problem of raising fresh equity (as Andrew Smithers rightfully points out will be necessary) from skittish major investors who will also question just when to expect the bleeding will stop.

It is also likely hard to imagine an American public that would do anything as financially self-destructive as to be akin to the Mob tossing out Louis XVI. Yet, attitudes amongst the well-to-do as well as the struggling middle class toward the US Treasury's plan to 'ring fence' toxic securities from the banks is a sort of upside down, "Let 'em eat MBS."

With due respect for their other fine qualities, many of my countrymen are cowboys with little awareness of history. It does not occur to even many among the upper-middle class that the enlightened nobility went to the guillotine in equal proportion to hardcore aristocrats. While they are talking tough now, how many are really ready for a financial form of the Terror? Hopefully it doesn't come to that.

What is as disconcerting as the response of the well-to-do is Americans is the degree to which they seem unaware (or unwilling to consider) that even though home prices tripled between the mid 1980's and the peak in 2005 they also developed a sense of entitlement which means that any significant correction should just not occur.

In another form of greed and fear, they are now offended that they are being asked to purchase the hangover medicine for those who were later to the party than they were, and tried to play 'catch-up' by overindulging in potent Hybrid Adjustable Rate Mortgage party punch. They certainly were not complaining while prices were going up.

[A Carload of Beef](#)

As a preamble to the topic of blended loads of any commodity, we note this morning's news that Sigma Finance, the last of the complex debt funds at the heart of the credit crisis has collapsed. That ends a 25-year project to create a "shadow banking" industry. Of note, the name of the fund's manager was Gordian Knot.

The irony should be lost on nobody that this is also the name of the puzzle from antiquity that nobody was able to untie until Alexander the Great allegedly slashed it to prove his right to invade and take control of Asia. What may have begun as fund manager panache ends as a macabre aside.

With all of the focus on the degree to which the tainted portion of the mortgage-backed securities (MBS) are a problem for resolving any blended debt securities pricing issues, it seems there is a major conundrum on how to decide just how much value remains in light of the US housing weakness. It is not news to any of our readers that the 'reverse actions' being proposed by Mr. Paulson and Mr. Bernanke are an expedient where there is no obvious valuation mechanism.

Just as it was apparent where the money is to that insolvency attorney friend of ours we mentioned in the [Key Views](#), it should have been apparent to any reasonable individual that their home does not appreciate by 10% a year for quite a few multiple years without being indicative of a bubble that will indeed have a correction.

Their view seems to be anchored in the perception that at least they still have substantial equity in their home. It does not occur to them that unless at-risk borrowers whose properties are worth less than the balance on their mortgage gets some relief, further foreclosures will hurt the housing market in future.

This is due to the compound problems of complexity and the current exceedingly weak US housing environment. It is now a given that the degree to which the complex nature of the securities has not allowed any ready resolution of issues in renegotiating the problem loans. Mr. Paulson said so himself after extensive meetings a full year ago with the securities firms and banks burdened with these loans.

Of course the dilemma is that the loans were securitized into various slices that went into different securities. And those created debt holders that were both broadly dispersed geographically and with varied interests depending on the specifications of their particular slice of the debt. Really not so hard a conundrum to conceptualize; just to solve.

And of course (once again) here is a single common feature: a borrower who was at risk of default. While there are some other reasons in quite a few cases that possibly can not be addressed, a significant portion of those individuals are at-risk due to the very nature of the mortgage: the Hybrid Adjustable Rate Mortgage (HARM.)

It is especially the 'hybrid' aspect of the HARMs that is the problem in most cases, where a very attractive 'tickler rate' lapses into a rate that is calculated as a premium to a broadly recognized short term interest rate, with regular reset schedules.

While in principle none of that should be a particular burden for the borrower if the loan was structured to modestly increase the rate of interest once the initial artificially low rate 'tickler rate' lapsed, in practice the increase in the interest rate is very often not supportable by the borrower.

As more than a few commentators have noted, it was either greed and/or misguided enthusiasm that drove the aggressive sale and issuance of these mortgages. The new borrower wanted to cash in on seemingly ever escalating prices of homes, and the lender was happy to let them do so.

It is now clear that the securitization of those mortgages that was supposed to insulate the purchasers of portions of them from risks (through being blended in with more solid credits) actually left an overly complex and amorphous hard to price instrument in place.

That is now a major part of the conundrum of how to address the borrowers' need for relief if the mortgages thus generated are not to end up in foreclosure; with the also now obvious bad effects in the securities portfolios holding them along with the US housing market in general.

Yet again we note that amidst all of the complexity that exists on the side of the mortgage holders (lenders) there is still just one borrower who has a problem that, if solved, might provide at least some the solution to stemming what is becoming an unacceptable level of weakness in the US housing market.

Attacking this common denominator of the problem still seems a necessary adjunct to any attempt to re-liquefy the credit markets by ring fencing bad MBS to provide a stable outlook for banks. It can be visualized to some degree as what might happen in trading of a far simpler asset from the old fashioned cash commodities: beef.

Having started on the commodity futures side of the business before there were any such things as financial futures (much less options and swaps), we can tell you that blended lots of a commodity (which at some point it was deemed 'debt' and foreign exchange were also) are not really any sort of new phenomena.

Average grading and/or specifications for the individual components a blended load have been used in all sorts of agricultural commodities since extensive commercial deliveries were invented centuries ago. There is little hope that all of the grain or meat or cotton in a particular load will conform to an idealized 'average' quality grade throughout. It is a given that the different grades in a load will be assessed as part of the load being priced at a premium or discount to 'par.'

Yet, none of that has to do with loads that are tainted by rot or disease. If we were to come to you with a load of beef that is made up of 40% Prime, 50% Choice and 10% of lesser cuts like Chuck, you could figure out the reasonable value based upon current market prices. However, if we further inform you that part of the Chuck is tainted with salmonella, and we do not know its extent or whether it might be able to spread to the higher grade cuts, what would you then bid for that carload? Probably nothing. As you would have no way to know the degree of the problem, there is a disincentive to bid anything for that particular load of the commodity being offered.

While seemingly much different for the sophisticated creative finance instruments that are burdening the mortgage-backed securities portfolios, one of the great insights that brought all financial futures into existence in the first instance back in the 1970s was the idea that an exchange rate or the various components of debt were indeed 'commodities' that could be actively traded. And that was well before anything quite so exotic as a futures contract or option on a stock index.

Back to our tainted carload of beef, what if you are subsequently informed that we had isolated the tainted portion of the beef, had removed the from the rest of the load, had also inoculated the rest of the load from any potential that it would be infected with the salmonella, had reduced the price of the carload to reflect the lesser value of the now diminished amount of the commodity, and asked what you wanted to pay for it?

There is a good possibility that you would be able to come up with a reasonable price which reflected the changed circumstances, where his previous you would not have wanted to bid on it at all due to the fear of overpaying for a product with more damage than you wanted to own. Now substitute individual lots of MBS for the carload of beef in this metaphorical example.

Because that is exactly what the combined effect of the financial rescue package and the rapid implementation of the Hope for Homeowners Act passed by Congress back in mid July (along with the GSE reform bill) will likely accomplish. Lowered principal values on mortgages to reflect the drop in the actual home prices will be the lenders' *quid pro quo* for receiving FHA guarantee that the loan is secure. It is an inoculation program that once again allows holders of MBS to feel secure that some goodly portion of the security is sound.

[The Fiddler's NotionSM](#)

The Fiddler on the Roof is part of eastern European folklore. His essence was beautifully captured in the late nineteenth century book by Sholem Aleichem, *Tevye the Dairyman*. Yet, the popular name taken by the musical production is based on the quasi-cubist painting by Marc Chagall. 'The Fiddler' is a metaphor for survival in an uncertain world that is very apt for capital markets participants at all times; especially during the more volatile, erratic phases. As luck would have it, about ten years ago I came across a unique, purple palette print of him. My wife was extremely hesitant to even allow the green-faced man in the house. He ended up on my office wall. I now realize this is just as it was meant to be, as he looks over my shoulder in the rear view mirror on my computer monitor. The Fiddler's NotionSM is devoted to observations on risk that may not correlate with some of the typically market trend oriented factors in our other analysis. It is fitting that one involved in such a risky pursuit is looking over my shoulder. Whether or not you like to think about it, he is likely looking over yours as well. So welcome up to the rooftops, where you can share the Fiddler's perspective.

Rules Moot in Failure of Will

There was an excellent editorial in this past weekend's Financial Times that expounded "In praise of free markets" (attached.) It was a very balanced perspective on not over-reacting by rushing into poorly thought new rules and regulations. In essence a cogent plea to not throw out the free market baby with any unethical behavior bathwater.

While that is certainly good advice, the normally well-informed letters published in response have unfortunately been fixated on either how problems developed or apportioning blame. That misses the editors' primary point of there being an "...even greater risk: that the politicians now... draw the wrong conclusions..."

As important as that consideration is for the general maintenance of the free market, the same risk applies to specific aspects of the future situation. Among the most troubling are lack of trust in meaningful analysis, and misguided inference that crisis mitigation triage is a good guide for future structures. In his FT Comment ("New banking rules: tread carefully", September 30) London School of Economics director Sir Howard Davies exhibits an extensive knowledge of regulatory implications, while expressing extreme skepticism that analysts can project implications of current problems. (It is attached for your direct review.) Did his "diligent Google search" really fail to find any warnings of the crisis that was forming from "celebrated commentator Harry (and I presume Harriet) Hindsight"?

It is typical that academics and politicians do not trust analysts' abilities. In this case that would need to include the financial Times' own Gillian Tett's insightful and prescient observations on the major problems brewing in the credit bubble from 2005 onward. Amongst more than a few other analysts we were also very pointed on the degree to which central bankers, and especially the Fed, were risking the return of

irrational exuberance if they failed to cool expectations from late 2006 onward. In a July 2006 letter the FT was kind enough to publish we noted "...the degree to which the US economy and stock market remain drivers for their international brethren." And "...its desire to be everybody's friend will actually make the Fed its own worst enemy."

The belated recent attempt to stress test banks' risk management systems can not match the real test: central banks showing the will to cool economies. Especially once the DJIA hit a new all-time high in late 2006, my analysis included the centuries-old observation from French fabulist Jean de La Fontaine, "Our destiny is frequently met on the very paths we take to avoid it."

The Fed either had an inability to comprehend, or lack of desire to act upon the degree to which strong equities and easy credit would foment excessive asset appreciation assumptions. That was a clear failure to test new credit market instruments' resilience. The FT's head economic analyst Martin Wolf was very right about the efficacy of central banks leaning against bubbles. Last weekend's editorial provides an accurate box score for the Greenspan Doctrine of no central bank action to deflate bubbles in their early phases: Crises 2, Central Bankers 0.

The implications for future regulatory and market structures are interesting. While Messrs. Greenspan and Bernanke both expressed concerns about the irregularities in the mortgage market, they were quick to note it was not within their bailiwick. *Au contraire*. It was within their power to use the crude tool of higher base rates and more hawkish pronouncements, and (discreetly) signal banks under their direct oversight that bogus mortgages being spun into exotic debt derivative securities was no longer acceptable.

The same can be said of the SEC in regard to securities firms, and UK super-regulator FSA buying into it being 'so different this time' that a 'borrow short and lend long' model was not presenting an extensive risk at the now failed Northern Rock. All were a lack of will or analysis, not of rules; and that is a tougher problem requiring address.

Which is why the second wrong conclusion which has gained quite a bit of support would be to cede major additional regulatory powers to the Fed. The justification that it is shelling out huge sums and therefore needs more oversight is a misguided knee-jerk institutionalization of temporary triage.

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

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What the recent situation has made clear is the Fed providing extensive and sustained liquidity injections borders on making fiscal policy. And that is something which even Alan Greenspan says is not useful in combination with its need to employ its balance sheet to modulate the economy.

While regulatory reform is indeed desirable, central banks must also get back to more willful and anticipatory control of their respective economies. They remain the only participants with both the power and incentive to prevent a bad hangover by pulling the punchbowl when the party gets too raucous.