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Key Views, Overview,…

…Beige Book, When Ag Matters, RTC-2008 Revisited, The Fiddler's Notion

Key Views

- **As much as the equity markets were in disarray late last week, their cleanup this week has once again been less than propitious for the fixed income markets even though equity market weakness in Europe seems to have helped the US dollar recover from the US equities leading the way down last Friday. Yet, the fragile state of the stock markets to some degree still seems to reflect financial authorities' disarray.**

- **That is a reasonable response in light of the even more hawkish than expected view from ECB President Trichet at Thursday's rate decision press conference now being backed up by continued overshoots on inflation indications. Some verification of those concerns even came from the Bank of Canada yesterday, as it did not ease its base rate as expected. It noted that the upside risks to inflation had increased in spite of the weakness of US demand weighing on the Canadian economy. That same sort of condition is now evident everywhere, even the weak Japanese economy, where this morning's Domestic Corporate Goods Price Index (MAY) outpaced expectations. It is also opposed everywhere by flagging consumer confidence and even some real economic weakness. The next major conundrum is likely in today's Fed Beige Book.**

- **As noted previous, lack of further DJIA upside progress above the 13,100 resistance for such a long period after the mid-April UP Break above 12,768 (February highs) had allowed much more pernicious technical tendencies to take hold. Friday's failure below 12,500-450 was merely confirmation that the loose Double Bottom (which was apparent in some other markets as well) is not likely credible any longer. While there were reasons to doubt it for quite some time (too lofty an upside Objective at 13,900, and too little Volume on the push above 12,768), last week's failure points to a likely violation of the January lows for a second wave of the bear trend.**

- **Whether or not DJIA holds interim support at 12,230-12,175, or sinks quickly to lower levels should be a heavy influence into other markets. It's recovery from that area has left the fixed income damaged and the US dollar buoyant. The next major lower support is 12,070-000, and if that is threatened it might diminish the continued 'basing' perspective to a degree that squeezes the fixed income once again. While there are lower supports into 11,756-731 (the Spitzer-Stearns trading lows), and the 11,635 major trading low from January, the Double Bottom would look damaged on any swing below the 12,000 area. September S&P 500 future below 1,373 support has more into 1,350, 1,336 and 1,326, DAX below 6,900-6,865 has near term supports 6,657, 6,585 and the 6,500 area, FTSE 100 below 5,950 and now 5,827 looks to 5,750 and 5,600 area support.**

- September T-note slipped below 113-00/112-24 area contract and continuation support yesterday, with mid 111-00 and 110-00 areas below that. Initial lower support is not just a recent trading low, but also a key continuation level. Even if it should have another rally above the 113-00 area, higher resistance is heavy into low-mid 114-00s. That remains very important due to the T-note historic tendency to fall sharply to at least 110-00 area or even the 108-00 area when it remains below 114-00 on the way back down.

- Having dropped further than T-notes previous, weakness in European fixed income is still bad below extended supports. The Bund below 113.00-112.50 has also failed the mid-low 111.00 support and may hit last summer's 110.00-109.65 unless the US equities weaken soon. The Gilt drop below 106.70-.50 area was also below 106.04 October 2007 trading low, with next real support in the 105.00 area now violated on the way to a predictable test of 104.00. Although it has bounced from that area, a test of low end support into last summer's 103.35-122.90 cyclical lows is still possible if the US equities do not revert to sharp weakness in the wake of further central bank influence this week.

- There was not much of a surprise that the US Dollar Index finally failed into the key resistance at .7350-70, and was back below near term support in the area of the .7320 March high in the wake of the US equities leading the way back down last week. Extended US Dollar Index support is still into the .7200 congestion and .7160-35 weekly UP CPR. Yet, as the US equities weakness has also now spilled over into Europe, it is not that much of a surprise that all of the US-Europe trading seems to have become a trading range affair, with the energy price burdened Japanese yen as true weak sister.

- EUR/USD recovering further was also no surprise after Closing above 1.5500-50 near term resistance in the wake of Monsieur Trichet's hawkish comments last week after it held the test of 1.5350 extended support (aggressive weekly up channel and UP CPR.) Yet it has also stalled again around 1.5800-50 area resistance, even though it extended the rally above the 1.5817 high from two weeks ago just to kill all of the weak bears prior to dropping once again. Resistance remains into the 1.5900 mid-April Negated UP Break.

- EUR/GBP failure from .8025 weekly DOWN CPR (Tolerance: .8050) still saw it hold .7750 support (which remains support) yet with .8025-50 still critical resistance into this week. The British pound seemed to be rotating around to weak sister once again until the US equities weakness last week, and that will bear watching from here. GBP/USD is back up toward MA and congestion resistance into the 1.5850 area, with extended resistance into the 2.0000 area. Yet, only back below support into the low 1.9700 area would it appear the weak sister once again, with 1.9500 and the more critical 1.9350-00 below that.

- USD/JPY struggled mightily for some time with 105.00-106.00 resistance, yet has now pushed out above it. Higher USD/JPY resistance remains the 108.00 area, and then 110.00-110.50. Yet, (as noted previous) the yen has become the major weak sister in the wake of sustained high energy prices. With the EUR/JPY above 165.00-.50 and GBP/JPY through 208.00-209.00 to the upside, each of those seem to have several points to go even as strong sister USD/JPY lagged into the next resistance in the 108.00 area.

- As noted extensively previous, Crude Oil rebounding from 112-110 back above 120 also pushed above resistance in the 125-127 area, the low end of which was near term support with a buffer down to the 123.00 area (daily aggressive channel and Area Gap.) Having been above and back below 135 area weekly oscillator resistance interim support reverts back to bottom of the 127.79 Area Gap, with higher resistances in the 140 area (weekly MA 41 plus 40), and extended resistance not until 150-153 (MA 41 plus 50.)

Overview

This is really quite an interesting week on so many levels that the fact the Beige Book is released this afternoon is just one piece in the broader puzzle. In the past it might have been a dominant influence.

The reason for this is the degree to which the hawkish central bank influences have rightfully flowed from Europe and the UK in the first instance, and were a necessary evil for the Fed and US Treasury to take up in defense of the US Dollar. Yet, all of this aggressive inflation mitigation still comes at a time when the credit markets are returning to a more so unsettled state, US consumers are in a retrenchment of sorts (which is now being reflected in sentiment if not actions elsewhere), and the equity markets are showing the signs of that strain.

As noted previous, the most important central bank communications will not be the now broadly anticipated overt hawkishness of ECB into continued economic strength and deteriorating inflation risks; it will once again be whether the view of the Fed and US officials remains more hawkish to a degree which the equity markets consider inconsistent with the still fragile nature of the US economy and credit markets.

That means their very prominent influence will be most telling in the contents of this afternoon's Beige Book; especially as that comes into the tail end of the Boston Fed's conference: *Understanding Inflation and the Implications for Monetary Policy*. This has been a minefield for the markets, and the Fed's Mr. Kohn is speaking into lunchtime at the conference as well.

In addition to all of that, 'facts on the ground' are not auspicious for any control of inflation in the near term. That has been aggravated by the recent US storms creating problems for the US farmers now in charge of a significant portion of energy production as well as food. That has further implications for US (and global) consumers who are already under pressure. And it all only ties in that much more with the negative fallout from the continued US housing market weakness which now seems to be a factor for the UK outlook as well after even a more major bubble than experienced in the US.

A solution to the US housing weakness at the very least is most likely still at the core of not just the consumer sentiment dilemma at present. It continues to have implications for the international financial services firms as well, as has been illustrated by the surprising problems which have surfaced at Lehman Brothers (among others) that had previous claimed it was immune most of the calamity plaguing its cohorts. Rest assured that Lehman's is not the only one who will experience further problems if the US home price situation deteriorates markedly. It is still possible that a version of the extensive bailout used to rescue commercial property in the US will be needed. As such, we are looking for any further US housing weakness to encourage Congress to pursue what we referred to as 'RTC-2008' in our analysis last December.

Beige Book

It was most interesting to listen to Fed Chairman. Bernanke's exposition last week on why things may be bad, yet they are surely not as bad as back in the 1970's. Once again we see a professor with alleged iron clad knowledge of the history of the Fed who seems content to rely heavily on the current conditions instead of a forward view of where the overall trend might be leading. This is not very comforting at all.

(**Beige Book** cont.) After all, the conditions of the 1970's did not crop up overnight. They developed out of a long period of not just neglect of the inflationary forces, but also a loss of confidence that Fed and US Treasury officials knew what they were doing. On current form for both the US economy and closely related US housing market, we appear to be devolving into that state once again.

Just as he sat back and took credit for the good times when the DJIA went to new highs in October 2006, he is now more of an observer and commentator than prime mover who seems capable of prescribing solutions other than to create regulatory structures that would have mostly prevented the current crisis long after the horses have fled that particular corral.

His message seems to be, "Don't feel so bad; it could be worse." This puts in mind of a soliloquy from an eminent cinematic social observer, Woody Allen. In his self-written and directed role as neurotic comedian Alvy Singer in 1977's *Annie Hall*, he expounds upon the fact while he is miserable, that's really not so bad.

As he noted, "I feel that life is divided into the horrible and the miserable. That's the two categories. The horrible be (*sic*) like, I don't know, terminal cases, you know, and blind people, crippled. I don't know how they get through life. It's amazing to me. And the miserable is everyone else. So you should be thankful that you're miserable, because that's very lucky, to be miserable."

That sounds like Mr. Bernanke's suggestion for folks suffering the failings of the Fed to pull the punchbowl soon enough during the later, most pernicious phase of the credit bubble; which he and Mr. Greenspan both claim it was not their job to deflate. As we queried previous, "Then who?" Our view remains that Mr. Bernanke is meeting his fate on the very path he took to avoid it.

[For anyone who has not viewed *Annie Hall* recently, the cameo by Christopher Walken as Annie's crazy brother Duane (who wants to die in a fiery crash by driving head-on into opposing traffic) is worth the time to revisit this (some say) neurotic comedy classic.]

All of which bring us to the topic of today's Beige Book. As noted in last Thursday's ***Special Market Highlight***, US economic data has encouraged a swing around to much more hawkish Fed attitudes beginning with the May 21st release of the minutes of the last FOMC meeting (April 29-30.) Supported by better than expected US data, the Fed hawks are now also backed by Chairman Bernanke, reinforced by the US Treasury's desire for a stronger US dollar.

With equities seemingly stabilized again and inflation a stubborn problem, it would seem all of this was in order; at least until the equities began to crack under the pressure from the broader problems which fomented the original crisis that are not going away. What if the equities' bid is not as well founded as the Fed would like to believe?

Especially in the US (which is at the heart of the previous problems), the most recent MBA data showed that in the first quarter mortgage delinquencies, foreclosures and initiation of foreclosure proceedings all hit record levels. This gets back to previous observations that many mortgages are not in a position to be 'adjusted', and (even as Messrs. Bernanke and Paulson have noted) weakness begets weakness in US housing, as buyers are dissuaded by the price drops.

As such, if the Beige Book shows still weak economic tendencies yet with strong price pressures, then the recent Fed stance is likely to revert to a major problem for the equities. That is also tied into ECB Monthly Bulletin and Bank of England Quarterly Inflation Attitudes report releases tomorrow. It may just be that the Fed is premature in this after being too late previous.

When Ag Matters

The old saying is, "When it rains, it pours." Certainly all of the denizens of the central US can relate to that after the major storms that included quite a few more than normal early season tornadoes of late.

Yet, the other meaning of that saying is that major sets of occurrences and influences tend to come in bunches with somewhat significant lax periods in between. That is also very relevant to the same US storms that we have seen of late impacting the inflation outlook.

A *New York Times* report from journalists David Streitfeld and Keith Bradsher opens, "In a year when global harvests need to be excellent to ease the threat of pervasive food shortages, evidence is mounting that they will be average at best. Some farmers are starting to fear disaster.

"American corn and soybean farmers are suffering from too much rain, while Australian wheat farmers have been plagued by drought." (Full article attached.)

It hardly needs any further exposition from us for almost all of you to know what we mentioned previous about the degree to which feed corn is now both feedstock and fuelstock. Any upset to the corn supply has a dual inflationary impact into what are already extremely thin storage stocks.

What is not mentioned in the article are two other points. The first relates directly to late breaking news that likely cropped up (pardon the pun) after the reporters completed their extensive research: The recent flood in Indiana is a 100-year flood (actually just a bit less, as the last one of this magnitude was in 1913.)

The second point is something we have discussed previous, yet is worth revisiting. As high as red meat prices may seem at present, consumers are actually temporarily benefiting from the profits squeeze on the producers. However, that is due to the extensive culling (i.e. liquidation) of breeding stocks in order to very explicitly force prices higher later to cover the costs of production.

Smithfield Foods (a major pork producer and processor) is not at all alone in recently announcing a secondary wave of such actions, because the overall extent of increase in their production costs is so great that they fear the initial cull they announced months ago will not be sufficient to restore profitability. While that retrains prices now, it is anybody's guess what holiday hams will cost into late 2009.

Agriculture is normally assumed to have little impact on capital markets; until it becomes critical again, like in the 1970's.

RTC-2008 Revisited

There was an excellent article by Mr. John Dizard in yesterday's Financial Times that aptly described why "There is no choice but to guarantee the big lenders' debt." It is a very thorough discussion of the degree to which central banks (and by extension their tax-payers) will need to fund the resolution of the problems from debt derivative market abuses (article attached.)

That said, you are all aware that we have proposed a different solution to problems which continue to plague both the prices of homes in the US market (and now possibly UK), and the credibility of the interbank lending markets. The hope that the latter would right themselves by virtue of major trenches of central bank liquidity infusion is now belied by recent deterioration.

(**RTC-2008 Revisited** cont.)
Other than more of the same, there remains one additional alternative to saving these institutions which might bring quite a bit of sanity to the situation via better liquidity. Stop the rot in US home values.

At present the political will to pursue that has not reached critical mass. Yet with an election looming and US housing values continuing to slide, the environment for an expanded fix from Congress may well develop later this summer; even if over the strident objections of the administration.

About the same time it was mentioned by Alan Greenspan last December, we also noted that direct assistance to at-risk borrowers was likely to be necessary across the cycle. That is due to the convoluted nature of the securitization of mortgages creating significant hurdles to resolving all of the problems. In spite of the valiant attempts of the Hope Now program, it was Mr. Paulson who admitted as much after his meetings with investment bankers last summer; and he is astute enough to know.

While the administration has stuck to its ideologue approach, record highs for recent US Mortgage Bankers Association statistics on delinquencies and foreclosures belies assertions the Hope Now program is adequate to the task at hand. Whether getting at-risk home borrowers together with lenders holding shards of their now securitized mortgages was ever indeed possible, if the public pain ratchets higher into Labor Day it will be compelling for politicians headed out for re-election to act in a forceful manner.

That this will produce some perverse effects and encourage a degree of future moral hazard is certain. It is also certain they will be clever enough to enact a rescue plan that avoids the most obvious pitfalls. In the first instance it will likely only be available for owner occupied housing, so as not to reward speculators.

The combined negative wealth effect, failed mortgages creating more individual pain, and (most critically) the degree to which they will foster more problems in financial institutions' securitized debt portfolios is an entrenched, multi-faceted problem. It's like termites armed with hand grenades.

On current form, there will come a point where an at-risk borrower bailout will seem a lesser of evils to taxpayers whose home values are being adversely affected. The politicians are likely clever enough to see that keeping neighbors in their homes is preferable, even if distasteful. The only alternative is having them evicted; driving property values still lower, and then having to hand the same (or larger) mountains of cash to the now-detested, debt derivative dissembling investment banks.

While the administration will protest, this will be passed by Congress. The true lame duck character of Mr. Bush's Presidency will become glaringly apparent when Congress just sits back and says that they do not care if he vetoes it. They will just commit to passing it as emergency legislation in the first quarter of 2009, and make signing it an election litmus test for Messrs. Obama and McCain. And that will most certainly be a huge gift for Mr. McCain if he agrees; what a wonderful way to differentiate himself from the current administration.

In fact, In a CNBC interview this morning Mr. McCain explicitly accepted the efficacy of a support program (i.e. 'bailout') of at-risk home borrowers, which is contrary to his previous wholly free market approach.

He spelled out his reasonable requirements for this, and it was no surprise that included the caveat that any program should only be available for owner occupied housing.

The Fiddler's Notion℠

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℠ 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.

Bernanke *mea culpa*?

Talk about risk that is assumed on behalf of others without regard for the consequences. It still seems to us that Mr. Bernanke is responsible for the extensive commodity inflation reaching the proportions that it has. This is substantially due to his lack of desire to be the 'bad guy' back in late 2006 when he should have reasonably knew that credit market excess and the DJIA moving above its 2000 high (a fillip for asset appreciation expectations) was a toxic combination.

Of course, that has been the proverbial water under the bridge for quite some time. However, what was not were his previous sanguine views on inflation potentials that seemed a bit naïve to any of the more experienced observers. Repeated ideas on the degree to which forward futures prices were providing comfort to his analysis on future inflation potentials seemed as misguided coming from him as any of the other market participants who had made that mistake in the past; not the least of whom were the early 2007 interest rate bears who relied too heavily on the forward pricing of the Eurodollar futures contracts.

While it was not presented as such, his discussion of this at the Boston Fed's conference on *Understanding Inflation and the Implications for Monetary Policy* (in his *Outstanding Issues in the Analysis of Inflation* speech) was a *de facto mea culpa*.

What else are we to make of new views on policy makers' reliance on futures pricing. Mr. Bernanke finally admitted that "The poor recent record of commodity futures markets in forecasting the course of prices raises the question of whether policymakers should continue to use this source of information…"

News Flash for Mr. B.: That tendency is not *recent*!! Yet it is less than encouraging that a full professor and Fed Chairman whose area of expertise is the history of the Fed (and we presume the markets as well) is just coming to realize that fact. We might have hoped this was something which he knew well prior to becoming the head of the world's most important central bank. Stop and think for a moment about the fact that he seems to have believed previous these were indeed 'forecasts'!!?

Bear Failure Review, and Irony

Prior to its demise, Bear-Stearns suffered from many problems that went far beyond any specific investment or portfolio problem. There was seemingly a dilemma of culture that was too aggressively risk acclimated, and too politically leaden. It seemed to suffer from a series of less than prescient positions that did not reflect either the market or political reality, and that is in spite of what seemed a very strong bit of credible hindsight by its research department in the wake of the debacle.

Yet, on balance it was…

Undiversified: Talk about risk that is assumed without regard for a stop-loss consideration: What could they possibly have been thinking as they continued to expand a book on a very thin balance sheet that was so totally concentrated in the debt derivatives area? Especially as it was not a 'real bank' (in the classic sense) that had depositors or a credit card business to right itself if things went wrong.

Unloved: First it is only fair to extend the same concern and sympathy as everyone else from all sides of the spectrum for the personal tragedy this represents for the mostly hard working and diligent Bear-Stearns staff, as well as quite a few of the passive investors. Yet, the firms' penchant for bucking the 'Street' on important matters was legend. That was most prominent in its refusal to participate in the LTCM bailout back in 1998, and many feel (rightfully or not) that at least part of its recent problem was the degree to which many felt its own failure from over-concentration in one area was a case of 'just deserts.'

Unrepentant: All of which brings us to the irony of Bear-Stearns research department criticism of the overall economic landscape (and associated culprits) in its own demise. A WSJ.com note on this is attached: It was an exercise in hubris on one hand, and a not so very far-fetched post mortem on what went wrong with the markets on the other.

To wit (just an excerpt), "It is only a pity… …that the Fed didn't hike rates more rapidly in 2004 and 2005, which would likely have headed off the rise in leverage and the boom in mortgage lending." "It is also unfortunate that the Fed didn't introduce its new lending facilities when the pressures first emerged in… …August 2007."

As all of our readers are well aware, we couldn't agree more with the assertions regarding the Fed's lack of credible 'leaning into' the sustained economic strength prior to the bubble mentality developing into 2006 and 2007. In that regard we felt a bit more sanguine ourselves until the alarm bells went off on the October 2006 new all-time high in DJIA. However, on balance just because the firm failed does not necessarily make the analysis any less credible on the big view failures of the US central bank.

That said, the real irony is that they seem to state this as facts, and of which they were more than well aware as a research team. We only inquire, "Where was a reasonable commensurate adjustment in their firms' master portfolio and risk management to reflect this?!" These folks were supposed to be Masters of the Universe. Their acute and prescient appreciation for when central banks are out of step should have left them benefiting markedly instead of becoming a victim of their central bank's poor macro-economic management of the situation.

Failed execution of any view as accurate as they expressed after the fact can only be a symptom of the triumph of hope over broad experience. That is normally only the mien of the uninitiated punters; or a simple case of rampant greed that failed to heed its own understanding that the end was nigh.

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

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