

# Rohr Report

## *CAPITAL MARKETS OBSERVER*

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**Overview, Markets Summary,...**

**...Flailing II, Stag-Flation, All Over the Map, RTC-2008 II**

### Key Views

- Quite a bit has transpired right at the first of the year that is consistent with our skepticism of the equity markets, temporary friendliness to long-dated fixed income and sustained bearish view of the US dollar. Yet, the most interesting phase is just beginning, as we see what the Fed is willing to do about a potentially dangerous situation in equity markets if they continue their precipitous fall.
- After a holiday week drop down from 13,500-13,550 resistance, the DJIA has violated serial supports 13,350-13,250, 13,000 and even the Schumer letter (defund Countrywide Financial) scare low at the bottom of the 12,800-12,724 range (all now resistance.) It is now going to be very critical what the Fed does if there is a violation of the 12,517 August 'spike' low just tested. While there is additional support at 12,500-300, whether that can hold is problematic. Next supports are not until 12,000-11,940 and 11,750.
- The fixed income is exhibiting a typically bi-polar response to equity market moves; dropping with them due to inflation fears, then rallying sharply when the equities break badly enough to create economic fears. The latter tendency is apparent in (upside leader) March T-note's push above the 114-30 continuation high. While the extent of that swing has been limited so far, 116-16/117-00 is next resistance (consistent with oscillator thresholds), and broad resistance remains in the 118-00 and 119-00 areas. Lower supports are 114-00, 113-05, low 112-00 and mid 111-00 areas, and all of that will be influential for the other long ends that are not quite as exuberant as the T-note.
- Short money remains significantly disjointed, as the US and UK seem to reflect the likely effects of the looming slowdown in the US and continued financial service firm problems with the interbank market and securitized debt issues. Yet European short money still seems to be buying the ECB's robust economic and inflation perspective.
- Previous US Dollar Index strength was not a major trend change, especially as it stalled into .7820 previous 1992 major all-time low. It has now dropped back to below the previous .7620 daily H&S UP Break yet held no worse than its Tolerance to .7560 (basis the daily Close.) Similar weakness affects the US dollar elsewhere, and it is joined by co-weak sister's Japanese yen and British pound, where EUR/GBP above the .7250 and .7350 areas is stalling near .7500-50, yet GBP/USD is critical into 1.9650-00.
- As noted previous, Crude Oil was so orderly below 89.00 we were not surprised that it rebounded from 86.50-.00 support, and geopolitical tension propelled it to 100.00. Now the near term supports are 95.00-94.00, 91.50-.00 and back in the 90.00-89.00 area.

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## Overview

This Overview is going to return to its normally concise style after last week's need to update our extensive pre-holiday views from *CAPITAL MARKETS OBSERVER* III-41 (December 19, 2007) in our first issue of the New Year. All of the same views remain very relevant for short- to intermediate-term trends, yet have seen significant further information evolve from various important sources. Those perspectives are expanded in this week's topical discussions.

As important as the discussion of any background factors or specific trend projections is the general nature of trends that are now evolving. The 'stagflation' scenario that we cautioned was going to increasingly reinvigorate itself across time from March 2005 onward is now in full bloom. As noted in the title and throughout our major report at that time, **1970's Redux: Son of Stagflation**, this means the disparate psychological influences on the markets from stagnation and inflation will create significant trend swings due to rapid psychological shifts as much as any actual economic influences. The sort of short- to intermediate-term trend volatility that has seen the equities and the US dollar crumble since December 26<sup>th</sup>, and the T-note recover sharply from the mid 111-00 area to above the 114-30 high are here to stay.

For now the prime mover for many other trends remains the trend of the US equity markets. In the short term the weakness of US equities is the driver for the strength of the long-dated fixed income that is being led by the US T-note with the other international long ends in tow. Yet, as noted previous, one of the keys to the overall trend in the long ends may be the tipping point where the equity markets fail so badly that the Fed is compelled to provide an inter-meeting easing prior to the end of this month. If so, then the implications for the resurgent global (not just US) inflation are fairly pernicious.

That could signal a sea change in the long-dated fixed income, as it tops out in deference to the potential inflation engendered by the economic rescue operation the US central bank (likely along with Bank of England) will need to perform. That will be to offset the worst effects of US housing's Hybrid Adjustable Rate Mortgage (HARM) interest rate reset problem, and its associated debt securities market (including all of the complex derivatives) impact.

The general impact on the US dollar will also be very pernicious. As noted previous, the most absurd aspect of recent strength in the buck (from late November into mid-December) was that it occurred in the wake of worse than expected inflation numbers. The entire psychology revolving around inflation being bad enough that the Fed could not ease further appeared specious at best. The market seemed to agree once equities came back under pressure in the post Christmas period during which the DJIA has dropped seven percent (basis the daily Close) since the Santa Claus rally ended on December 24<sup>th</sup>.

In truth, this year's anticipated pre-Christmas bounce was more of a Santa Claus 'loan' to the bulls that was quickly called in once Santa saw the true scheme of things by December 27<sup>th</sup> (very charitable insofar as the markets waited until after the Brits' Boxing Day to begin the precipitous early year decline.) That minor December respite was also only a minor bounce in a trend that has left the DJIA down almost eleven percent from its early October all-time high near 14,200. Eleven percent in just less than a full quarter speaks of more than just a correction; and that is in spite of four months of extensive easing by the Fed.

It gets back to our observations on the **Nexus of Denial** (*Capital Markets Observer* III-39, Thursday, December 6<sup>th</sup>) that Fed rate cuts are moreso symptomatic of weakness that will continue in spite of them, rather than a 'cure' for what afflicts equity markets and economies. Using the commencement of the last easing cycle as a guide, we doubt this one is any more a sign of the next equities bull market than the full point of rate cuts provided by the Greenspan Fed back in January 2001 (beginning with the early month surprise half point cut that was followed by the additional half point at their end of month regular meeting.)

In fact, the unease with the economic outlook is even spreading to other places that (as yet) have not experienced economic weakness. That was amply illustrated by the disconnect we noted yesterday between the much weaker than expected Euro-zone Retail Sales (NOV) for the second month in a row, and very strong German Factory Orders (NOV.) And the real shootin' this week only begins in the wake of this morning's BoE and ECB rate decisions and ECB press conference. As noted in Tuesday's *Weekly Preview*, that includes the speeches by Mr. Hoenig and even chairman Bernanke speaking on *Financial Markets, the Economic Outlook, and Monetary Policy* into lunchtime (EST) today, and the OECD Composite Leading Indicators (NOV) tomorrow followed by further significant communication from Fed officials.

## **Markets Summary**

### **EQUITIES (and the moon and the Fed)**

It is not very surprising the **DJIA** should bounce from the initial retest of the 12,517 August spike low after a break of over 1,000 points from the Christmas holiday rally trading high to yesterday's low. Similarly the March **S&P 500** future was certainly entitled to a bounce after a selloff of over 120 dollars from its equivalent high. What is critical now is whether these are minor bounces prior to the next failure, or represent the beginning of an overall bottom for a significant recovery, even if those are also only sustained upside reactions in what are still bearish markets overall.

One of the odd things which analysts who include exotica in their assessment (which we do on at least a passing basis) that works in favor of the bulls after such a devastating early year equity market selloff is the moon phase. That's right, the moon phase. Waxing and waning moon phases are alleged to respectively boost and depress general human mood, and the markets are in part an extension of all that. While that may sound a bit far fetched, in the most recent cycle the market activity since the last full moon on December 24<sup>th</sup> certainly lends some bit of credence, as does yesterday's return to waxing from Tuesday's new moon.

However, the early portion of the phase shift carries the most influence, and whether the full cycle will be a key to the equity markets recovering into the next full moon on January 22<sup>nd</sup> is far more problematic. That sort of sustained improvement likely requires reinforcement from price activity that solidifies yesterday afternoon's initial recovery. So it's time to leave the Werewolves baying, and head back to the reality of the trend activity.

Yesterday was not just an impressive bounce from that significant 12,517 August low; it was also the first test of 12,500-300 area as well as an overt technical bottom formed yesterday. The latter is the most short term and unreliable indication; worth dispatching first. The new low for the selloff followed by the recovery to a nicely higher daily Close has left a daily UP Closing Price Reversal from the Tuesday's 12,589 Close.

In theory any Close back below the 12,565 Tolerance (Tuesday's low) of the UP CPR signal should represent a failure for a move to a new low. However, the 12,500 area to as low as the 12,300 area contains quite a bit of further support, which is why we have expressed it as the rather broad berth 12,500-12,300 range. Therefore, even if the DJIA should indeed post a daily Close back below 12,565 that Negates the near term bottom, there is important further support waiting below 12,500.

Those include an array of significant Fibonacci retracements that were brought into alignment by the temporary DJIA push to the 14,200 area after the aggressive mid-September FOMC half point easing. While it does occur occasionally, it is indeed rather unusual to find three major Fibonacci retracements all in such a tight range. All in the 12,480-12,440 range are the respective 0.50, 0.382 and 0.25 retracements of the swing to the 14,198 October all-time high from the 10,683 July 2006 low (last pullback prior to exceeding 11,750 January 2000 high), the 9,708 October 2004 (interestingly enough the last major pre-US general election) low, and the 7,197.50 October 2002 major intermediate term bear trend low of the last cycle.

As this is such an important area on both that basis and due to 12,503 being major up trend channel support (rising to 12,527 next week) also from that October 2004 pre-US general election low, we are giving a broad berth to the lower 12,300 congestion. We also maintain our sentiment that while the Fed is keen to maintain its inflation fighting credibility, it must be more concerned about the potential for sentiment from the equity market to turn so bad that it will make a bad situation worse for the general public's sense of financial well being.

While we have made clear (along with no small number of other analysts and commentators) that the Fed cannot 'cure' the housing and debt securities market problems with monetary easing, it remains on the front line as a circuit breaker for any equity market meltdown that threatens to become 'disorderly.' In that regard, there is a question of just how far the Fed should or will let the DJIA slip below that 12,517 low (and other supports in the 12,500 area) prior to stepping in with some sort of palliative in the form of easing; even if that means on an inter-meeting basis that it is rightfully hesitant to provide.

Yet, if it allows the DJIA to slip too far below that 12,517 low (ergo the importance of the next support at 12,300), then any attempt to underpin the market may seem too little too late, as there is not much between 12,300 and next supports in the 12,000-11,940 area. While any rescue from that area might provide sustainable support for awhile, it would also moreso tend to reinforce the recent congestion in the 12,800 and 13,000 areas as formidable resistance on any recovery.

On the other hand, if the DJIA holds by no worse than 12,300 modest slippage below 12,517, it would foment a more resilient mentality (pending the nature of the near term general news and economic data) that might still allow for near term recoveries to as high as the 13,300 or even the 13,500 areas. It is all a matter of how much incremental slippage the Fed will tolerate prior to feeling it must prevent a debacle; as it knew it needed to do back in August.

Yet, the critical near term battle which precedes any of that is as noted early in this analysis: whether the current bounce in US equities can carry on for some time for a significant gain, or is just a minor flutter back to the 12,724-12800 range prior to a more vigorous challenge to the 12,500-12,300 support. The DJIA desperately needs a Close above 12,800 to stabilize.

The exact same psychology applies to the **March S&P 500** future, which also left a 1,397 daily UP CPR (Tolerance 1,393) from the new 1,385 low for this selloff that was only near its 1,375-1,364 lows from August and March (respectively.) That leaves residual support below this market as well, albeit with higher resistances into 1,416-26, 1,435-40, 1,450 and 1,480.

It was also no surprise that the worst of the US selloff and timely recovery occurring after European trading hours allowed the strong sister DAX and somewhat resilient FTSE to avoid cracking their rather well-established near term congestion supports early today. **DAX** had been back up near the 8,151 high of the summer rally as recently as last week, and so far has actually managed to hold with only minor slippage below its 7,800-7,770 congestion in spite of the return to weakness by the US equities this morning. However, any return to significant weakness in the US will likely lead to a more extensive violation of that support, even if interim support remains as nearby as 7,720-00, yet with more major support not until the 7,600 area, and extended support not until the 7,450-00 area.

Similarly, recently weaker sister **FTSE** had a DOWN Break below the 6,550 area, and unlike DAX had trouble remaining above it on its mid-December rally. It is also now back below the previously violated 6,400-6,350 support, and slipping marginally below interim congestion in the 6,250 area. This market remains more vulnerable than the DAX, with major supports in the 6,040-00 area, albeit still well back above 5,821 mid-August low.

It is not necessarily a surprise in light of Japan's return to economic weakness exacerbated by political malaise that weak sister **NIKKEI** fell back below support on a serial basis below the 16,700 area as well as more major support in the 16,500 area back in early November when the other markets weakened. At that time it also violated supports at 16,100-15,900 that we suspected would remain resistance on the way back up as the US market exhausted its upside potential into the FOMC meeting.

In fact, its pre-holiday rally only carried it back up to previously violated major levels in the 15,600-500 area from which it has failed badly back below its 15,250 mid-August low once again (the only equity market to do that in the first place back in November as well.) It is now down challenging the top of its ultimate support back in the 14,400-14,000 range last seen on the sharp downside reaction in June 2006, below which it might drop to as low as the 13,000 area historic and more recent (from the move up in late 2005) congestion.

### **LONG DATED FIXED INCOME**

What a difference a New Year makes. All of the worst expectations for equities which affect fixed income in a positive manner have come home to roost in upside leader March **T-note**. After slipping back to a test of its low-mid 111-00 violated resistance (which became support) into Christmas, it recovered very quickly back above various interim resistances to first test and then exceed the lead contract 114-29 high left by the December contract in early December. As noted previous, next incremental resistance is in the 116-16/117-00 area (consistent with the next oscillator threshold.)

Even though there is a possibility of an upside blow-off of significant proportions, due to the inflation factors which are also lurking in the current 'stagflation' environment, once the equities break far enough (likely on any threat to the DJIA support at 12,500-300) that the Fed is forced into an inter-meeting easing, all bets are off for the durability of the up fixed income up trend. Lower T-note supports are 114-00, 113-05, low 112-00 and mid 111-00 areas, and all of that will be influential for the other long ends.

And if US long dated fixed income weakens, it leaves that much more room for weakness in the European long ends, as we have seen in December. The ECB (albeit not the OECD) tells us the European economy can remain robust in spite of US economic weakness, and that raises the spectre of further inflation. The key technical levels in the similarly recovered European long ends were the differentially weaker levels for the March **Bund** that has used the US equity market weakness (and strength of the T-note) to rally back above its 114.45-.55 area Negated weekly down channel UP Break as well as 115.00 congestion. That leaves the higher incremental continuation (and somewhat higher) contract resistances at 115.50 and every half point higher from there up to the 117.50 area original bear trend DOWN Break from all the way back in December 2006.

Moreso similar than previous for what was the strong sister **Gilt** that overran lower 108.83-.66 resistance and sprinted above 109.50 initially to test its 110.50-.84 resistance, it fell apart in December after the Bund came under pressure. Quickly back below the 109.50 level, it also slipped below the 109.20-.00 support, only holding once it reached the next incremental support in the 108.00 area (which had a buffer to 107.50.) Yet, true to its bi-polar nature from the degree to which the UK economy is viewed as moreso vulnerable like to the US, as quickly as it dropped it recovered once the T-note gained strength from late December in the wake of the equities selloff. Back quickly above all of those technical levels, and even 110.50-.84, it is now challenging the 111.20-.50 resistance, above which there is not much until the low-mid 112.00 area.

### **SHORT MONEY**

The short money remains a completely different animal in the US versus Europe, with the UK moreso like the US in spite of today's setback in the wake of the Bank of England 'no action.' Due to the significant reaction into mid-December, the March **Eurodollar** has recent oscillator resistance up into the low 96.00 area (i.e. near the 96.025 June 2005 contract high.) Closing above 96.05 allows for a push to the more major oscillator resistance in the 96.25 area (daily MA 60 plus 0.50) or even more extended oscillator projections (daily MA 60 plus 0.75 seen in August) into 96.50 might be achieved.

It seems that the minor upside corrections in the equities are having quite a bit less effect on the US short money forwards than the long end, and that reinforces our expectations that any actual near term forced easing by the Fed may not be as good for long-dated fixed income as the short money. It also points out the degree to which the US debt market (and others as well) may be entering a long-deferred phase of curve steepening. That had been mitigated previous by the rampant flow of credit to all parts of the yield curve when inflation was less of a threat. While it does remain more of a threat than 'core' reality at present, any aggressive central bank easing to stem the tide of an equity market debacle likely contributes to a more positive yield curve than seen for some time.

All of which points out the degree to which the US equities influence is driving the outlook, yet inflation expectations may drive the trends outside of the US short money. That will remain a force that influences the foreign exchange (obviously especially the US dollar), and the degree to which the US leading the way down (mirror image of 2003-2005) is fomenting an equalization of short term interest rates with Europe across time. In light of the ECB's nominally rightful hawkish stance that has been reiterated by Monsieur Trichet this morning, March **Euribor** is now only approaching its hefty 96.52-56 failed support (now resistance), with extended hefty congestion as nearby as 95.60, and lower support back into 96.40 and 96.25-.20.

Of course, much as with the Gilt, **Short Sterling** is a bit of a changeling stuck in the crossfire between the US and Europe. While the March contract has indeed made a new high for the cyclical rally from the summer lows, it is not nearly as strong as the Eurodollar. While it has indeed pushed above the hefty resistance in the 94.40-.45 area, it still has had a problem today maintaining itself above fairly strong resistance at the serial lows and highs left in the 94.55-.58 area since May 2006. Only on a Close convincingly above 94.60 does it indicate a potential move to the more major 94.80-.90 area. However, depending on how forcefully the Fed may need to react to the further US equities weakness, we must presume this other weak sister economy may also anticipate more aggressive central bank easing to follow sooner than not.

### **FOREIGN EXCHANGE**

As noted previous on the foreign exchange, the near term US dollar strength still appeared an extended upside reaction rather than a trend change. The idea more aggressive US inflation is good for the buck because it will prevent the Fed from easing was always specious at best. We felt that could change at any time, and the lower the equities sink in the near term, the more so the inflation-risk factor will pale in comparison to the Fed not allowing a meltdown in the equity market. Of course, that will leave the US dollar even weaker than previous if the Fed is forced to cut while inflation influences are still in play.

On a technical trend view, the **US Dollar Index** did manage to leave a .7670 UP Break from its weekly aggressive down channel in mid-December, yet after recent slippage has now had trouble pushing back above it. That plays in very well with the obvious failure from broader trend resistance into the upper .7700-low .7800 area since it was tested in mid-December. Recall that .7820 was the major 1992 all-time low for the US dollar Index, and the sharp one day rally from the .7700 area could not penetrate that level back on October 22<sup>nd</sup>.

***Capital Markets Observer*** III-41 contained clear indications that weak activity in all of the weak sisters could ensue once the equities get back into trouble, as seems the case recently, and it is most pronounced in the British pound in spite of the nominal resilience of FTSE. As noted above, it is likely to ensue once again if equities weaken enough to force an inter-meeting easing from the Fed. Lower US Dollar Index support at the previous .7620 daily H&S UP Break was under threat last week during challenge to its .7570 Tolerance, and we suspect it could still fail. That pattern was distorted enough to leave a question over its reliability. Extended supports remain .7500-.7450, .7350, .7200 and .7000.

Euro becoming weak sister in the wake of the notion that the Fed could not ease further had seen **EUR/USD** failing 1.4535-20 on a DOWN Break from a distorted (and as such also very possibly unreliable) Head & Shoulders Top. While the Objective of that pattern was down in the 1.4100 area, there was only minor slippage below the next interim support in the 1.4400-upper 1.4300 area. Now, just as the US dollar Index has key support into the .7620-.7570 area, the original EUR/USD daily channel 1.4720 DOWN Break would require a daily Close back above 1.4800 to convincingly Negate the last weak signals. That would likely liberate EUR/USD to finally trade at the very least to psychological resistance at 1.5000, with oscillator indications moreso up to 1.5100 and 1.5250.

The weakness of the British pound is also more striking, with **GBP/USD** now failing support in the 1.9650-00 area major congestion, which also leaves a 1.9660 DOWN Break from its broadest weekly up channel from the major 1.7050 November 2005 reaction low. Along with the weekly and daily MACD remaining DOWN, this points to a potential for it to drop to the 1.92-1.92 area congestion prior to hitting the next major support. Much below that it is back into a major historic range; while there is interim support into 1.85 and 1.80, the low end of that range is back into the major historic congestion in the low 1.70 area. All of which seems a very big assumption, except for the pound's historic tendency to revert quickly back to mean trends once it is done either underperforming or outperforming.

Even though the US dollar has returned to the secular weakness as well, the pound is now the weakest of the weak sisters. Previous this has also allowed **EUR/GBP** push above both long term congestion in the .7250 area, and quickly used that momentum to also violate the interim resistance in the .7350 area. While grinding above a key historic low at .7476 (from January 2004), there is some further congestion and weekly oscillator resistance into the .7500-50 range. However, our overall target remains in the mid-.7700 to mid-.7800 area.

As we have also noted previous regarding the recent selloff in the European currencies against the Japanese yen, the difference between the euro and the pound is also striking on that front. **GBP/JPY** fell below its 220.00 support and paid the consequences, with lower supports for its failed up trend into the 213, 210-207 and 200 areas. On the other hand, **EUR/JPY** is holding once again near 159.00 support, which is not necessarily very surprising with the Japanese indications becoming so weak once again while Europe remains the last strong sister standing. Indeed, even if it should fail, next supports are as nearby as 155.00 and 152-150 (the latter of which remain lows that were held in March and August of last year.)

How much further any equities break strengthens the Japanese yen will be very interesting in light of so many speculative carry trade positions having been ostensibly unwound already. With **USD/JPY** already having held tests of support around the 108.00 area, it may be very interesting to see how previous weakest of the weak sisters yen responds to the potential softness elsewhere. Yet, we can not get too bullish the yen, as weakness elsewhere is not really a long term positive for a Japanese economy still so reliant on exports. Lower supports are 106.80, mid-low 104.00 area, and the 102.50-101.70 (major January 2005 low) area.

It all still smacks of the US equity market weakness being a harbinger for broader economic weakness likely into the first half of this year, and that keeps the US dollar on the defensive, alternating with the other weak sisters when they get awful news as well.

## **ENERGY**

January **Crude Oil** had been so orderly below 89.00, we were not surprised that it rebounded smartly from the top of the lower support at 86.50-.00. Yet, even as that contract expired, the **February** contract pushed incrementally back above resistances in the 93.50 and 95.00 areas, the lower of which is being retested at present, with not much below it once again until the 90.00-89.00 area. Extended resistance remains 97.00, 98.00 and the 100.00 area.

## **Flailing II**

Following up on previous indications that central bankers attempting to solve the liquidity crisis by throwing money at the interbank lending market were flailing, we must add another suspect to our list of froth churners: the Bush administration. We have expressed our sentiment previous that Mr. Paulson's HOPE NOW alliance is a laudable attempt to create a free market solution to the housing and Hybrid Adjustable Rate Mortgage (HARM) problem at the root of so much economic weakness and the securities market problems. His repeated appearances and efforts also reinforce our esteem for one of the smartest, most articulate folks from Wall Street who is one of the most candid in Washington D.C. as well.

Yet, that very candor can work against him and the administration at times, and his recent remarks (on Monday) and stint as a guest host on the 'Squawk Box' show on financial news network CNBC both illustrated just how daunting are the housing related problems. In his determination to maintain the respect of Wall Street and Main Street, he has succeeded by being very candid, and that is to his credit.

However, the points that are so plainly stated as to sound like calm matter-of-fact are in reality very troubling. Some of it relates back to the seeing disconnect between the HOPE NOW effort's seemingly obvious assistance available to at-risk borrowers and the lack of any response from those folks who might benefit most. As we noted in our last couple of issues of ***CAPITAL MARKETS OBSERVER***, let us presume for a moment that this is due to the hesitance he has noted on the part of the borrowers to come forward. Fair enough; possibly the public who is a little less financially sophisticated needs some additional encouragement.

Now it seems that the encouragement has indeed been provided. According to the text of his remarks made on Monday, "...the HOPE NOW alliance sent over 450,000 letters to at-risk borrowers who had not previously contacted their servicers. Servicers estimate that, as a result of this effort, approximately 10 percent, or 45,000 homeowners, have called their servicers to see if foreclosure can be avoided."

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

We must presume that to optimize their resources in such a daunting situation as 1.8 million homes being at risk over the next two years, that 450,000 letter mailing was directed at the folks most at-risk in the first half of 2008. We do not know this, yet until we hear different it is likely a good assumption that the HOPE NOW alliance would not waste their time on folks who are not at risk until the second half of this year and beyond. If that is so, then how can a program that has been imploring people to seek help for several months now, and even bothered to send letters, have such a paltry response?

Once again we ask that you think about that. If you were in a house, and you only had to call your servicer to significantly improve your chances of remaining in it instead of being evicted, wouldn't you make the call?! Our guess is that something far more pernicious is afoot here than anyone dare expected at the start of the effort. Part of that is likely that many more loans were mis-marketed to parties who did not really qualify, even though they were very sincere in wanting to own a home, and committed to maintaining the mortgage.

On the other hand, as we had asked previous as well, might some of those who have not even bothered to pay the initial 'tickler rate' payments on their mortgages possibly have treated the later phase lunacy of 'no dow-in-doc' (i.e. no down payment, income proof or documentation) loans as a good way to achieve rent-free living in a house until they are evicted? We must suppose there are a limited number of cases where the home owner should not be pitied, but rather admired for their ability to fleece an out of control system.

On another front in his prepared remarks from Monday, Mr. Paulson points out another problem (amidst the improvements in some areas.) To wit, "House prices are falling in many parts of the country, and elevated housing inventories suggest that the price adjustment is not yet complete." "In this environment, buyers will be reluctant to commit to new purchases. Moreover, until investors have confidence that prices have stabilized, they will remain cautious about funding new mortgages. This is particularly true for new subprime mortgages, which are not currently being securitized by Fannie Mae or Freddie Mac, and for jumbo mortgages which do not qualify for Government Sponsored Enterprise (GSE) securitization."

Of course, the most telling bit is that, "In this environment, buyers will be reluctant to commit to new purchases." Securities professionals, and especially traders, pride themselves on being clever enough to avoid any attempt to 'catch the falling knife.' The desire of lower income buyers who were clever enough to avoid getting stuck in the HARM fiasco to not put their net worth at risk while home values appear to still be falling represents the "Joe Public" version of the same savvy. While it doesn't do the housing market any good, they are probably right to remain circumspect while the prices continue to fall.

Tighter lending standards also likely have some impact on home affordability. Yet, even with that factor considered, the degree of resistance to home purchases will likely remain high. That will continue until the rightfully cautious lower-middle income buyer has some sense the situation has stabilized, especially in a weakening economic environment. All of which adds further impetus to the likelihood of and RTC-2008 solution that we have suggested previous to stabilize the housing market prior to its weakness spilling over into too much overt economic weakness to readily address; especially in a US election year. More on how the political climate is already evolving toward that from a very interesting source below.

## Stag-Flation (and implications for long-dated yields)

The long-dated fixed income has reached a level of uncomfortable conundrum: everyone seems to appreciate that headline inflation worsening and threatening to leak over into the core readings means that there is no value in instruments inflated (i.e. yields depressed) by their response to extreme equities weakness. Yet, on the other hand, the trading tone of the long ends remains far too strong to reasonably encourage a bearish view at present.

As one of our more astute fixed income dealing clients summed it up, "The markets sure seem quite a bit more concerned with 'stag' (i.e. stagnation) than 'flation' (i.e. inflation) at present." And that is both well said, and a good summary of the degree to which markets are relying on the evolving economic weakness to address the inflation problem. As that has been the natural evolution of things across the intermediate term cycle s since the early 1980's, it is natural to believe it will once again be the case.

However, as we have noted at various times since the major economic and market top back in 2000, this is not the part of the cycle that is consistent with the 1980's and 1990's; it is moreso once again back to **1970's Redux: Son of Stagflation**. As such, it is more likely that the long ends may respond badly to further easing necessary to mitigate economic weakness in the US that is likely to spill over at least nominally to other parts of the global economy.

Inflation may abate slightly, but any further extensive easing will also make it more likely it remains higher at the bottom of the current downward phase than previous; and that will not be good for the long ends. Which is why we feel that any forced inter-meeting easing by the Fed will be so negative for the long ends. In fact, due to the especially weak equity market and associated housing and debt securities market scares, it is possible that the long-dated fixed income may have put in the full correction from the cycle low last June in as little as seven months.

While that is quite an extreme view in light of those corrections normally requiring from a full year to a year-and-a-half, special factors may have compressed it in this cycle. After all, the lead contract T-note has rallied more than eleven points from the June lows. Even more incredibly, it has rallied to not much more than five points below the June 2003 inflation scare high (i.e. yields have dropped fairly near their equivalent low.) What justification is there for yields to remain that low under any reasonable comparison of the conditions and general deflation fears of 2003 when compared to the current situation, and any reasonable short- to intermediate-term anticipation?

While we also look forward to its Composite Leading Indicator release tomorrow, if anyone needs any further insight on just how bad and entrenched the inflation has become, take a look at the OECD Inflation (NOV) report released on Tuesday. While further economic weakness is likely to mitigate it to some degree, it is unlikely that energy prices will get back anywhere near the previous cycle lows of the late 1990's. Food prices will also more likely remain elevated now that SU ethanol production from feed corn will be impacting the economics of meat and milk production regardless of any near term economic weakness. This is another 'cure' that may be worse than the disease, as Americans drive up food costs (which is a global function) for all sections of society in an effort to save a few pennies a gallon fueling their SUV's. Of course, other solutions are also a bit misguided at present, as well as being significantly...

## All Over the Map

When the situation is both very troubling and seemingly intractable, everyone still wants to be the party credited with coming up with a solution. And some very smart people have made quite a few suggestions of late. We prefer to remain with our view that nothing less than a stabilization of the US housing market through a Resolution Trust Corporation type of program will solve both that specific drag as well as the associated securities market problems, and the other solutions we have seen to date seem both unrealistic and moreso mitigation than a real solution of the problem.

Rather than any extensive analysis of these by, we have attached the Financial Times article covering comments by Mr. Ray Dalio, who is a very accomplished fund manager, as well as the FT Comment column by one of Mr. Paulson's predecessors, the estimable Lawrence Summers (currently a Harvard University professor.) Mr. Dalio seems to feel that the problem can be solved through trade, and that a major revaluation of the Chinese renminbi would go a long way toward solving the problem.

He is surely right that this needs to happen, and will be healthy for all involved in the long run. Yet, we are not dealing with the long run here; any solution must solve the problem into the mid-to-late part of this year. In last week's *CAPITAL MARKETS OBSERVER* we noted a New York Times editorial statement that "...the next administration will have a lot of work ahead to clean up the subprime mess — once and for all." We found it telling that they are already looking for a government fix; and quaint that they feel it can wait for the next administration to take office and gets its programs in gear into mid-2009. We feel the same about the timeline involved in curing anything by waiting for the Chinese to adjust the rate of the renminbi-dollar peg, even though that has accelerated of late due to their own inflation mitigation needs.

On the other hand, Mr. Summers wants a fiscal stimulus package to offset the impact of the housing drags, and he is not alone in that. Yet, once again, this is only mitigation of a problem which might spin out of control before the multi-quarter stimulus he proposes gets a chance to address it. Once again, it deals with the symptoms instead of the actual problem.

## RTC-2008 II

As we already laid out our case for the need for RTC-2008 if the housing and securitized HARM loan problems worsen this year, we will be brief. In addition to Mr. Paulsen's recent formal remarks, his appearance as a guest host on CNBC Squawk Box was very, very interesting on many levels. Candid to a fault, he did not challenge various facts that were reviewed, including house prices increasing at an unsustainable pace for the ten years into 2005 (which showed quite a spike on the chart); that while subprime loans were indeed 22% of total loans outstanding, adjustable rate prime loans were also showing more problems than previous; that housing wealth in the US was going to fall \$5-6 trillion across this cycle; that it is was hard to make the HOPE NOW alliance work due to its industry-wide focus instead of individual lender reviews (as suggested by Ms. Faith Schwartz of the alliance); and that not only is housing not yet improving, there is no guarantee it has even bottomed. His one sop to comfort was to continue to cite Q3 growth as very strong, and we wonder why he did so in light of such downbeat expectations for Q4 and Q1 2008.

However, yesterday saw the US House Select Committee on Financial Services Chairman Representative Barney Frank also interviewed on CNBC, and his views were even more interesting in their way. As we had noted previous, he revisited the idea that many states and especially municipalities are having problems with abandoned homes impacting the values on which they can assess real estate taxes; that creates a major fiscal problem. He also noted that low end buyers are now being allowed to refinance through the Federal Housing Authority, and that in Massachusetts homes in the \$500,000-600,000 range are no longer luxury homes.

And then the bombshell in response to a question regarding whether home prices falling was a good thing for the buyers who had been prudent enough to wait? He acknowledged that this was so, and that those who were involved in shady financing should not be rewarded. Yet, as one of the folks that has bothered to educate himself on real world implications of finance, he also noted that the problem was "house prices falling too quickly", and that this would create so many problems as to require intervention!! Viva RTC-2008; the groundwork is already being laid for the American taxpayer to bail out a situation rather than live through years of the negative economic fallout, as happened to the Japanese after 1990.

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

-Rohr  
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