Rohr Report

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Key Views, Overview,…
…*Super-Cycle Correction*SM, The Fiddler's Notion
***Super-Cycle Correction*SM slideshow to follow. *In order to include today's DJIA Close**

Key Views

- **"Well, it ain't that pretty at all."[1] So saith the late, quasi-great rocker Warren Zevon, in what is *apropos* description of the current state of equity and credit market trends. Zevon won adherents with phenomenally impressive musical arrangements married to gritty lyrics. As life imitates art, gritty is also a reasonable description of how the economic outlook is beginning to feel. His excesses leading to disease that claimed his life (18th century poet-style) is a good metaphor for previous unsustainable global credit excesses that are now killing the economy (with a modest assist from misguided official action.) In Zevon's case, he refused the medicines that might have modestly extended his life, yet would have engendered great pain. In the case of the current crisis, great pain has been met with the doctors accurately diagnosing the root cause, yet choosing to treat broadly metastasized symptoms by forcing the wrong medicine down the throats of less than willing patients, with no relief in sight. (More below.)**

- **"…I'd rather feel bad than not feel anything at all."[2] More vintage Warren Zevon. 'Not feeling anything at all' is likely another very good metaphor on how the average investor feels. They likely recoiled in horror upon opening their brokerage or wealth management statements reflecting third-quarter equity market Closes. Yet, by the time those hit their mailboxes they were keenly aware the equity markets had shed another twenty-five percent of their value. Consistent with Warren Buffett's designation of credit market derivatives as financial Weapons of Mass Destruction, there was no small amount of 'shock and awe'. Likely most of them are 'numb'; compounded by their sense that leaders have still failed to address the core problem. The good news is that there is a way past 'not feeling anything at all.' Unfortunately that is to immerse oneself in the full realization of what is occurring, and come to grips with it.**

- **As we have already noted it previous, we won't be coy: the DJIA failure well below 10,000-9,700 violates previous sustained trend support from the December 1974 low. Unless and until it can Close back above the 10,500 area, it will remain a secular bear market that is a *Super-Cycle Correction*SM. While there are interim supports along the way, the major channel support needed to be rebased from the July 1932 low, which points to a confluence of indications converging in the DJIA 5,800-5,400 range.**

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[1] ***Ain't That Pretty At All***, Marinell & Zevon) 1982 Tiny Tunes (ASCAP) & Zevon Music (BMI)
[2] **ibid.**

▪ Just to be perfectly clear, in spite of the current aggressive downside volatility in the equity market trends, that is a long-term projection. We have no guarantee the market will actually drop quite that far, especially if the new administration in Washington establishes steps that can address the core problem of asset value destruction. Nomination of Tim Geithner for Treasury Secretary on Friday already seemed to help. Therefore, it is neither certain it will ever be hit, nor (even with the current downside momentum) that it will be hit next month, next quarter, or even next year. That said, classic form for a market that violates one of its major trend support or resistance projections is to either reverse back through it and reestablish the previous trend, or indeed need to move fully to the next major levels before the current trend is complete.

▪ As to the market tendencies, in spite of the major swing in equities and elsewhere, quite a bit is still consistent with our extended projections from Wednesday morning's *TrendView* GENERAL UPDATE. Therefore, we refer you back to that for trend perspectives and technical levels for any markets not covered below requiring further review. That will allow us to proceed timely to the major secular trend analysis.

▪ As noted previous, the nature of any continued DJIA weakness below key 8,200 support and the 7,900 area recent Loose Double Bottom low at 7,882.50 is important. While that satisfied the classic bear market definition of "lower lows", the issue for any further basing attempt is whether DJIA is able to hold the next incremental congestion from 2002-2003 at 7,500, and claw its way back above 8,200 to at least begin a possible Inverse Head & Shoulders Bottom. That would actually be constructive in the near-term insofar as it would call for a rally back to 9,600 area to complete the pattern, whether or not it ends up being a *bona fide* bottom for a return to a bull market. On the other hand, if the DJIA cannot stabilize before hitting the major 7,200 area October 2002 intermediate term cycle low, then any recovery will be that much weaker on the first retest of 8,200, and possibly leave too distended a low to evolve into that Head & Shoulders Bottom.

▪ Part of the outstanding question at this point also relates to what has been very strong activity over the past several sessions in the long dated fixed income, and somewhat less bullish activity in the US dollar and Japanese yen. In the "govvies" it is of note that European long ends are once again pushing up through key resistance levels and even the US T-note overran important resistance at 120-00. However, that has not as yet turned into a weekly Close above the 120-29 weekly DOWN Closing Price Reversal signal from the post Bear-Stearns topping action back in March. The more interesting price activity and challenge for analysts is in stronger sister Gilt that this week has overrun the 115.00 and 115.50 areas, the major 116.08 January 2006 trading high next level above that, and ultimately the 116.58 June 2003 all-time high. That leaves us relying upon historic weekly oscillator resistance (MA 41 plus 08.00-08.50) into the 117.00-.50 area. Coincidentally (as it is not correlated to the same scope of trend) the top of the daily up channel from the significant June low is in the low 117.00 area as well. December Bund is far more straightforward having already violated mid-upper 117.00 area resistance, it also Closed above next resistance into the mid-upper 118.00 area on Tuesday and the 120.00 area yesterday, with an attempt to also overrun the 121.00 area on yesterday's Close, with 122.50-.65 area (from all the way back in January 2006) as higher resistance.

▪ It is a similar lack of confirmation over the past several weeks that the US Dollar Index has not been able to post a weekly Close above its .8750 resistance which it is still struggling at in spite of Closing above it yesterday. Obviously quite a bit of what transpires in foreign exchange from here remains dependent on the equity markets.

▪ **What can one say about December Crude Oil remaining below key supports at 69.00 and 66.00, except that a move down to more major support at the 55.00 congestion was likely, and that has now been violated as well. Next support at the 49.90 old major UP Acceleration and low end of the major mid-2005 through mid-2007 range is critical again on modest slippage below that level today, with next support not until 46.20.**

Overview

There is so much to say about the broader context of the *Super-Cycle Correction*$_{SM}$ that we have decided to provide it as a series of views instead of the logical thread that we normally impose upon topical discussions. That is the reason we did not include typical extended topical titles at the beginning of the report; there were just too many, that were too far flung in nature to effectively summarize them under just one or two titles.

Which is not to say there are not major themes worth mentioning here, some of which return to and expand upon previous views and some with are new. There will also be the typical referencing of outside resources that we find compelling (on a fully attributed basis, of course.)

The primary major theme is that so much has gone wrong in so many areas with so little effective attention to the root causes, it is likely not possible to put the recently fallen financial Humpty Dumpty fully back up onto the wall. That is not necessarily news. Most folks would be happy to be able to visit Humpty in a regular hospital room instead of the intensive care ward.

The degree to which even that is possible is likely to be reflected in the success or failure of the DJIA and holding either the more attractive 7,500 level, or even the slightly less encouraging intermediate-term cycle low in the 7,200 area from back in October of 2002. That is due to the consistent quality of the DJIA in being a trendsetter for the other markets, even with the greater weakness in other US equity indices and variations against Europe at times.

However much one may want to view the predations of credit market failures and the attendant economic weakness to date as the influence which is keeping the equity markets in such a volatile negative trend, history has taught us that the markets are in fact a discounting mechanism for what is coming down the road anywhere from 6 to 18 months from now. That is reinforced by some factors we will be reviewing.

Consistent with that broad theme, while the US change of administration may ultimately prove to be very constructive, the fact we are both in a transition and there is no small amount of politics being played on all manner of emergency funding and future regulatory regime considerations is only adding to the uncertainty and even overt weakness at present. However, even though that is also a temporary phase, the changes which a shift to a more Liberal regime portends are not necessarily all that constructive for the business and economic outlook in the intermediate-term.

Just one example is the likely empowerment of greater labor union strength and militancy beginning next year. That is not necessarily an evil unto itself, as American workers have indeed been shortchanged in large measure on productivity improvements they have provided industry. It just happens to be occurring, as Murphy would appreciate, at the worst time in the long term cycle.

Aside from any of the overt criticism we and others have (and will continue) to provide, this is about many things many folks will need to 'unlearn' in order to move forward.

The *Super-Cycle Correction*SM

The Broad Economic View

Admittedly our primary focus is upon technical price trend evolution, as we find it most useful in both long-term and requisite shorter-term perceptions on how trends are going to evolve overall. Yet, using that as our primary prism for assessing trends also comes with a requirement that we at least figure out some fundamental 'rationale' that supports the technicals in order to develop a balanced and cogent trend analysis.

While it is less critical in the very short term perspective, that fundamental reinforcement for trend projections becomes important for effective long-term analysis. That is true both for those times when the fundamental view reinforces what appears to be a very credible technical projection, and those times when the fundamental background raises significant suspicions over the efficacy of pursuing the technical signals without a grain or two of salt.

The latter was the case out of early 2007 into summer of last year. Understanding that equity markets were maintaining upside momentum in nothing less than a full-blown bubble was the key to not trusting the last DJIA mid-July 2007 major pattern UP Break above the 13,700 area. As that projected an Objective all the way up in the 15,400 area, it was not consistent with the creaky economic underpinnings of the market. As we noted at the time, that smacked of more of a 'last hurrah' than any sustainable major trend extension. Ergo, the importance of fundamentals to the 'macro' (combined technical/fundamental) analysis.

Once the DJIA failed on heavy volume later last July while exhibiting high volatility back below 13,700, the general tone of the trend was reversed from the previous sustainable, albeit highly distended, uptrend.

That laid the basis for confirmation of the bearish cycle taking hold when the heavy credit market stresses triggered a sharp selloff last August first characterized as technical problems in the interbank lending market. That was actually the first sign of the beginning of deleveraging and asset value destruction that has continued since.

Our realization that was the case as early as last September is in large measure why we remained so bearish through all of the subsequent equity market rallies late last year, and bottoming attempts at various points this year. Of course, as clear as we felt the technical signals have been, our ability to maintain an aggressively bearish fundamental rationale was assisted by some of the very insightful resources we rely upon to inform our view of the broader economic background and highly critical credit market conditions in this cycle.

As we have made clear previous, there are kudos due the folks at the Financial Times who we rely upon for some of our broad trend perspective, and the commentators and analysts at CNBC who do an excellent job of breaking down the impact of short-term market influences. Of course, each of them has provided analysis we have also found useful in other scopes of trend views beyond the narrow long- or short-term perspective just noted.

Among our favorite long view analysts is the Financial Times Tony Jackson, who once again had some excellent perspectives on the need for caution even as some folks became more hopeful late last month into early November. To his credit Mr. Jackson also derives a good deal of information from highly credible resources of his own, as was the case over the past month.

In a late October article where he cautions against being misled into searching for a bottom just because equities had dropped so far in price, he notes that while it is an absorbing topic, fundamental analysis is "…only occasionally relevant to market reality." That was part of the review of a question over whether the equity markets had reached 'fair value'.

While not necessarily easy in normal times, he noted that expectations for corporate earnings were "deeply obscure" during the current disorderly economic phase. Also noting that "sector analysts,… are no good at turning points" left him turning to more tactical considerations.

Among them was the observation on the extent of previous major corrective drops "Most strategists say by 30-40 per cent in total. But that is merely the average of the past few earnings cycles. This cycle might be average, but it scarcely feels like it."

Seeing as that degree of adjustment has already been significantly overrun by the abysmal guidance to date, he was prescient in noting that markets which had become extremely overbought during the bubble likely also had further to fall than just getting back in line with fair value.

Posing the question of what happens on the bigger corrections, he referred to Andrew Smithers of Smithers & Co., a very well-respected UK economic analyst. It was no surprise that he noted Mr. Smithers "… is not sanguine."

"Since 1920, the US market has hit six real bear market bottoms - in 1920, 1933, 1942, 1949, 1974 and 1982. These bottoms have averaged precisely 50 per cent below fair value by the Shiller method, the range being 39-68 per cent." It is striking that this is what the historic research tells us about the remaining downside potential.

This is not some technical analytic view or model from some extrapolation-crazy trend analysts. This is the hard, cold historic context for markets which have come down this far to date. As that late October fair value assessment is roughly at the 880 level for the S&P 500, which is roughly equivalent to just below DJIA 8,500, the implications are daunting.

There is something to be said for all of the liquidity which powers-that-be are currently infusing into a crippled system (more below on whether or not that is effective in its own right), insofar as it will hopefully help us all avoid the sort of worst-case scenario that occurred out of 1929 into the early 1930s. While we have not formally inquired, our presumption based upon awareness of the broad historic trend tendencies is that the 68 per cent drop below fair value was indeed into 1932.

On that form the full discount below fair value in a situation where liquidity dries up completely, would indicate the DJIA not basing until 2,700 area. While we have not necessarily agreed with all of the tactical maneuvers of the Treasury Secretary or Fed chief, we encourage them to keep the rescue liquidity going full blast (now a question regarding Mr. Paulson.) Even so, consider that the seemingly less threatening fifty percent drop from fair value would still mean a DJIA fall to the 4,200 area. Even as long-standing bears, that sounds crazy.

However, a simple calculation of what a 39 percent drop below fair value would mean indicates the DJIA price dipping below the 5,200 area. Cold, hard statistical frame of reference. And you thought a projection of major trend support in the 5,800-5,400 area (from the July 1932 low) was depressing? We mentioned above that Murphy would appreciate US re-unionization occurring at the wrong time. Murphy would also likely appreciate that we are fellow optimists.

Mr. Jackson's full column is attached as usual for your direct review; as is his column from the following week that also had fairly daunting analysis on the likely path for the overall global economy. While it may be a truism that people tend to seek out opinion that reinforces the very views which they already hold, this thorough dissection of the IMF study of developed economies (along with quite a bit of other perspective) is impressively depressive.

And most certainly supports our technically inspired belief that the DJIA failure below 9,700-10,000 derailed the equities' up trend (and we presume the associated growth trend) from the December 1974 low in a manner that will not leave it in a position to exceed that level again for many years.

While technical projections can be Negated if the market reverses back through the key price level, the fundamental rationale in this case would seem to support the notion that expectations for corporate profits will not be healed to a degree that indicates sustained valuations back above the 9,700-10,000 area any time soon. Under the Rohr Axiom (as such not really proprietary so much as a fact of life) of *Dynamic Disequilibrium of Price Trends*, prices exist in a constant state of *disequilibrium* due to short-term impacts as well as unknowns. However, rather than standing frozen like a deer caught in the headlights, prices are *dynamic*, and will generally seek to discount future influences through directional trend movement.

Why is that somewhat self-aggrandizing theoretical exposition important at this time? Because one of the very most important components of fundamental or technical 'trend' analysis is the 'inferential deduction' aptitude to appreciate that prices which are definitively *not* moving in one direction will find an excuse to move in the opposite direction sooner than not.

It is very much akin to that passage from the Sherlock Holmes mystery "The Sign of the Four" where the master detective responds coolly to misguided guesses of Dr. Watson on a matter of investigation, "…when you have eliminated the impossible, whatever remains, however improbable, must be the truth." [3] Of note, the title of the first chapter is "The Science of Deduction."

Trend analysis (admittedly as opposed to quite a few other forms of deriving price projections) is a bit like that. The difference is that it must be allowed the market can do whatever it wants, whenever it wants just because it decides to do it (a lesson many of the uninitiated have learned of late, much to their chagrin.) As such, and there is no 'impossible'. However, some sense of what is likely 'very highly improbable' on both a fundamental and technical basis does form a goodly portion of any forceful directional trend projection or opinion.

That is one of the least well-kept secrets in the world. Yet it takes most novice analysts and traders quite a bit of time to realize it. That there is so very much far-flung and phenomenally multidimensional data, along with many scheduled and ad hoc events, it obscures a simple truth: the actual price trend is two-dimensional, so any directional manifestation is actually a binary decision.

Which gets us all the way back to how can we be so technically bearish on the equity markets in spite of how far they have fallen? Whether one's primary mode of analysis is fundamental, statistical or technical, they must each be assessed independently of the other. While it has been put forward at times that it should be theoretically possible to combine them in a "master model", in our experience most folks who have attempted that have ended up mad or in financial ruin. Yet when independent analysis methods concur, it can be a strong indication.

[3] Arthur Conan Doyle, The Sign of the Four (Various Publishers, 1889 and subsequent.)

To get back to the crux of Mr. Jackson's second column, amidst many other stresses on future corporate earnings that were duly explored, the macroeconomic implications from that IMF study due to the confluence of certain factors (just like multiple technical indicators reinforce the importance of key price levels at times) is particularly daunting on this downturn.

To summarize those concise points would be foolish when they were so well stated in the first place right in the middle of his broad-based analysis:

"First, recessions preceded by a financial crisis tend to be deeper and longer than others.

"Second, they tend to be worse again if the crisis is in banking, rather than in securities markets or foreign exchange.

"And third, the countries hardest hit are those with so-called arm's length financial systems, such as the US or UK. If banks are free to innovate, they tend to build up more pro-cyclical leverage.

"In practical terms, the IMF found that recessions linked to banking crises lasted twice as long on average as those not linked to any financial crisis, and the cumulative loss of output was about four times as great."

Like we said above, we're looking distinctly optimistic compared to some of the more classical analytic inferences. As it relates to pro-cyclical leverage, the crisis being in banking, and the financial crisis preceding the recession, Mr. Jackson notes that this downturn is firing on all cylinders; or is that better characterized as misfiring?

In any event, one of the key components is the lack of effective countercyclical action by the powers-that-be in a major asset value stabilization area that has been a consistent point of ours (along with many other folks): US housing values that have had a significant negative impact on general confidence, whether of bankers or bakers. However much the rapid shifts of intent and action from Secretary Paulson have eroded confidence that there is a *bona fide* plan, there is plenty of blame to go around.

General Government Failure

If it so weren't tragic for millions, it might actually be amusing that Mr. Bernanke, the Great Student of the Depression, had not realized its real lesson. As we have long suspected, he has never really made the transition from academia to real-time financial leadership. Bank insolvency was merely a symptom of broader loss of confidence: falling asset prices.

What we have noted many times since last September (and were reinforced in that perspective by far more sophisticated observers) has finally come to pass. This was always more so about asset value destruction than liquidity; in essence, more of a solvency problem from the outset than one of banking system liquidity alone.

It was increasingly obvious into the late part of last year that all of the liquidity provision in the world to offset losses was not going to be effective in solving the core problem of asset value destruction. Which is why we noted last December that all the sound and fury around various rescue plans even at that time was nothing more than central bank flailing. US home values were going to be the key for both Wall Street and Main Street for all manner of reasons. That is also why we predicted back at that time that there would be an RTC-2008. However, that prediction was also substantially wrong insofar as we felt it would be directed at assistance for at-risk borrowers, and not to merely cover serial rescues or bailouts of government entities and securities firms.

As we have repeatedly cited chapter and verse on the failure of Messrs. Paulson and Bernanke to provide that relief for the underlying Main Street assets that were also plaguing Wall Street, and revisit the more major historic implication in **The Fiddlers Notion** below, we will not explore it at any great length again here.

Suffice to say that Mr. Paulson's imploring banks (virtually threatening the ones for whom he kindly crammed the government investment down their throats) to engage in 'prudent' lending is a giant joke. The heads of those organizations have a primary duty to protect the interests of those who own stock in their companies. And the sharply falling asset values he and Mr. Bernanke have engendered with their lack of support for US home values when the time was still ripe means few loans are now 'prudent.'

It would be an interesting exercise to put Mr. Paulson at head of one of the banks upon which he forced the government capital injection, and ask him to approve loans for which he would then be held responsible. Exactly what assets is it he would feel comfortable are good collateral at current valuation on a 2-5 year forward view? No wonder the well-capitalized banks were not very happy about taking on (and grudgingly accepting at that) government funding that carries onerous interest rate escalation features in down the line covenants.

We have noted many times during the past several years' bubble and bust cycle that ironies abound, as they always do. We can all be fairly certain the more astute leaders at the better capitalized banks realized instantly that they were being saddled with their own little version of the same problem that had triggered the whole mess (even if excessive credit creation was the broader background): the Hybrid Adjustable Rate Mortgage (HARM.)

Kind of poetic, isn't it, that while they will repeatedly cite the US housing situation as the primary factor behind the economic and market failures we are experiencing, in their attempt to reinvigorate the economy and markets Messrs. Paulson and Bernanke are happy to foist upon the banks the same sort of loan covenants that cause individuals to default on their mortgages. Breathtaking.

Amidst everything else that has abrogated free market principles for the ostensible conservatives (really not so much), this forced government funding was an attempt at 'crowding in' bank loan activity under an otherwise unfavorable lending environment. While seemingly clever as a tactical move, all of the subsequent talk 'imploring' banks to lend is only reinforcing everybody's instincts on just how bad things must be.

If the situation were anywhere near back to normal (which it is not), banks want to make prudent loans to qualified borrowers. It would be quite a surprise if they were all sitting around saying, "There we were, conniving about how to go out and make a significant number of imprudent loans, then along comes Henry to remind us we actually need to be prudent; what a killjoy."

What is imprudent is forcing banks to lend in an environment not conducive to prudence. While it was apparent that some banks may have actually needed the capital, this was a thinly veiled attempt to provide a handout to the weak sisters without raising concerns about the government getting further into the banking business. However, whom among the potential candidates for loans should the banks really be lending to in the present environment? And against what collateral? As CNBC's Rick Santelli duly noted, this was nothing more or less than government sleight-of-hand; a parlor trick to try and look like they are doing something in the wake of exacerbating the problems.

Political Machinations

Hallelujah!! Congress has finally stopped 'pussy-footing' around the foreclosure issue, and has become viciously aggressive. It is about time, and in fact long past time that something specific is demanded on this. That was sharply visited by Mr. Paulson's friend Chairman Frank, as he noted efforts of this sort have only been paid lip service by the Treasury and Fed during previous visits to the Hill with the begging cup.

To wit (from House Financial Services Subcommittee Chairman Barney Frank in frustration at Mr. Paulson's typical attempt to divert the conversation into discussion of other efforts that have already been afoot, yet which in most other folks view have clearly failed), "It is nobody's view that we have been as successful as we need to be in preventing foreclosures." Hallelujah!!

But wait. What is their first act in the wake of such aggressive (personal and financial system) edifice enhancement expositions that included quite a few other Committee members as well? Go on holiday.

That's right. It's time for our Thanksgiving break, and they do not want their turkey get cold while they hang around Washington putting a real fire under the direct at-risk borrower relief legislation they worked so hard to push past the Bush administration, and only succeeded by tying it into the Fannie Mae and Freddie Mac rescue back in mid-July.

In any event, when they get back in ten days the first order of business will likely be to tell those pesky US auto makers why they cannot give them any money unless Congress gets to tell them what kind of cars to build. While that may sound a bit of classic European social market economy *dirigisme*, given the recent track record of US automakers' executives and their new product development teams, who knows? Maybe it's not such a bad idea.

Of course, there is a slight problem with the degree to which the general confidence is shattered to the point where not much of anyone is buying anything. And unless the collateral they can put up against the loan is something other than the automobile they are purchasing that automatically drops in value as soon as they drive it off the lot in normal times (with much worse indications than that from the present used-car market), banks do not have a heck of a lot of money available for automobile loans in any event.

As such, as Congress looks to ensure there is no further net expense to US taxpayers, where are they going to the confidence to loan money to the automakers based upon any reasonable estimate of sales figures that are at all believable? The key to the political machinations is that nobody wants to be held responsible for splashing any more money around that might not come back to the taxpayer.

Part of the current reasons for the return of stresses in the credit markets that backlash into equity markets is Mr. Paulson indicating that without major troubled asset purchase programs (the original intent of the funding) to pursue, he is pretty much done lending, and will leave a nice fat balance in the TARP for his successor.

How jolly. Looks like almost everyone in Washington (save a notable exception discussed in the next section) is more so concerned about responsibility deflection than taking a few risks to restore confidence in the economy. The most blatant example circles back to Mr. Bernanke responding to an inquiry on whether the recent massive liquidity injections would allow the US to maintain its strong credit rating. Response? Likely so, as he "has not heard anyone give an opinion to the contrary." Opinion to the contrary? Reactive to a fault, he seems to be waiting for someone to wire in 'opinion' on money velocity impact on inflation.

Transition

In a parody of what the inveterate hustler Professor Harold Hill tells the good folks of River City (regarding pocket pool) in an attempt to relieve them of their ready cash, …we've got trouble… and it starts with a capital T... and that stands for Transition.

While most forms of democratic government have some delay in the formation of a new regime after an election, the US is a bit odd in having a set 75 day period (more or less) after even any resounding victory prior to a new President taking office. Only after that does a process of approving nominees for major cabinet posts and executive branch organizations begin to occur.

Even in normal times that tends to create some concerns over things like security risks and continuity of programs. Yet in the current circumstances the need to instill some confidence in depressed, disorderly markets puts additional pressure on the incoming administration. That the populace and the markets have little faith in the existing team was amply demonstrated by the quasi-euphoric response of the equity markets to the indication that Mr. Obama had settled on New York Fed chief Tim Geithner as his nominee for Treasury Secretary this afternoon. While it is a sad commentary on the state of the economy and markets, it was an enlightened move.

As such, the *de rigueur* leaks (in practice an extended national form of what marketing consultants call 'focus groups') on potential future appointments that point to Hillary Clinton as Secretary of State, and business and energy market savvy (in fact previous Clinton administration Energy Secretary) New Mexico Governor Bill Richardson as Secretary of Commerce are all somewhat comforting to the markets. However, there was none more so than the Geithner nomination, for obvious reasons.

It is a rare confluence of factors contributing to the degree to which the exact timing and nature of announcements from the incoming administration is so critical to the markets. While there are many good reasons why even the finest minds and best decisions will not prevent all the economic weakness that has been engendered through the combination of past excesses and the poor handling of the crisis to date, at least the markets will not be operating in a vacuum.

Yet this whole waiting game took on a very curious twist at that testimony in front of the House Financial Services Subcommittee early this week. While ostensibly part of the current administration, FDIC chairperson Sheila Bair sounded more competent than either Mr. Paulson or Mr. Bernanke, and had accomplished an interesting feat.

She seems to be one of the few folks in government to both make real sense (which we readily admit Congress has done in principle) and actually to have put her ideas on foreclosure mitigation into practice. Wow, what a concept!

In the wake of the failure of major savings institution IndyMac Bank, she solicited the support of securitized lenders, and along with the bank's own loans came up with a rapid fire approach to modifying mortgages in a way that is keeping borrowers in their homes. As we and many others have noted for a long time, the administration's failed HOPE NOW (we have un-officially dubbed it NO-HOPE NOW) program of strictly free market adjustments to existing mortgages has been falling seriously behind. No matter what the Treasury Department and the Fed would like us to believe, if it was working, we wouldn't be in this confidence and market implosion. It's the verdict of the markets that both current conditions and the outlook are abysmal.

While this is not the forum within which to extensively explore the full program that she had the FDIC implement to accelerate the review and adjustment of at-risk mortgages, suffice to say that the key was a model that allowed for adjustment of the mortgage principal value that would reduce monthly payments in a way that left the homeowner with a 31.8% debt to income ratio, while providing guarantees to mortgage holders that the government would underwrite any subsequent losses.

Those are the two substantial issues that have attracted the support of the securitized lenders while leaving homeowners feeling it is worth their while to continue paying the mortgage. That is because one of the biggest issues for the securitized lenders is the re-failure of the modified loan prior to any payments on the adjusted mortgage; rightfully viewed as a pure stalling tactic.

Both as best practice and to ensure that the government is not throwing good money after bad, she informed the Committee that the FDIC is also following up on any of the modified mortgage arrangements with the first-hand verification of borrower income.

There is no secret about a major part of the problem in the later, completely delirious phase of the credit bubble being that even the most modest standard prove-ups of borrower financial capacity were not being verified in any way.

Of course, speaking of borrowers, one of the primary impediments to feeling there a reason to continue paying the mortgage was the degree to which they were “upside down”: the now all too well-known condition where the principal loan amount on the mortgage is far greater than the current depressed value of the home. As US fixed rate mortgages are structured so that the borrower does not accumulate equity until the later years that is a problem.

However much the free-market approach attempted to stretch out the duration of the loan, convert to a fixed rate that eliminated the onerous explosive adjustable rate and lower the rate as well, there was still little logic for an owner remaining in the home if they were going to need to come up with tens of thousands of dollars if they ever wanted to sell. Now that was addressed.

And the most amazing part is yet to come: they did it all by post!!! That’s right; no long meetings, no tedious delays for borrowers nervous they could be evicted, and no delay in confirming the borrower would accept the terms of a modified mortgage. Astounding.

Ms. Bair’s team simply ran the calculation, mailed the at-risk borrower the paperwork that stipulated the new principal amount (calibrated to that 31.8% debt to income ratio), had a brief form included for them to sign and mail back to the bank with the first of the adjusted monthly mortgage payments as an indication the borrower would accept the new terms. Of course, as noted above, final confirmation of the modification would only occur once FDIC verified the borrower income requirement.

Not only was that elegant, as is the case with so many things that people tend to over ‘complexify’ within their specialty (notice to Messrs. Paulson and Bernanke), the more so straightforward solution often proves to be very effective. At IndyMac 40,000 loans that were eligible for modification were mailed the paperwork since late August, not much more than 30 days after the bank was put into conservatorship. As of the time of this week's Committee meeting, 5,000 loan modification agreements were completed, and the overall positive response rate to accepting the modified loan arrangements was in excess of 70% (albeit with most still pending income verification of course.) That is our idea of a free market solution that serves both borrower and lender.

Isn't there another irony in the foreclosure problem has getting so bad that the major banks who either chose to hold those loans in the first place or inherited them in takeovers are now involved in significant principal loan value adjustments in order to avoid the next wave of the foreclosure tsunami? That is especially ironic in light of the continued implicit agenda of the Treasury Department and the Fed to allow home values to fall until they stop, as we noted in the **Antipathy Abides** topical discussion of the early October ***Capital Markets Observer*** IV-15.

And that is in no way news to Ms. Bair. More so likely that she is also feeling the brunt of her disagreement with Mr. Paulson. That much seemed obvious from the tone of the discussion and body language at the Committee hearing.

She well understands it is the ultimate insult to injury for all of those homeowners either already dispossessed or under threat, as well as all of us who have been advocates of solving Main Street's problem (as a more sustainable way of solving Wall Street's problem as well) that Mr. Paulson explicitly rebuffed Ms. Bair's enlightened, expanded plan to stem the mortgage foreclosure juggernaut before it is too late.

Bair has criticized the Bush administration's $700 billion bailout package, saying it will not do enough to help Americans facing foreclosures. In various interviews she has clearly articulated that the interest of the administration and the Fed seems to be attacking the problem at the financial services industry level as opposed to the individual borrower level.

We certainly are kindred spirits in her observation that it is borrowers defaulting, and that is causing the distress at the institution level, and suggesting we tackle the borrower problem as a way to restore the system. Hear, hear

Bair recently released details of her much more ambitious plan for a $24.4 billion government program (ambitious? Congress has already set up H4H for $300 billion) to prevent as many as 1.5 million foreclosures. The Treasury Secretary's response? He will not pay for it.

Of note, she has also published two books for children providing good examples of money management. The American people have probably missed another bet; it would seem we should have figured out a way to get her to Washington a long time ago to run some remedial fiscal policy training.

Stressed Cities & States, Union Militancy, Revenge of the SarbOx Monster

You hardly need us to tell you that there are further chapters of the economic horror story being written even as you read this. Just because they are not as prominent in the headlines as the doomsday scenario for the auto makers or the foreclosure story does not mean they are not out there.

As unemployment rises, foreclosures continue and retail sales drop sharply, the tax base of American cities and states is severely impacted; especially local school systems that rely in large measure on property taxes that are understandably not being paid, or at least not being paid timely.

As noted above, the unions are likely to regain the right to secret ballots that will increase militancy at the wrong time in the economic cycle. Which is not to say that workers do not deserve a better share of the major productivity increases from which they have only seen a minuscule portion.

Last but not least, in another example of the path to hell paved with good intentions, the Sarbanes-Oxley rules that were put in place to prevent irrationally exuberant corporate profit estimates now have most executives regularly putting out defensively depressed earnings and business guidance

The Fiddler's Notion$_{SM}$

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 Notion$_{SM}$ 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.

Un-Learning

Investors

Ms. Gloria Steinem famously once said, "The first problem for all of us, men and women, is not to learn, but to unlearn." While she was obviously referring to gender relationships and awareness, that is a very good precept for investors who wish to pursue enlightened self-interest in their portfolio management to remember.

Too much of what passes for qualified financial and investment advice is not much more than a lot of folks who rely consistently on the inexorable upward trend of equities. And some of what the public hears is indeed useful for long periods of time.

However, every couple of generations or so 'buy-and-hold' meets up with some form of the *Super-Cycle Correction$_{SM}$*, and is almost derailed. Considering investments as long-term "trade" positions seems too complex and nerve-racking and too speculative for the general public. And the lack of interest in efforts to understand cycles and trends is aided and abetted by the legions of brokers and advisers who for the most part want to get paid for being smarter than the client.

That said, the current situation is just the sort of traumatic education by icy blast that it takes to have the general investing public question what it is they have paid for in either brokerage commissions or annual wealth management fees. The issue is not whether they need to make an avocation out of market analysis. It is more so a matter of the minimal amount of education necessary to understand two simple facts of investment life.

The first of these is how to understand the basics of market trends and cycles. While that may sound daunting to most novices, there are some straight forward techniques by which anyone who wants to invest the minimal amount of time can become aware of broad strokes market tendencies.

The second investment fact of life that all successful traders or portfolio managers appreciate from very early in their career is the concept of asset allocation. That does not just mean among subsets of one asset class such as equities. It also has much to do with how one spreads their investments between different asset classes.

There has been much made in recent years of the degree to which people living longer means folks should be happy to ride out the cycle with a buy-and-hold equities strategy. Which is exactly why there is so much pain-and-suffering at present among so many investors who were led to believe it is a never ending cycle of serial new highs.

It seems that what the investing public needs to "un-learn" is the idea that buy-and-hold always works out in the long run. It is the received wisdom from the brokerage and wealth management industries that "if you have not sold, you have not really taken a loss." We suspect that brokers or wealth management advisors who attempt to comfort clients in the current environment with that sort of standard folderol is likely in for a very interesting conversation.

"Eternal vigilance is the price of liberty" is a quote that is often misattributed to Thomas Jefferson when the actual source was a man who was not even born until Jefferson was quite old. That was Wendell Phillips (1811-1884), an exceptional American orator and agitator, advocate and lawyer, writer and debater. The nature of that statement should be no surprise from someone who was also a highly active abolitionist in the years leading up to the American Civil War.

What we do know Jefferson did indeed say was, "I have no fear that the result of our experiment will be that men may be trusted to govern themselves without a master." While that may be an extremely enlightened view of how people should structure their affairs among themselves, it seems that a certain Mr. Greenspan has had to recently allow that greater direction from above is necessary to restrain the worst instincts of some of the Masters of the Universe in the financial services industry.

The combined lesson there for enlightened investors is that 'eternal vigilance' is indeed the price of 'financial liberty', and that they would be better off 'governing' their own investments without relying on a 'master' to tell them what to do.

Which is not meant as a disparagement of the instincts of the honorable brokers and wealth advisors who truly have their clients' best interests at heart. Rather, it is an observation on the degree to which they tend to drink the industry Kool-Aid (a hip pocket reference to blind loyalty regarding the mass suicide poisoning method used by the infamous Jim Jones religious cult.)

That always seems to gravitate back to the similarly blind long-term over-confidence in bullish equity market trends; with the more recent tendency to be over-positioned from that otherwise enlightened perspective that people are indeed living longer.

We have a corollary to that somewhat misguided investment axiom (such as it is) noted above, "If you have never sold, you have never actualized a profit." That is the primary reason why investors need to go to school on the perspective of the most successful trend analysts and discover two important things, no matter how hard they may be to understand and implement.

The first is the ability to identify when the major trends reverse, or for specific equity market stocks, when the trend reverses for that particular company. The second is how to use effective capital preservation exit strategies that the investor can apply no matter how optimistic their advisor might be. Sustained optimism that is often an effort to get investors to pull money out of the FDIC guaranteed mattress to achieve higher returns is not intrinsically evil; just less than effective at times, …especially like these.

Un-Learning

Central Bankers and Treasury Officials

Speaking of being overly optimistic, and not changing tactics as markets tell you you're wrong, how about that Ben Bernanke?

One of our favorite quotes on developing an informed view is the classic broad strokes perspective from Georges Santayana, "He who does not learn the lessons of history is doomed to repeat its failures."

The problem is one of digging below the surface for the full lesson. As we have noted previous, there is a tendency to take the surface lesson and apply it in too broad a fashion; a matter of failing to distinguish between coincidence and causality. That is something Malcolm Gladwell cites as a modern psychological construct in his excellent book "The Tipping Point" as a "Fatal Attribution Error."

And the ostensible 'big picture' lesson from the monetary and economic history of the Great Depression was that the rapid drop in liquidity left banks without money to lend. And that was the proximate cause of the extensive business and banking failures that backlashed into the general economy, and destroyed consumer confidence.

And in that last phrase lies the rub. In the final analysis consumer cutbacks and rapid deleveraging were responsible for loss of velocity in the M2 Money Supply as well as sharp deterioration in commodity prices and the general downward price spiral.

Whoever had money wanted it back from the banks and were not leaving it on deposit for lending, and whoever was indebted was not a good candidate for loans once the banks became significantly concerned about the *extended future value of any assets* that could be posted as collateral. For all of the massive funds splashed about in attempts to maintain liquidity, that sure sounds awfully (in the literal sense) familiar.

As such, it was true that the banks were not adequately capitalized. And in fact the Fed was constrained by stubborn legally binding adherence to the gold standard that also prevented the creation of any additional money stock. It was not just an elective decision on the part of a dominant and inflation paranoiac New York Fed (other than a lack of desire to apply the requisite political influence to get the laws changed), which is often misunderstood. In fact, the governments of the UK and Scandanavian countries left the gold standard quite early once the economic crisis hit, and came out the other side of the downturn much sooner and in much better shape.

Nonetheless, that lack of confidence is always the key element that must be avoided at all costs (including the risk of some distortion in some markets for a period of time) if a central bank is to properly maintain a fiat money regime.

And what was that very substantial asset of US consumers who drove the entire world economy for the last few years? (Not like you needed us to tell you...) Their home. And there is little doubt that even after two years of falling modestly, US home prices were likely still more than a bit overpriced as the credit market crisis first began to bite last summer and continued through the fall right into this year.

As we have noted on quite a few occasions, Messrs. Bernanke and Paulson were not wrong to see how things developed on a free market basis late last year, and even into the early part of this year. Yet, once home prices were obviously falling at a double digit annual rate, it was time to abandon the ideology and change course into more direct at-risk borrower relief; even if that included what some characterized as rewarding 'bad decisions.' As noted above, that didn't stop relief for Wall Street.

Throughout the entire affair there has been much official talk of how the housing market needed a good economy instead of the other way around. There were more than a few very pointed questions during a series of Congressional hearings on why it was more effective to offset losses than at least get more aggressive about addressing the core problem. Mr. Bernanke's consistent response was, "Housing won't do well in a weak economy."

It seemingly has either still not occurred to him, or surveying extreme carnage on the financial and economic battlefield, he is now rue to admit it. (Even Mr. Greenspan was allowed a bit of time in retirement prior to falling on his sword.) The fact is that it is actually the other way around if the key is confidence. Any address of the situation required a major shift over to house price stabilization that Messrs. Bernanke and Paulson either never understood, or were ideologically averse to pursuing.

As noted above, if it so weren't tragic for millions, it might actually be amusing that Mr. Bernanke, the Great Student of the Depression, had not realized its real lesson. That stubbornly maintained 'static' view of everything turning out okay as long as huge piles of money were shoved at the banks, even as consumers went on strike, is now a tragedy that could have been limited to a manageable problem.

Professor Bernanke has put his stock (and all of ours to some goodly degree for that matter) in a false lesson inferred from not fully pondering the real implications of liquidity drying up in 1929-1932. In his adamant stance that saving the banks would also save the economy (which is actually comprised of a whole series of independent operators who can choose to disengage if their confidence fails them), he has come around to failing at the one task he always felt his intellect could conquer.

As we have noted regarding his failure to cool the economy from what many of us saw as an overly exuberant (with a nod the Mr. Greenspan) credit and equity market situation once DJIA surpassed the 11,750 January 2000 previous all-time high from the Dot.Com Bubble, avoiding decisive action has come back to haunt him.

As we noted in a July 2006 letter to the FT Editor, "…its desire to be everybody's friend will actually make the Fed its own worst enemy." And that now seems to be the case both on the lack of desire to pull the punchbowl before the party got too raucous on the way up, and the inability to see the sense in applying capital to the core US home price problem on the way back down. As French fabulist Jean de La Fontaine noted centuries ago, "Our destiny is frequently met on the very paths we take to avoid it."

There is quote from Lawrence Summers back in 1991 that Bank of England MPC member David Blanchflower used in his presentation late last month that also applies to the dilemma of Mr. Bernanke not having effectively made the transition from academia to a true global financial leader. "…progress is unlikely as long as macroeconomists require the armor of a stochastic pseudo-world before doing battle with evidence from the real one."

It seems the 'received wisdom' that many took from studying 'obvious' lessons of the 1929 stock market crash devolving into the Great Depression must be 'un-learned', or significantly embellished with real world perspective the Cassandra's have wailed about for some time. A fiat currency regime requires maintenance of confidence above other priorities, even if it means distortions in some markets. Under the circumstances, who would really have cared if US home prices were kept a bit too high for now after years of distortive government support?

As we have noted previous, in light of all of the encouragement for home ownership by folks who could barely afford them but were underwritten by the very liberal policies at Fannie Mae and Freddie Mac, 2008 just seems like an awfully odd time for the government to 'get religion' on the strict application of purist free market ideology.

Somehow it would seem more rational to assist the credit junkies in withdrawal from their heady addiction by offering them a bit of medicine along the way; much as one would allow that a heroine addict who was experiencing a grand mal seizure should be allowed some methadone. As much as that would calm nerve endings and prevent the major heart attack or respiratory collapse for the physical addiction, it can only be hoped that it is not too late to calm the current panic seizure of the US general public with a dose of foreclosure relief.

That would seem to be the other lesson that needs to be re-learnt by the central bankers, especially the ones down at City Hall in Borrowing Binge Borough. It does not really matter how much liquidity you apply unless you also take steps to ensure confidence remains high enough to maintain the very minimum of requisite velocity necessary to avoid a crash. Which is exactly what we have had: our version of 1929.

It may well be that the lesson of 1929-1932 was not to let liquidity dry up. Yet unless the deeper lesson that confidence failing was the greater evil that contributed mightily to the liquidity problem is also absorbed, the current pain will not necessarily result in the success of any brave new regime powers-that-be envision for the future. In fact, this gets back to the question we posed in the last ***Capital Markets Observer***, courtesy of the vintage lyrics from Bob Dylan regarding "…what price, You have to pay to get out of, Going through all these things twice." It is likely odd to other folks as well that the price has been exceedingly steep, yet we've not gotten out of going through anything which guarantees a better way forward than the early 1930s. Where is that nice Ms. Bair?

That does not even begin to address the follow-on problems from the massive liquidity operations. While it might seem premature to look through to the other side of the cycle, once the authorities find the means to reinvigorate the economy (as they will at some point), it does add velocity to a bowl that is filled near the brim with liquidity. Is it reasonable to imagine that none of it will come sloshing over the rim in the form of inflation? Our 10 year T-note yield target across the cycle is still up at 9.00%-9.50%. Yet that is a conversation for another time.

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

-Rohr
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