

# **ITI Institutional Trend Insight™**

## **SPECIAL MARKET HIGHLIGHT**

MONDAY, MARCH 21, 2005 (as of Friday's Close)

### **1970's Redux: Son of Stagflation**

***"...we could send you back to the future."***

-Professor Emmett Brown to Marty McFly  
...in the movie *Back To The Future*  
(1985, Universal Studios; Director: Robert Zemeckis)

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**Summary:** The overall theme of this report is anomalies in intermediate term fixed income and foreign exchange cycles due to this extended trend phase also encompassing long term adjustments at the end of the twenty-to-thirty year economic and equity market cycle. This calls for rather more extensive review of politico-economic and price trend tendencies than our normally somewhat extensive Special Market Highlight text, and additional chart attachments. Yet, all of these factors are relevant to addressing the various "conundrums" (as Mr. Greenspan aptly expressed it) which have been vexing even long term, successful market analysts and portfolio managers over the recent evolution of the current cycle.

Long dated US yields still seem much too low compared with recent sustained rate hikes from the FOMC. Yet, with the March T-note future failing important historic and recent congestion support in the mid 111-00 range, and the discounted June T-note futures now becoming lead contract below the next lower major support in the 110-00/109-16 range, it appears that the long deferred aggressive bear trend is about to re-emerge. That leaves this week's important news and market response to FOMC rate decision and policy statement as a bellwether. In a turnabout of the old cliché, it is what they say, and *not* what they do: All eyes will be on whether the presumed 25 basis point increase is accompanied by any change to the "measured" language regarding removal of accommodation. Yet, whatever transpires tomorrow and later this week, the factors that caused the longer term rate up trend (and down trend in the instruments) to be so erratic and subdued to this point are worth reviewing as a potential guide to what to look for next.

The US dollar suffers in spite of the US economy remaining much stronger than Europe, with EUR/USD back above the early 2004 high at 1.2925 that was also a very important weekly trend failure attempt, from which the Euro has now rescued itself, to the benefit of other currencies against the US dollar as well. Yet, unless the Euro can exceed the 1.3500 area against the US dollar, the trend in the buck is more likely than not to remain stagnant, as no real follow through back through the 1.2900 area against the Euro is likely.

Until just recently, the US equity markets remained very robust in spite of all the pernicious input from rising costs all around: energy, interest rates, and raw goods. Now that the upside leader DJIA demonstrated its inability to hold a modest retracement below its major 10,832 Head & Shoulders Bottom Objective (that it previously struggled near in February and December 2004,

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and again in February of this year), it is likely in the early phase of a broader correction. As noted previous, that H&S Objective is such a big level that it will now likely act as a cap after the weekly Close back below the 10,800-10,780 congestion support. Yet, if the long dated fixed income is going to experience the more aggressive selloff that longer term cycle influences suggest, it will likely be due to stronger economic news that might buffer any DJIA slide as early as the 10,400 area. As such, it is more likely to be a gradual turn back down in the equities, not a debacle.

**Overview:** Why does it feel like we are headed back to the future? Simply stated, this is very much like the early 1970's once again. And while intellectually aggressive individuals may learn the lessons of history, whole cultures rarely do. As such, they are (as Georges Santayana has cautioned) "...doomed to repeat it ...". Considering the most recent historic phase was the Dot.Com Boom Fantasy Land (metaphor consistent with our long held belief that the developed world's governments are running a Disneyland for Dummies), by comparison current circumstances appear dire indeed.

Yet, the previous US administration had the luxury of huge tax flows from what was the last long term cyclical economic bubble, (self imposed) extremely low defense spending, and a gullible audience who just loved "Mr. Bill." Giving credit where it is due, even as he abandoned wholesale the most treasured platforms and programs of the Democratic Party, President Clinton did prove beyond any shadow of a doubt that another previous US President (Abraham Lincoln) was very accurate in his assertion, "You can fool some of the people all of the time,..." Of course, that said, we must allow that Mr. Bush is busy doing the exact same thing from the other side of the political spectrum, while Howard Dean plays court jester to whole lot. If this proves nothing else, cult of personality trumps party politics in the new age of media madness.

As much as we hate to leave the rich rhetorical vein of political anomalies, market anomalies are moreso our expertise, and yet another robust topic today. These abound in recent and current international markets, in the form of the adjustments required by the typical bad hangover from the extreme excesses of the extravagant boom at the end of the last long term economic cycle. While these are actually typical long term cycle tendencies, they are nonetheless very unusual for the *intermediate term* market price activity that most investors and traders have come to expect. As a case in point, quite a few aspects of the fixed income trends since the FOMC rate cuts of 2001-2003, and recent rate hikes are inconsistent with the experience of most who successfully analyzed previous intermediate term adjustments in the early 1980s, 1987, 1994, and 1999. This is due to most folks feeling that if they achieved either professional position, or personal investment success, with both experience and expertise that allowed them to effectively assess the trends across the five, or seven, or ten year swings, that must be long term analysis.

Not necessarily. Ergo our opening assertion that whole cultures do not learn the lessons of financial history, because each generation's formative experience of necessity cannot include the previous thirty year (more or less) economic and investment cycle. They get to put their hand on the hot burner of long term cyclical economic and investment bubbles, just like the previous generation. In the most cynical sense, about every thirty years or so the market has a new batch of suckers willing to invest (emotionally as well) in the idea that it is "different this time," prior to relieving them of a significant portion of their net worth. For anyone who was indeed burned, don't feel so bad; this has been happening to smart, moneyed people since Dutch Tulipomania in the early 1600's, and even earlier.

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The background and technical conditions related to recent and current anomalies will be reviewed below. Suffice for now to know that old adage about trends extending farther and lasting longer than most folks suspect during the initial phase has been substantiated by those anomalies in the recent intermediate term cycle price activity. While we will attempt to couch it in the most useful manner, the important current question, which only time will answer is, "Are we now headed for sustained trend reversals that will also go farther and last longer than most participants consider reasonable in the context of current politico-economic expectations, and technical price structure?" As a precursor, it is important to consider how expectations evolved to create the current anomalies.

### **Historic Market Background: The Long View**

The first thing that needs to be said is that the US has been through these long term economic cycles since before the existence of organized national and international equity, fixed income and foreign exchange markets. No doubt the more advanced capitalist economy of the British Empire saw its share of boom and bust cycles prior to anything resembling a modern economy existing on our shores. Yet, even prior to the advent of the Dow Jones Industrial Average, there were discernable cycles that mostly encouraged, as Keynes put it, the "animal spirits," and spells in between that depressed them. As near as we can tell from what economic historians tell us, there was a lengthy post-Civil War recession in 1874-1878, serial short ones in the late 1890s through the early 20th century, another couple around 1910-1914, and very few at all after the "big one" in 1929-1932 (actually ending in early 1933.)

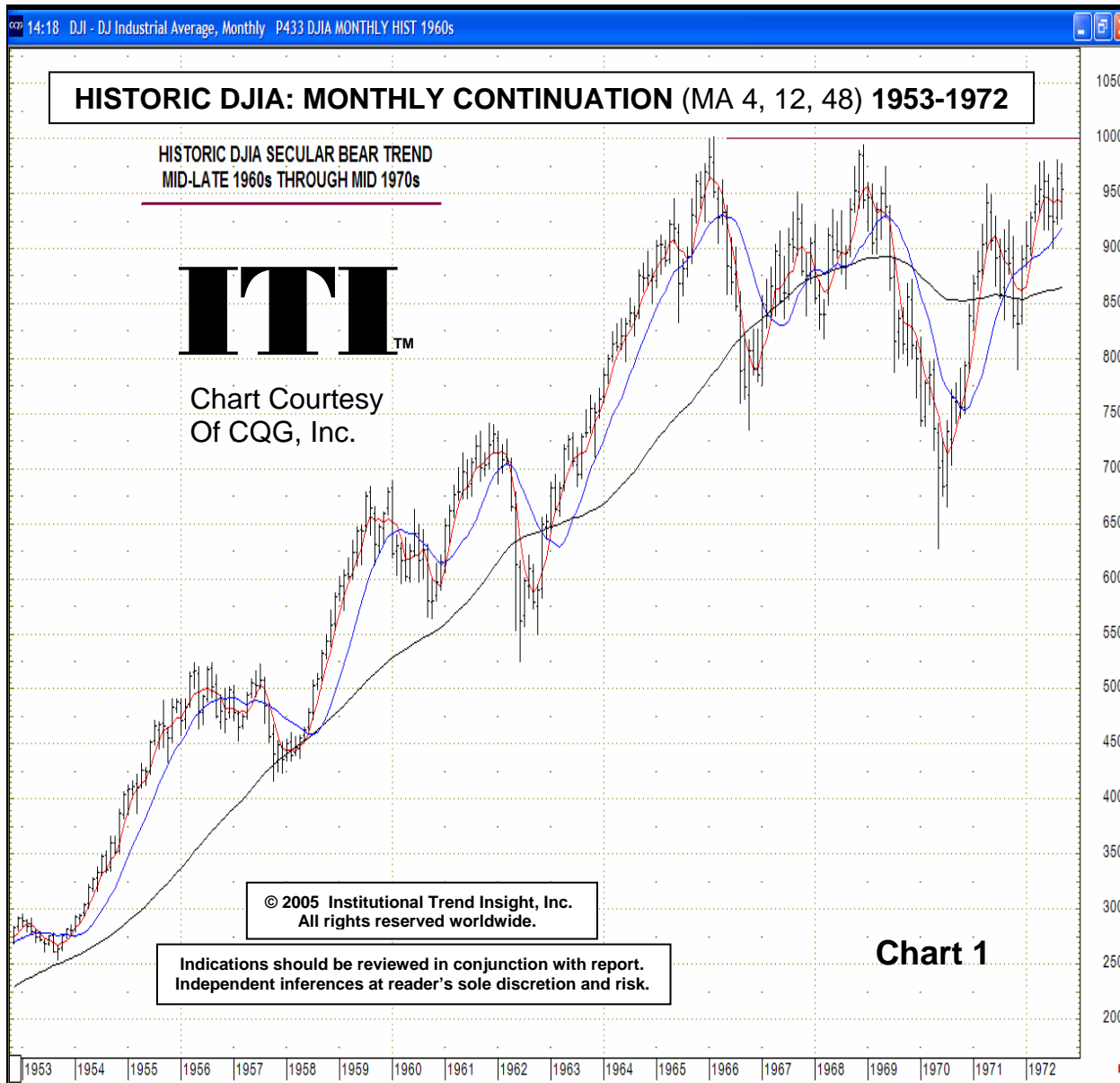
What is apparent from this is that while previous cycles were somewhat erratic, the developed economy of the US entered a Golden Age of extended growth after the financial and banking system consolidation that occurred in response to the Great Depression. Since that time, the downturns have been well managed, and only tend to significantly affect the long term trend of the financial markets approximately every twenty-five to thirty years after a particular major contraction's cycle low. That makes sense in light of the last major tops coming in the mid-late 1960's (from the previous 1933 low), and 2000 (from the 1974 low.) Of course, that does not guarantee that the next sustained up trend in the market and the economy will last for at least another twenty years or more as the market proceeds from the 2002 equity market low. And in any event, today's topic is moreso why the current trends have evolved as they have in the fixed income and foreign exchange.

While there are some comparisons between the recent historic top and the major bear trend of 1929-1933, we have reasons we are not going to attempt to compare that to the current cycle. For one, the extent of that very much more speculative market meltdown was related to a very much less regulated market environment, and can only be compared to the activity of the current era's NASDAQ Composite failure, with its preponderance of Dot.Com listings at the time of the more recent market rupture. In percentage terms, even that index did not quite match the loss experienced by the DJIA between 1929 and 1932. Further, the extent of the associated economic depression was largely the making of the inflation paranoid Federal Reserve Bank of New York, which had inordinate power in the early Federal Reserve system, kept rates too high, and thus prolonged the Depression.

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### Similarities with Benign Early 1970's Long Rate Environment

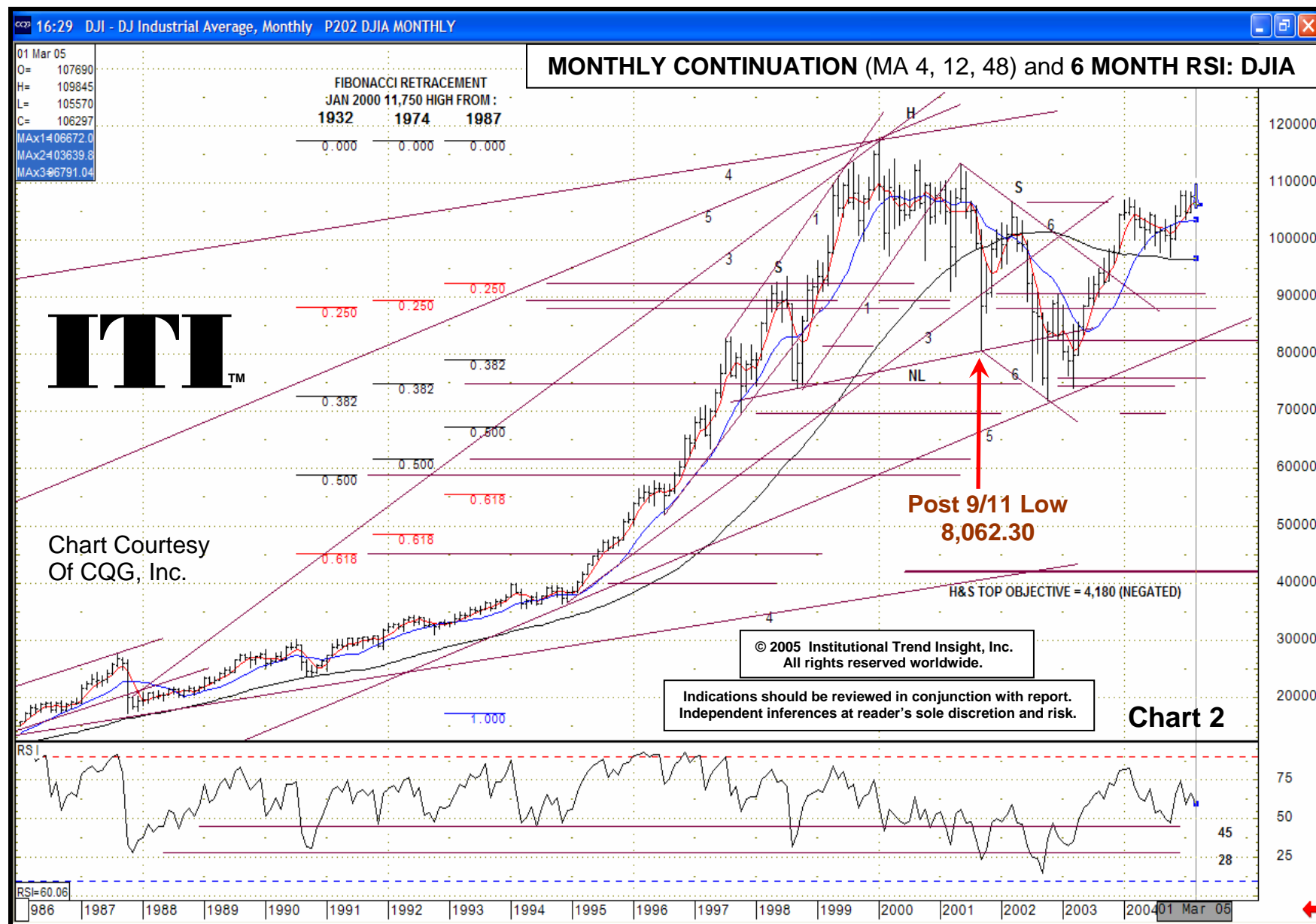


Which is why the only modern economic period that compares to the major economic and financial top in 2000 (and subsequent weakness) is the late 1960s-early 1970s equity market and economic top, and sustained weakness that followed. The long term cyclical pattern is similar to the bull move, selloff and recent DJIA recovery (Chart 1, left.)

The DJIA had experienced a series of significant setbacks in 1957, 1960 and 1962, yet always managed to shake off the weakness, and head back to a new high. This is the same sort of confidence that encouraged folks to feel the late 1990s bull would never end, after recovering from the Asian Crisis of 1997, and Russian Crisis of 1998 (Chart 2, below.) It is interesting on Chart 1 that after holding the initial selloff into 1966 the market recovered to very near the previous high, yet faltered. We believe this holds lessons for current trend activity after the technical failure noted in the summary, above.

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**10-year Treasury Constant Maturity**

**Chart 3**

**ITI**<sup>TM</sup>

Chart Courtesy Of Economagic.com

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Indications should be reviewed in conjunction with report.  
Independent inferences at reader's sole discretion and risk.

Economic Chart Dispenser

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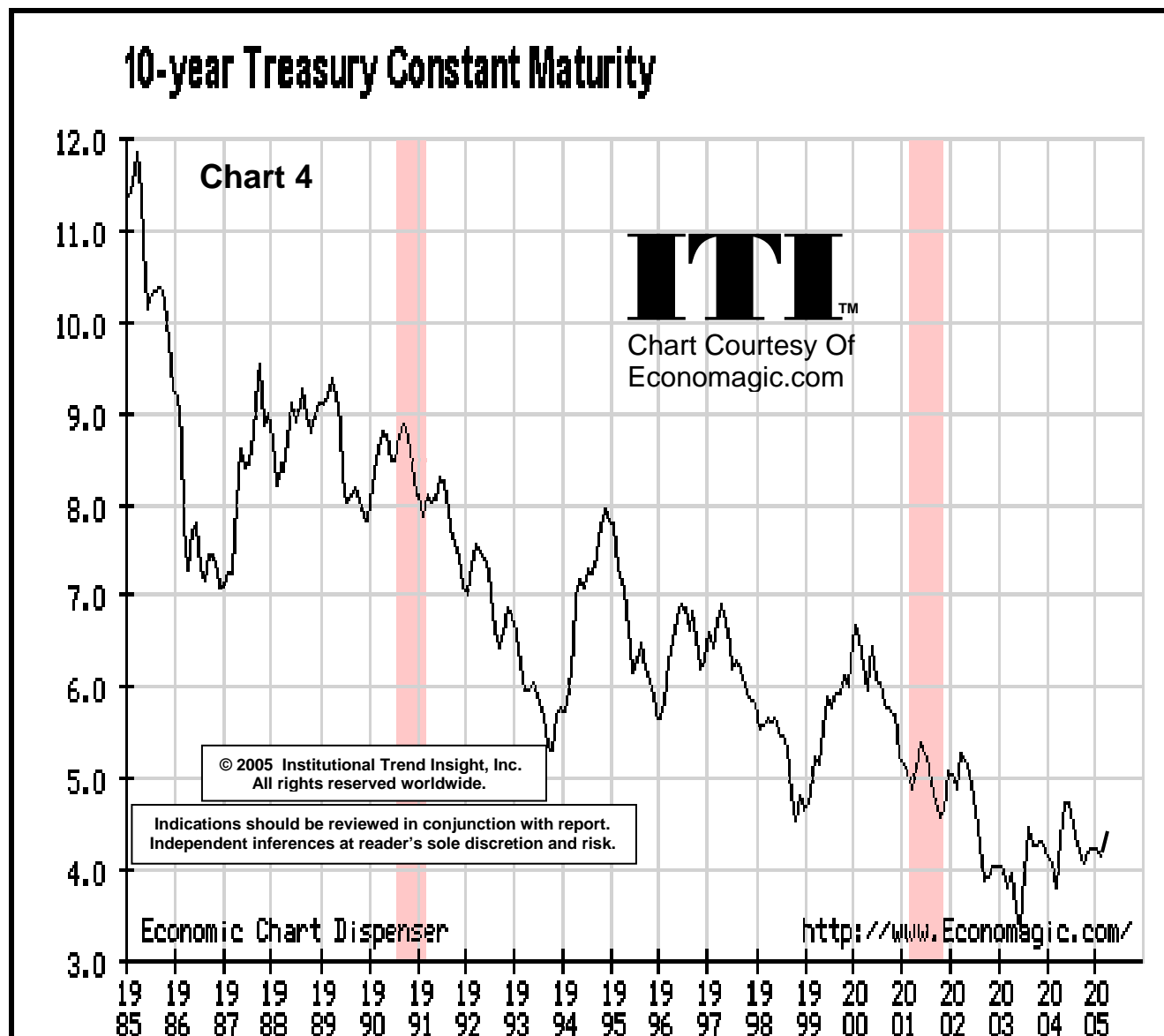
1963 1964 1965 1966 1967 1968 1969 1970 1971 1972 1973 1974 1975 1976 1977 1978 1979 1980

And that has fomented the more gradual return to higher long term US interest rates on the recovery after the major correction from the 2000 cyclical economic top, as compared to previous intermediate term cycles that most participants became accustomed to during the 1980s and 1990s. Note the long rate activity on ten year constant maturity Chart 3 compared to equity market activity on Chart 1. After the equity market confirmed a top by entering a secondary sustained selloff from near 1,000 area into 1970, long yields finally peaked, and dropped from near 8.00% to 5.75% by early 1971. While rates spiked back up fairly quickly from that low, just as they had done during the previous downside corrections in 1967 and 1968, they fell back to near the previous low in late 1971.

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Sound familiar? Note on Chart 4 that the market has also had trouble sustaining upward momentum in long dated yields since the major June 2003 low. While it is obvious that this is very different in being the bottom of a long secular decline in yields (more on that later), it is nonetheless a period marked by economic overcapacity, and the trend tendencies are very similar. In fact, if we disregard the “disinflation” (some would say disingenuous) scare that the Fed fomented in mid 2003, the yield has indeed returned to near the “real” low in the very upper 3.00% area repeatedly since October 2002. It is of further note that this is now very similar to the gradual up trend experienced by the yields in the early 1970s, and that in spite of the benign start, they did ultimately rise dramatically.



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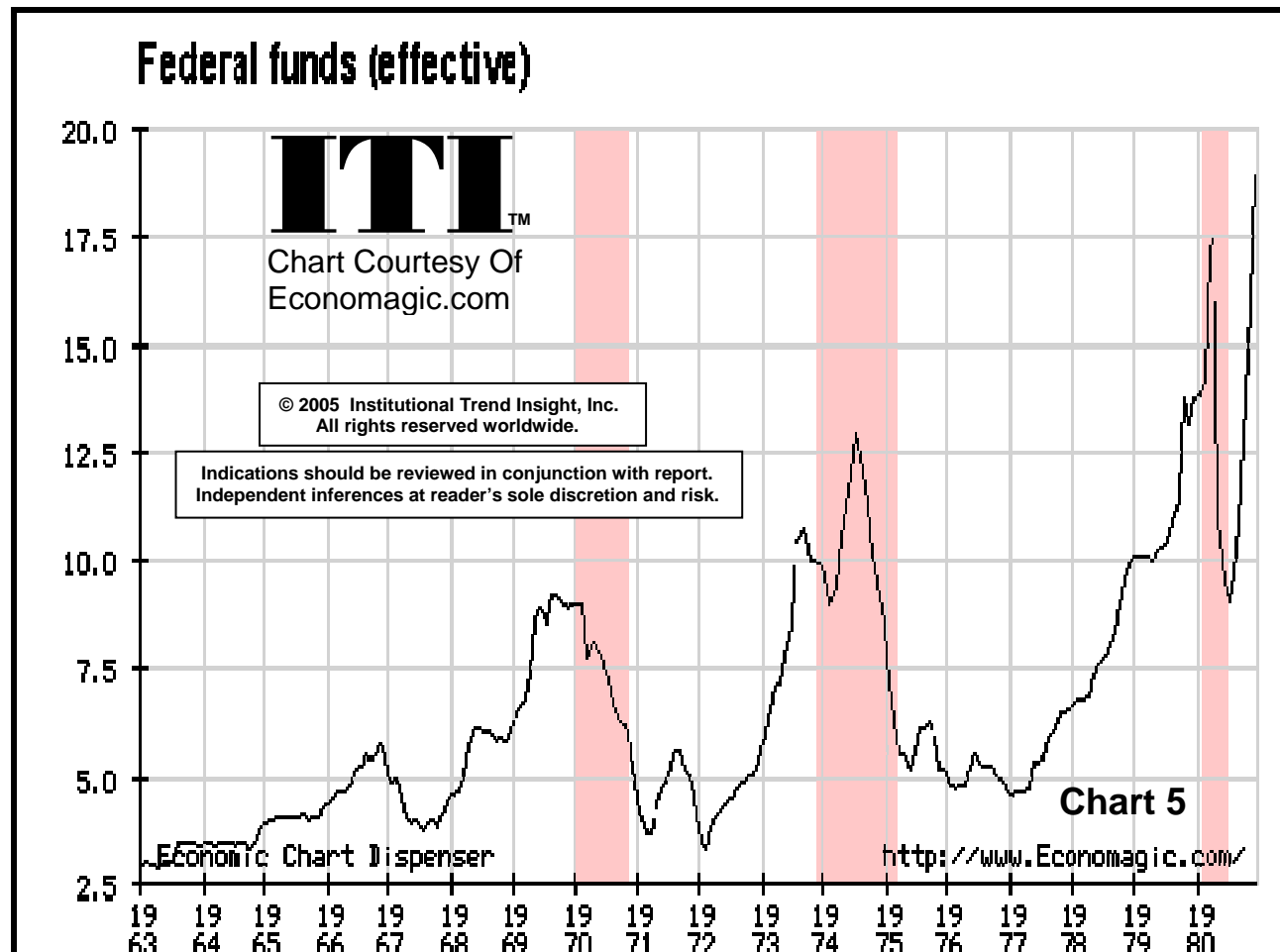
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As to the degree to which the FOMC is now hiking rates somewhat aggressively, and the relatively subdued trend of long yields seeming a bit of a "conundrum," the comparison with the previous long term cycle is also instructive. While generally at much higher levels than at present, due to the much higher inflation in the 1970s, the Fed dropped the Fed Funds effective rate to 3.00% by early 1972 (see Chart 5.) That was a new intermediate term cycle low, even though long rates did not drop below the early 1971 low (Chart 3.)

Of greater interest regarding the alleged current long rate/short rate anomaly, note how rapidly the Fed shoved short rates back up to 11.00% and then 13.00 % in 1973 and 1974; all that while the 10 year yield trended gradually back up from 5.75% to 8.00%. While

acknowledging that was a more inflationary time, and that action is likely what the market required of the Fed to ensure that long rates did not indeed need to rise faster in the absence of central bank diligence, it does put the current lack of long end leadership of the up trend in yields into perspective.

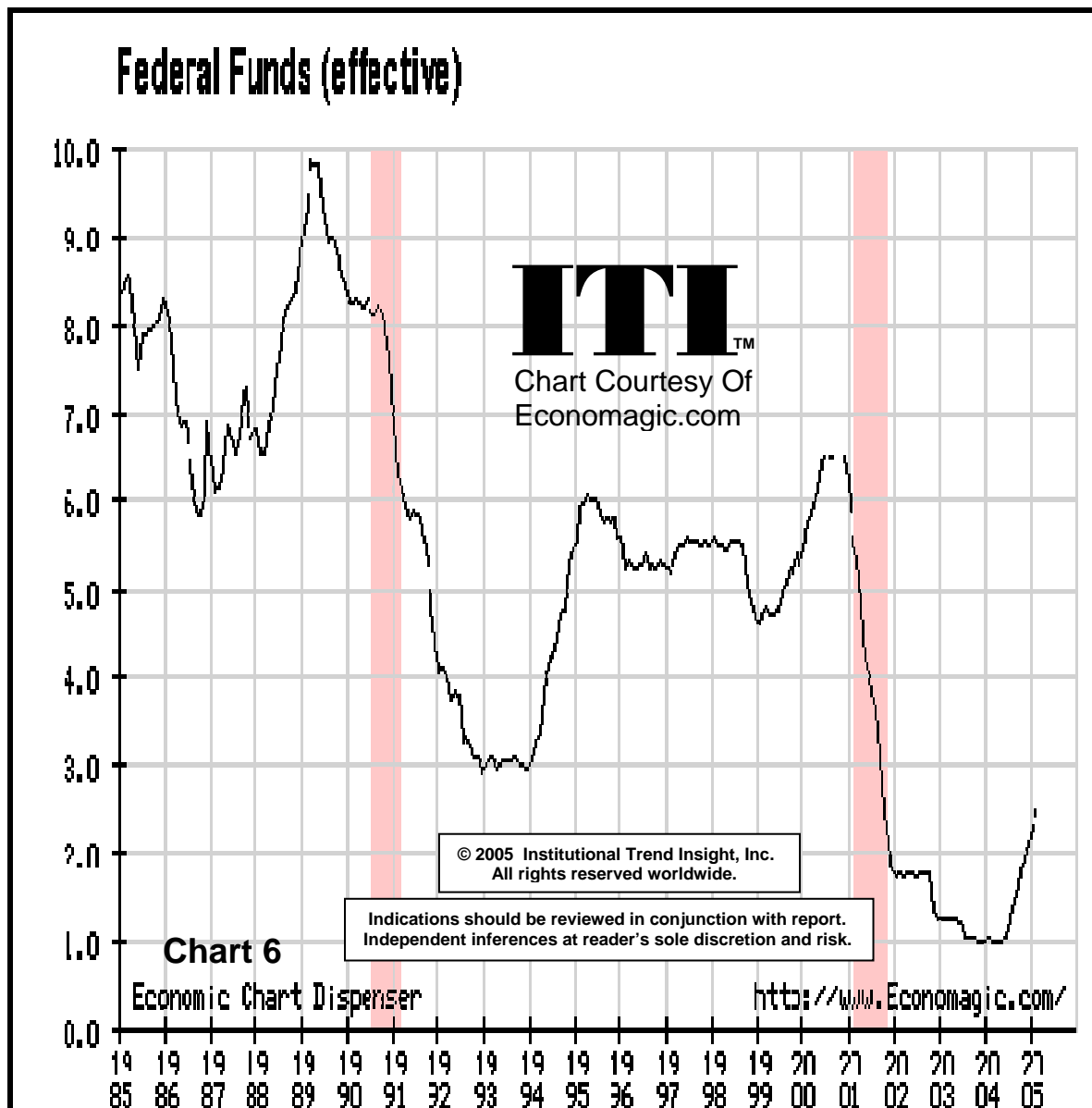
The "conundrum" seems to be a fairly straightforward long term cycle tendency for the short money to lead the yield trend back up from major cycle lows. It is moreso the degree to which most participants are accustomed to the intermediate term trend tendency for long ends to lead yield trends up once inflation tendencies surfaced that is confusing them than any actual lack of a net upward trend at present. More on this in long dated instrument intermediate term topping tendency review, below.





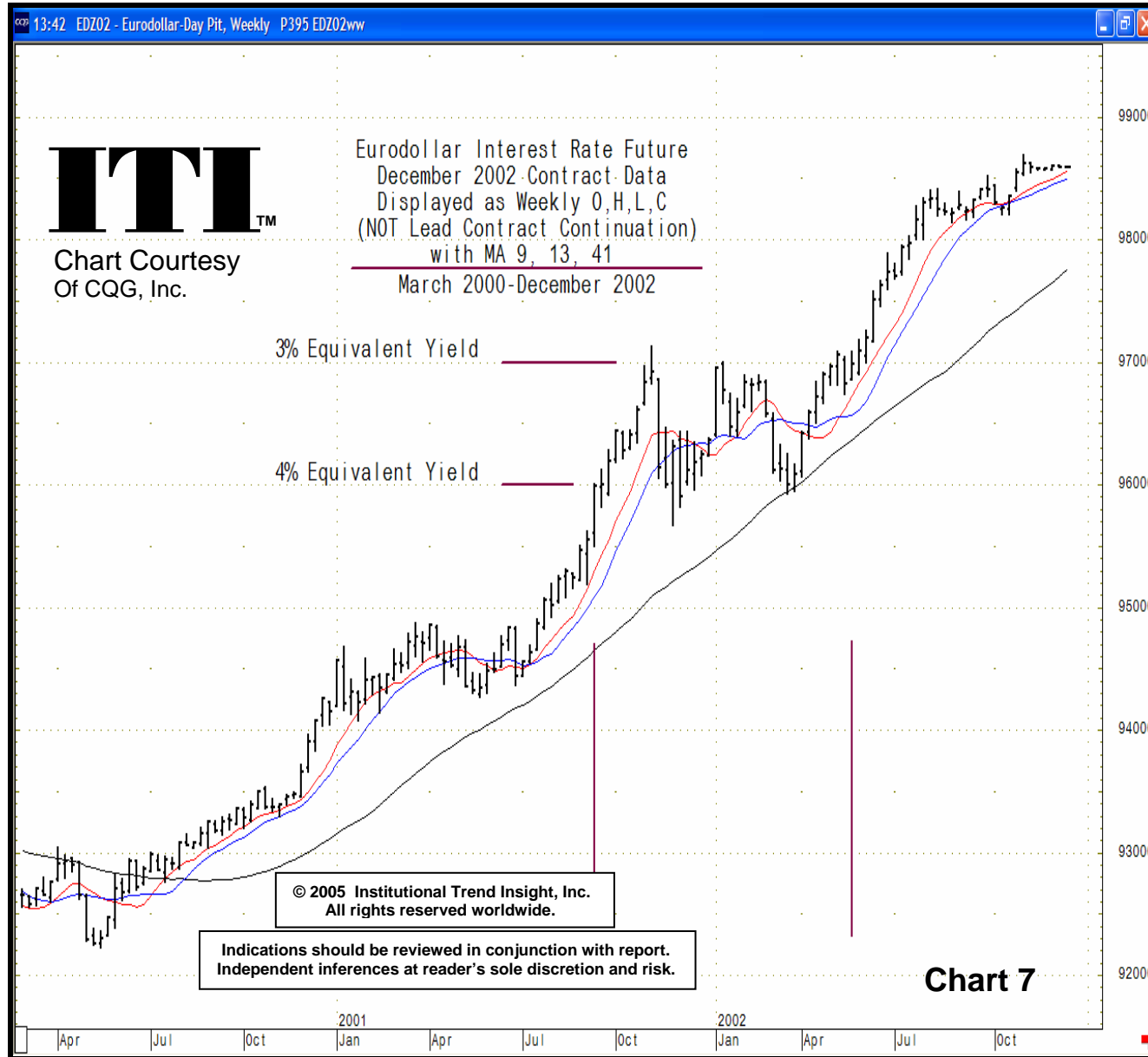
## This Cycle's Intermediate Term Lessons from Short Money Futures Pricing

Yet, this tendency to look for the sort of immediate counter-trend response from the rate instruments that had been prevalent during the intermediate term cycles was also the case initially for the short money expectations for Fed activity as well. In brief, the short money forwards were also conditioned to anticipate a robust response from the Fed in the face of any recovery from an equity market low. On Chart 2 the recovery from the post 9/11 (2001) low near 8,000 had carried up to above 10,000 by December 2001-March 2002, near the high "S" (for the right shoulder of an ultimately aborted H&S Top.) This recovery was assisted by Fed Funds cuts throughout 2001 (Chart 6) down to 2.00%. While it had rallied markedly in the wake of those sharp FOMC rate cuts, in respect of the strength of the equity market normally signaling a robust economic recovery was soon to follow, the December 2002 Eurodollar (discount yield index) future (Chart 7, below: daily contract data displayed as weekly ranges) remained down at levels equivalent to 3.00%-4.00%; note it was at its lowest during the equity market peaks in December 2001, and March 2002.



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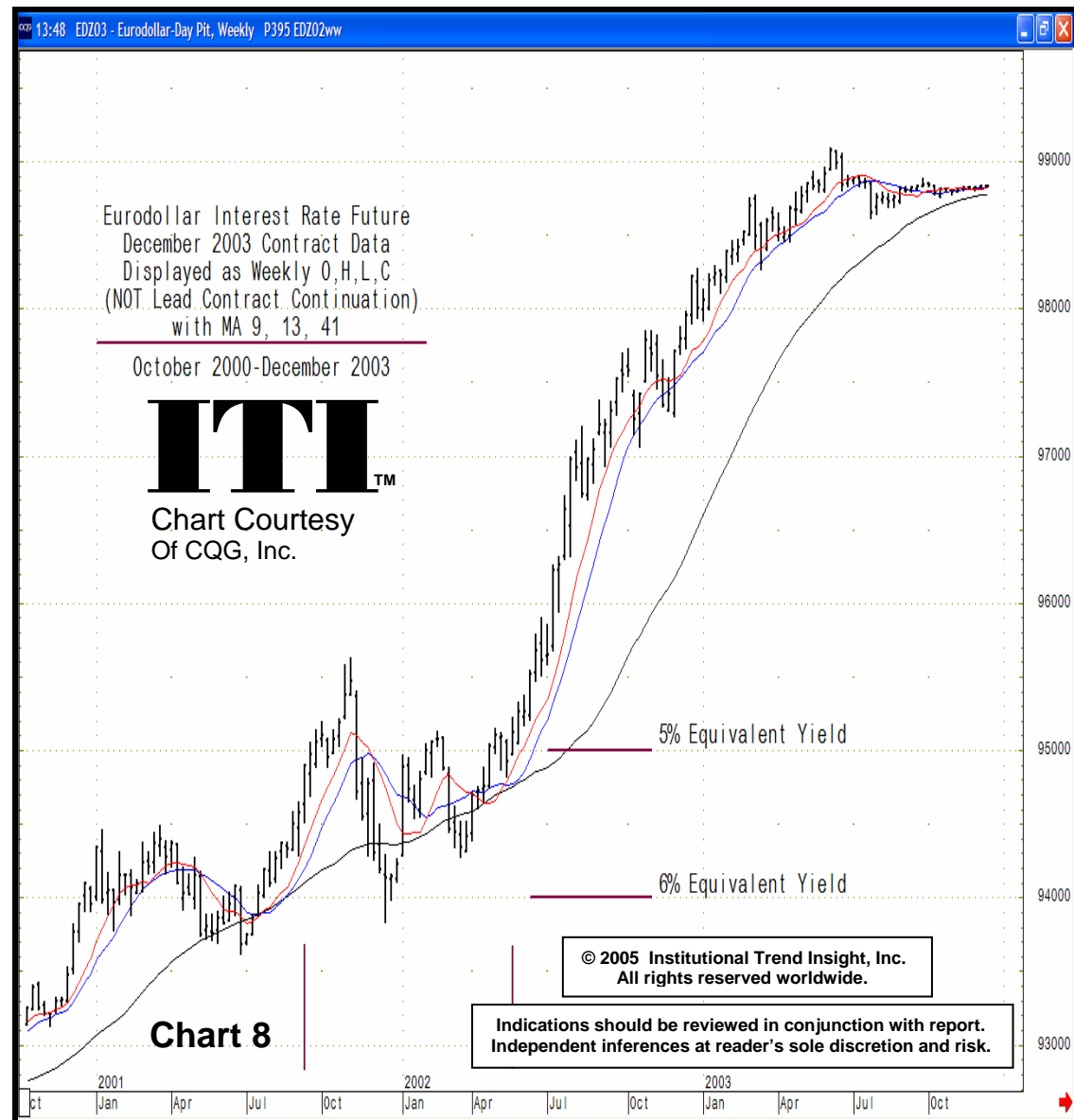


This discount yield index level was therefore commensurate with the FOMC putting rates back up from their January 2002 1.75% level by between 1.25% and 2.25% by the end of 2002. Yet, instead of the equity market trend continuing higher and economy rebounding, by May 2002 the accountancy and corporate malfeasance scandals were about to become the next burden on the market, and would prove even more economically pernicious than the effects of the 9/11 tragedy, even though that was a more regrettable human tragedy. In the event, this was reflected in the December 2002 Eurodollar pushing up through 3.00% equivalent 97.00 level in May, and rallying throughout the remainder of 2002 to reflect the Fed's ultimate need to drop rates to 1.50% by late year.

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This is an excellent example of just how trends tend to proceed farther and last longer than most participants expect from the comfort of the assumptions in place at the start of that trend. In a nutshell: events intervene. Nobody could have anticipated that May 2002 was going to be the precise moment when the fallout from the excesses of the last boom's endgame would return to haunt the market. Yet, this also illustrates the importance of a cogent intermarket view when assessing the trends, as proper interpretation of other markets' influences (which also shift across the cycle) is essential. In a more extensive case of over-anticipation of the Fed's response to the same activity noted above, December 2003 Eurodollars (Chart 8, right) had even more time to anticipate that the DJIA rally into December 2001-March 2002 surely foreshadowed an economic rebound which the Fed would need to address. As such, in that period it remained down at yield equivalent levels that represented 5.00%-6.00%, commensurate with the FOMC putting rates back up from their 1.75% January 2002 level by between 3.25% and 4.25% by the end of 2003. Wrong again; in the event they reflected the reality of a drop to 1.00% (Chart 8.)

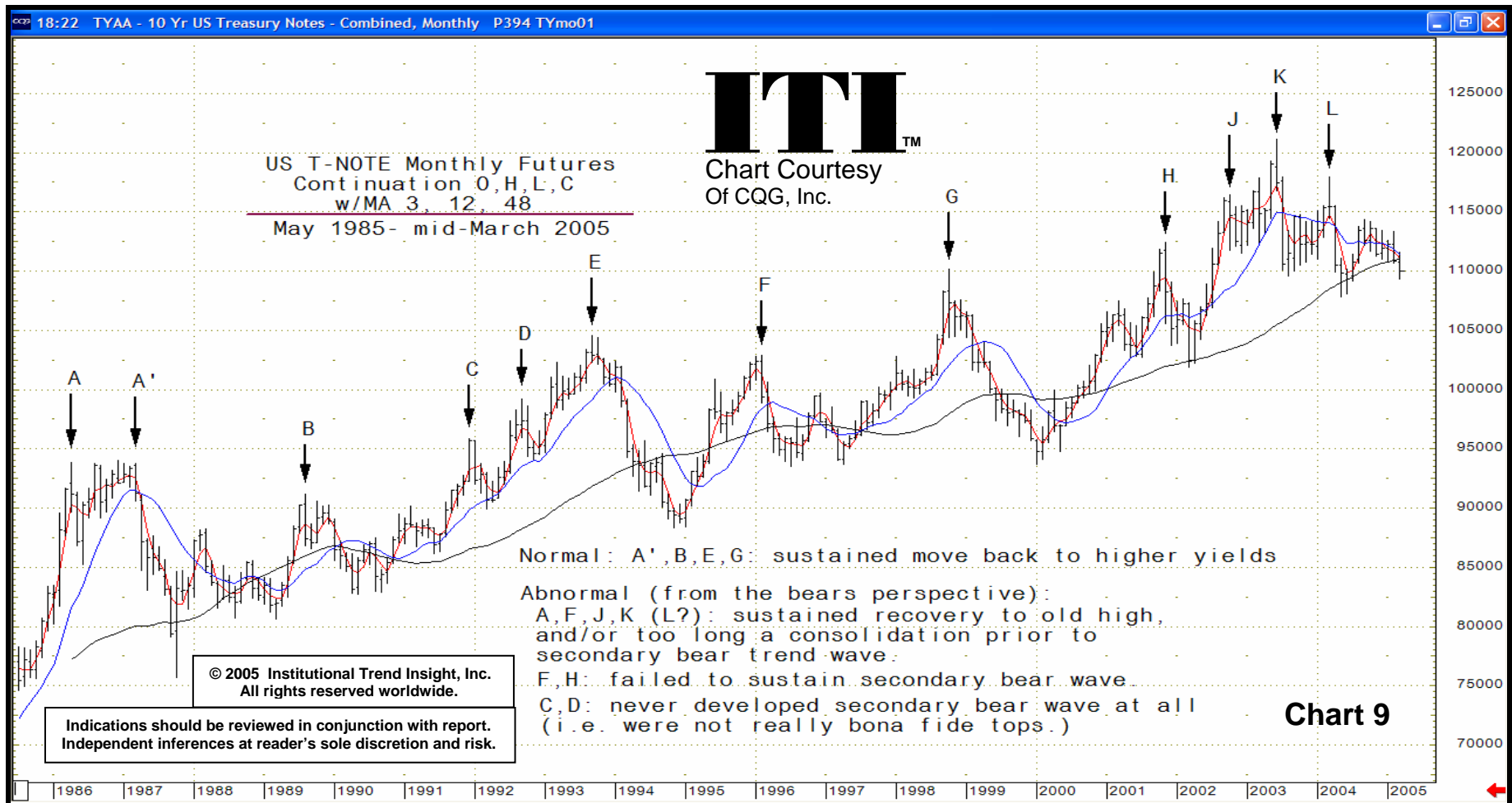


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### Long-Dated Debt Instrument Intermediate Term Cycle Tendencies

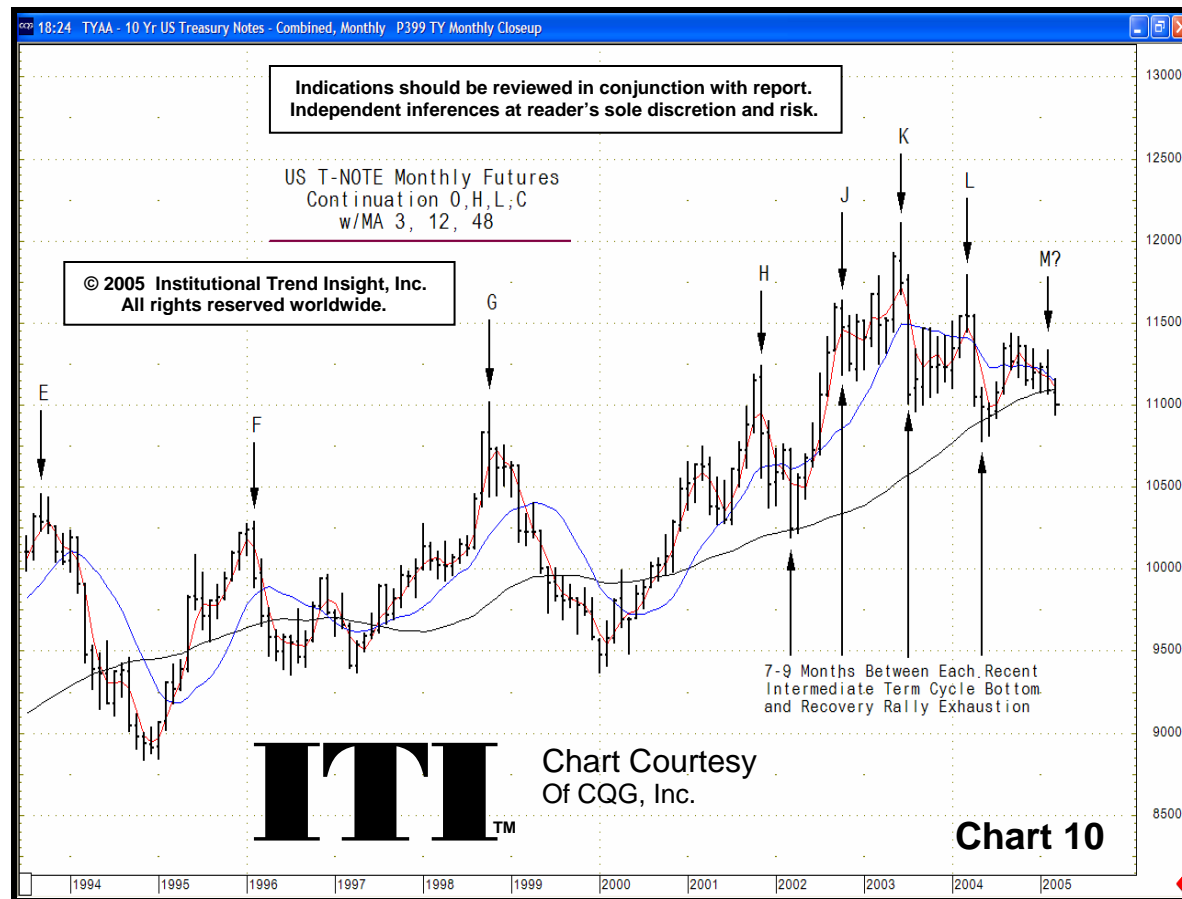
A look at classic intermediate-term Treasury note tops indicating a sustained move back to higher yields is instructive as to why many observers have been confused by the current cycle's anomalies. Previous successful tops in the long dated instruments (Chart 9, below) conformed to a pattern of an initial sharp selloff followed by three to five months consolidation prior to the secondary phase of the down trend commencing (examples A', B, E, and G, although B is a bit weak.) As a point of comparison, these periods were commensurate with the sustained higher yield trends during those periods (Chart 4.) We will not dwell on the abortive T-note intermediate-term top attempts, as the chart annotation explains these: either the secondary wave was aborted, or did not take place.



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This is why many analysts have expected that either the secondary bear wave would have occurred at some point after the recent sharp selloffs between late 2001 and spring of 2004 (H, J, K and L), or the T-note would revert to a more sustained up trend than it did. Yet, as noted previous, in true back to the future style, the recent T-note gradual down trend is very consistent with long term cycle tendencies, even if those appear erratic to observers conditioned by experience that only included intermediate term cycle swings. Typical of the influence of evolving fundamentals, the secondary break from the November 2001 (H) top was aborted due to the corporate malfeasance scandal severe equities selloff, October 2002 (J) due to uncertainty over the pending Iraq confrontation, June 2003 (K) because of uncertainty once the war's conclusion provided no immediate economic bounce, and March 2004 (L) due to Mr. Greenspan's dovish June 2004 reappointment testimony; a veritable textbook of fundamental factors impacting the technical trend.



However, especially within the auspices of that long term cycle tendency to begin with a gradual move toward higher rates, the question becomes whether after almost two years (from the June 2003 deflation-scare) are long yields are about to increase more rapidly? Considering the intermediate term view becomes important once again, as the market has now established a very interesting short-to-intermediate term cyclical pattern, annotated onto Chart 10. While the tops since November 2001 have not performed, they have occurred at regular intervals. Seemingly there are seven to nine months between each near term cycle low and the subsequent recovery rally exhaustion.

Within that context, and the T-note attempt to follow through in its bear trend last November being frustrated by strong inter-country debt influences (more on that below), might the aborted T-note rally in February have been the last gasp

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of a market that is set to resume a more aggressive down trend? While that will likely only become clear after the FOMC announcement and other important news in the next couple of days, two factors favor that development: the T-note is back below the major congestion area formed above historic resistance at 111-16/112-00 since early last August, and the market has crossed from above to below the 48 month moving average in a meaningful way for the first time since the extended 1999 down trend.

While that move looks marginal on Chart 10, that chart still includes the March contract as lead future. That expires today, and (at almost a full point discount) the June contract is actually down below the next lower historic congestion area at 110-00/109-16. Which is why the response to the FOMC and other important economic news in the next couple of days is so critical to the T-note, and the other long dated fixed income markets as well.

### **Long Term Factors Are Affecting Foreign Exchange Trends As Well**

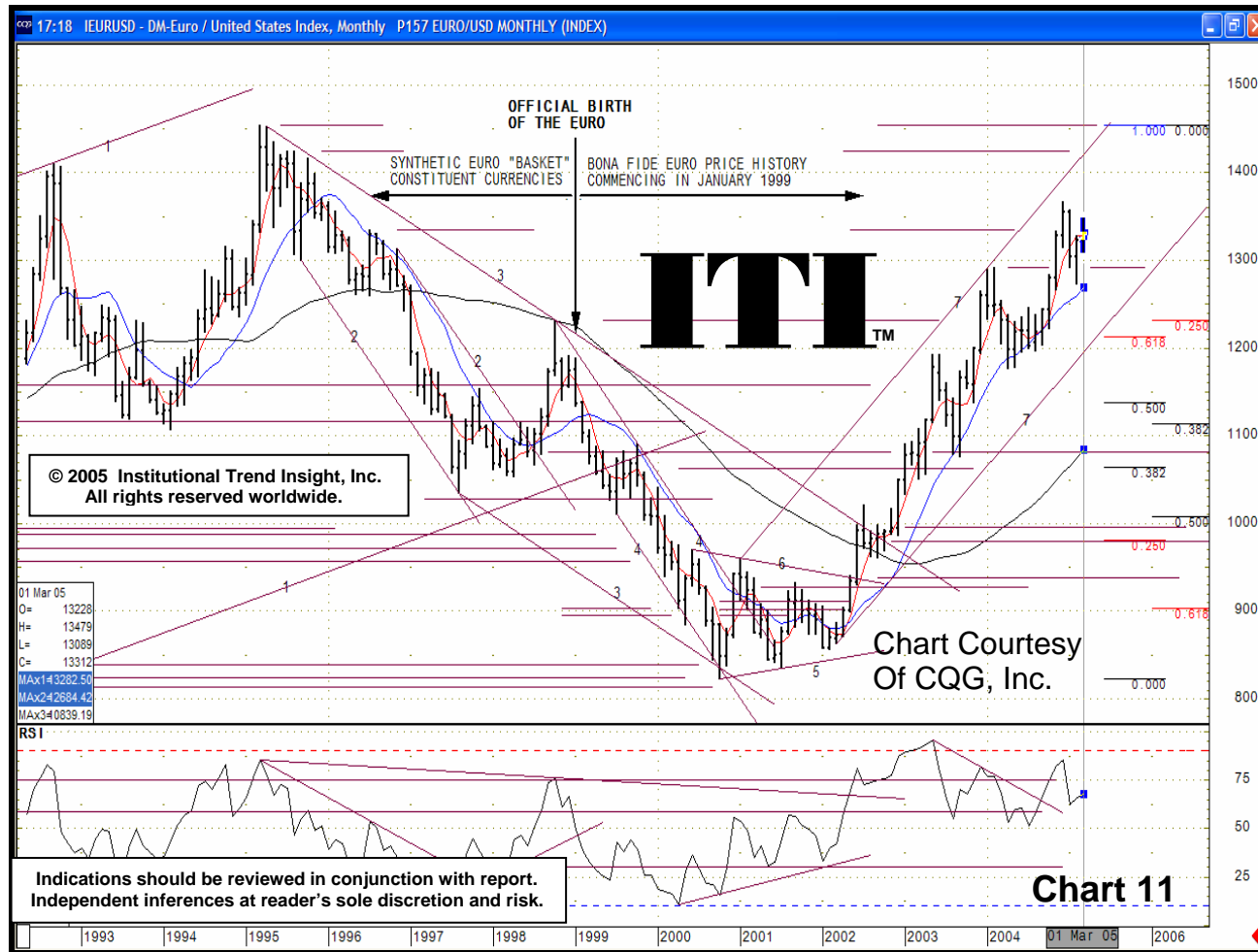
To digress temporarily from the interest rate cycle, recent distortions in the foreign exchange market also make sense in light of the economic dislocations that have occurred since the long term cycle peaked into 2000. Yet, first it is important to state the obvious, even at the risk of boring our most experienced, sophisticated readers: Comparative interest rates are a transitory influence on currency trends. The long term sustainable foreign exchange movements are driven much more so by inward investment. In the early days of foreign exchange trend analysis, many participants noted the tendency for central bank rate hikes to strengthen a currency. However, in the cases where that appreciation was sustained it was most likely that the economic strength attracting sustained movement into that currency was the reason the central bank was raising rates to fight inflation. High rates alone will neither sustain strength, nor defend a weak currency. Note the UK attempt to defend its EMS position in 1992, among many other examples.

In further address of common misperceptions, the Euro versus US Dollar is not really at an historic high relative to the historic Euro "basket" of constituent currency values prior to the official commencement of the Euro in January of 1999 (Chart 11, below.) Experienced participants are well aware that the actual low of the US dollar was made in spring 1995, and in the case of the synthetic Euro "basket" that was in March of that year at 1.4535. This still leaves higher resistance at congestion in EUR/USD at 1.4000 and 1.4250 between that major high and the 1.3666 level hit in December 2004. Yet, that is an afterthought to the considerations that have taken the US dollar this far down. Based upon the very inward investment tendencies we stressed above, historic expectations should have favored the US dollar over the Euro. So, what went wrong?

In the first instance it must be noted that fiscal and trade deficits do tend mitigate or exacerbate inward investment tendencies. In addition, the general global and "country" business environment influence inward investment, and these conspired to both create, and then destroy, the late 1990's US dollar "Golden Age." As other global investment centers appeared weak or unstable in the wake of the Asian and Russian crises, and Europe's economy seemed lackluster by comparison, more and more investment flowed into the US. Some of this was true inward investment in plant and equipment. Yet, the bulk of it was liquid funds looking for a home away from those unstable areas. As many intelligent observers noted at the time, once the bloom was off the US equity market rose (whose Dot.Com boom was being over-fertilized by some of those very foreign funds), that money would head for the exits in a hurry, leaving a potential US dollar debacle.

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Indeed that is what occurred. The US stock market confirmation in Fall 2000 that it was not just experiencing a larger than previous correction, but was indeed in a secular bear market, was enough to send the US dollar lower as well. It is very interesting that the Euro proceeded lower against the US dollar until just that time, finally trading at its official all-time low of .8228 in October 2000. Yet, obviously on Chart 11, it experienced a very dramatic initial recovery to the .9600 area by as early as January 2001. This is another of those fundamental factors causing a sea change in a Euro that was deemed to have incurable problems from the dual weight of "Euro-sclerosis" economic malaise, which would be exacerbated by the fiscal deficit restrictions of the Stability and Growth Pact.

The fact that the Euro bottomed in the face of seemingly intractable problems had little to do with an improved view of the Euro (at least at that point), and much more to do with the final confirmation that there would be a sustained flight from the US dollar. This was further evidenced by the weakness of the US dollar against other currencies as well. The more extensive improvement of the Euro had to wait for Monsieur Chirac's election pledge to temporarily ignore the fiscal deficit restrictions of the Stability and Growth Pact until France had achieved enough economic recovery to afford such discipline. That all sounds very familiar to Herr Schroeder's current battle cry (more on that below.)



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Yet, that does little to explain why the US economic resurgence has failed to create enough inward investment to put a bottom on the value of the US dollar. In the first instance, we suppose it was always going to be hard to offset the magnitude of the twin US trade and fiscal deficits. And in this realm, perception is reality: the more the world felt there were going to be far too many dollars around, the less attractive they became. Yet, there is a secondary factor that might have exacerbated the initial, very well-deserved US dollar weakness: the already noted Euro-sclerosis, and the Stability and Growth Pact. This is classically how fundamental factors morph into opposite influences along the way.

### **Lack of Inward Investment Reinforces US Dollar Weakness**

The fact is that by the time the US recovery was firmly established in 2003, corporate Europe was still having a terrible time with the weakness of their main economies, and they are classically the source of quite a bit of inward investment into the US. At that juncture, there was (and remains) a very dynamic inward cross-investment among the Indian and eastern economies that are willing to take the additional risks associated with investment in their fast-growing region. Yet, one of the larger normal sources of US inward investment did not have sufficient funds to spare to offset the US twin deficits to any significant degree. As such, initial US equity market strength brought a temporary top to the EUR/USD in March 2003 in the 1.1000 area (see left hand weekly chart on Chart 12 on the next page.) Yet, that was significantly exceeded by the end of April, as it became apparent that this was not a sign of overall economic strength. Similarly, the June 2003 high near 1.2000 was likely in response to the major DJIA Bottom UP Break through the 9,000 area.

Yet, that also proved a false dawn that was overrun before the end of the year. And so on, and so forth; with the strength of the US economy being such a perversely negative (trade deficit driving) factor in this cycle that the very day that the stronger-than-expected October 2004 US Employment report was released in early November was the day the EUR/USD finally posted a weekly Close above the previous, longstanding (February 2004) 1.2925 previous high of the up trend. We guess if your trading partners have no profits to invest, the strength of your economy (perversely) does not really help your currency.

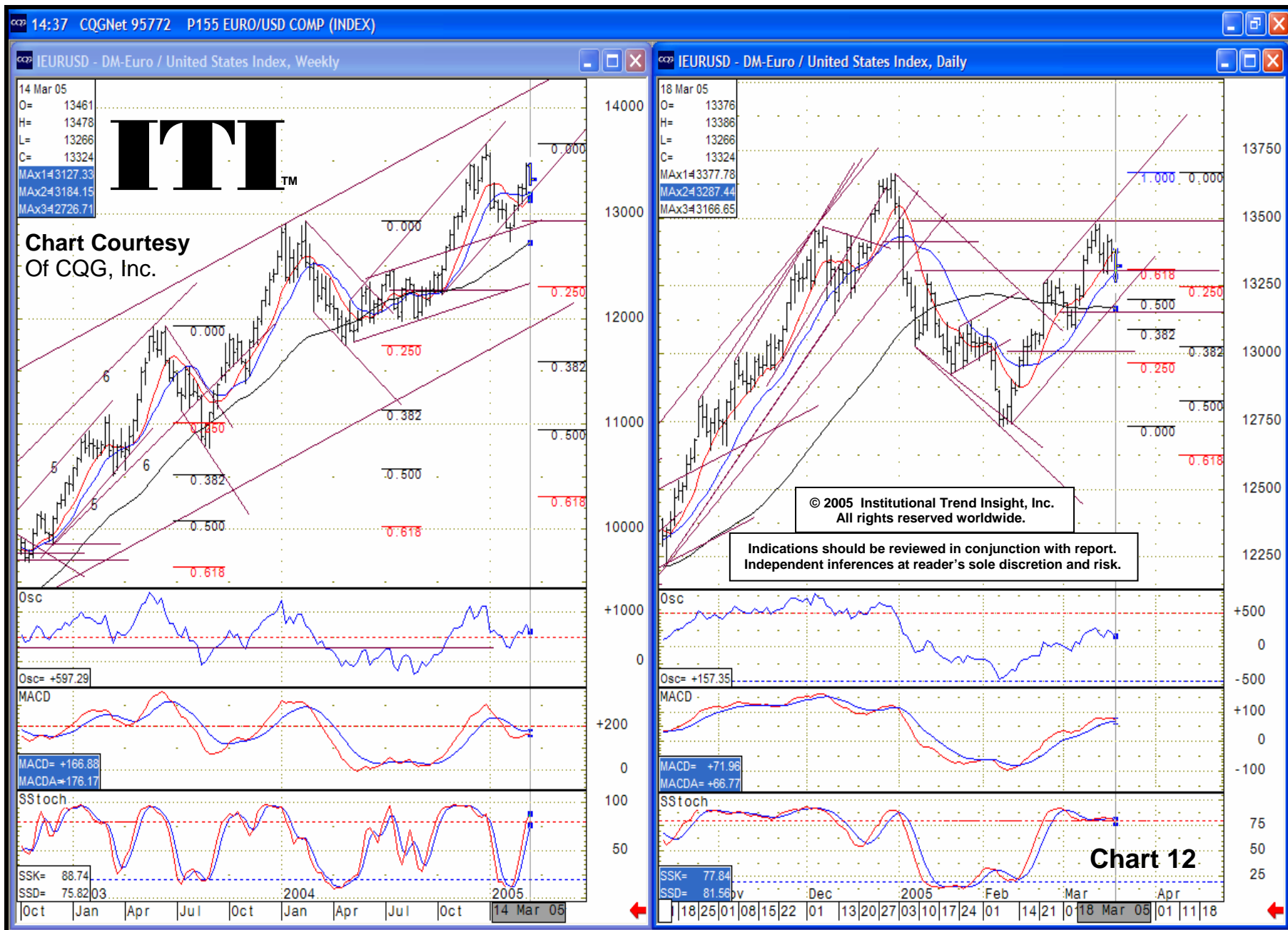
So, what now for the US dollar as the intermediate term foreign exchange cycle also seems to have aborted? It seems the same folks who exacerbated all of the negative feeling toward the US on a political level now ride to the rescue of the US dollar: enter Messrs. Chirac and Schroeder. How can this be? Simple: In their own self-serving electoral need to slip out of the Stability and Growth Pact strictures, they have effectively aborted it by enforcing a requirement of liberal interpretation of its guidelines, as opposed to the strict one desired by most of the other European Monetary Union participants. Coming soon to a currency market near you: sustained larger quantities of Euros.

As was the case with the initial Euro bottom against the US dollar, there is no compelling reason to be any friendlier to the US dollar today than yesterday, or last month; just a reason to be quite a bit less friendly to the Euro. Technically this likely means the US dollar has found a way to do no worse than the EUR/USD stalling against current 1.3500 area resistance, or hold against one of those extended 1995 congestions in the 1.4000-1.4500 area should the Euro make a new high. However, it is important to note, that it is not exactly a screaming US dollar bull yet either; that will likely take a good deal more evolution of domestic and international influences, with near term EUR/USD support around 1.3000-1.2900, and the major trend level still all the way back down at 1.2000. Remember that it took the Euro a year-and-a-half to bottom before its sustained rally.



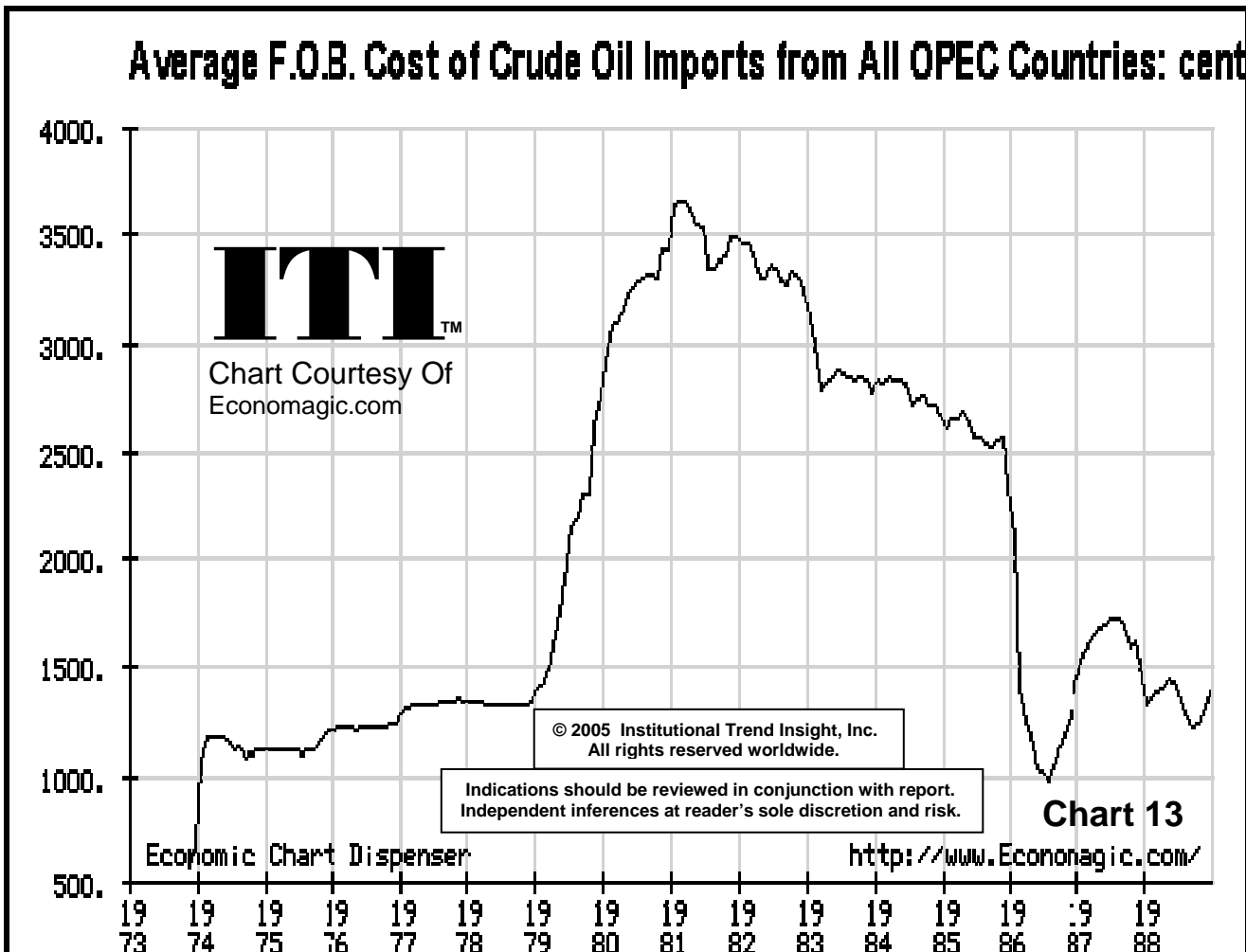
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### External Fixed Income Trend Influences: Energy and Europe

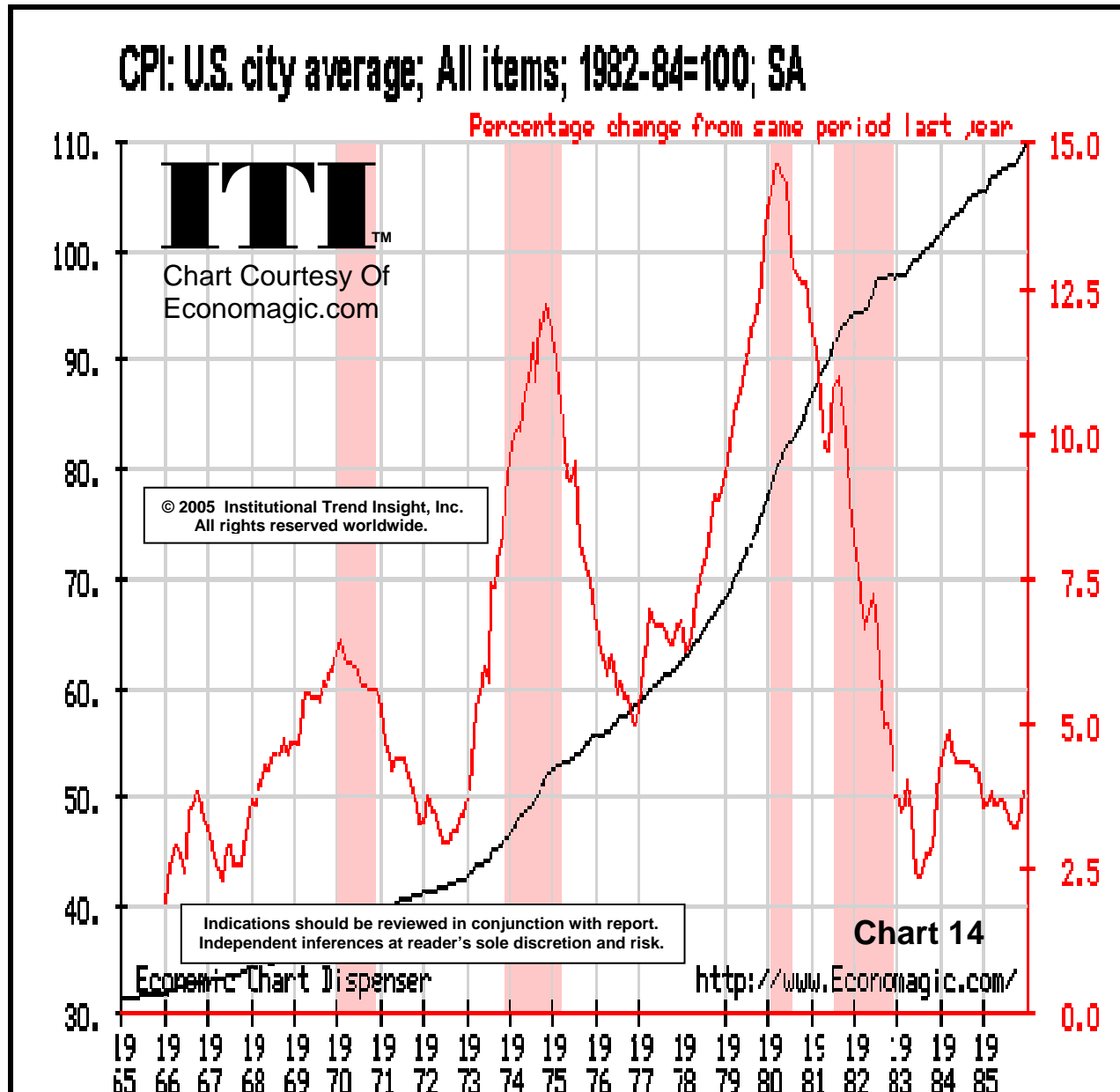
Casual observers and experienced analysts alike understand energy markets have the capacity to exert different influences on the capital markets at different times. The obvious change so far into the new millennium has to do with the general economic background to each era, as we have moved from the "demand-pull" inflation expectations of the 1960s and 1970s into the present excess capacity economy. Will that continue, or are we about to revert to a more 1970's style situation? That will have to do with whether recent slippage in developed economies' productivity continues just as those economies enter the broader resurgence likely from the more profligate approach of Germany and France.



Yet, that said, quite a few folks still mistakenly believe that the rapid escalation of crude oil prices was the primary driving force behind the inflation of the 1970's, even though it was moreso a response of the oil producers to the developed world's lack of a sound currency in which to pay them. The 1973 Arab-Israeli War was no more than a convenient excuse to effect the embargo that allowed oil prices to move up to inflation-adjusted levels necessary to compensate for the depreciation of the US dollar. After the initial push up to \$12.00/bbl. in 1974 (Chart 13), the oil market substantially stabilized. Due to the fact that it had achieved a premium price in one readjustment, and the wisdom of dominant members of OPEC that they had no vested interest in pushing energy prices to levels that would cripple the developed economies, it only increased modestly for the next five years.

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After that, further producer militancy, as well as the destabilization of Iranian supplies after the November 1979 US embassy hostage crisis fomented further significant and sustained price increases. Yet, were these the driving forces behind the inflation of the 1970s, or just one more manifestation? Chart 14 would seem to refute oil's primacy in the 1970s inflation conundrum. It appears that inflation was already increasing markedly during the late phase of the 1960s economic boom, running up to 6.50% before the Fed rapidly raised the funds rate to 9.00% (Chart 5) to cool off the economy. Yet, by late 1973 inflation was already back up, pushing to 7.50% even prior to the initial oil embargo pushing crude oil prices to the \$12.00/bbl. level. Even when inflation backed off from its extreme 1974 peak of 12.00%, it only fell to 5.00% into late 1976 prior to beginning an even more extreme climb into 1980. It was already back up above 10.00% when the early 1979 exacerbation of the up trend in crude oil took prices above \$15.00/bbl.

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That certainly does not make the case that the primary driver of 1970s inflation was crude oil. Indeed, other than sheer politicization of pricing by the radical regime in Iran exacerbating the situation into 1980, it appears they are moreso reactive than proactive. That sort of inflation was a reflection of two very important factors. The first was the significantly stronger labor union (some would say militantly so) economic environment of the 1970s. This allowed for the rapid recapture of inflationary erosion of buying power by most workers who were skilled enough to be in a unionized industry, whether or not they were union members themselves. Therefore, every increase in energy prices, milk and meat prices, insurance rates and automobile prices was a *cause celeb* that union leaders and members used to successfully demand their next pay and benefits increase.

And everyone seemed pretty content to go along with the program for quite a while: the companies could continue to raise prices knowing that better paid workers could afford it, and corporate profits would nominally increase; workers seemed to always be earning more; and the government had higher individual income and corporate profits to tax. All by consensus, a nice little bit of demand-pull inflation based on too many dollars chasing the same amount of goods. Yet, these things do tend to accelerate across time, as Chart 14 demonstrates occurred from the late 1960s.

The second, grossly exacerbating factor was the almost total incompetence of the Carter administration from 1977-1980; again see Chart 14. Nice man, President Carter. Undoubtedly one of the most moral men to ever inhabit the White House. Yet, his lack of expertise in matters both geo-political and financial made him one of the worst US presidents ever, nostalgia on the left for the "pre-Reagan" era notwithstanding. As in most things, what goes around comes around: He virtually bankrupted the political and treasure stores of the United States, then left office only to find that when Brother Billy was not being caught on camera urinating against a wall, he was busy pissing away daddy's peanut farm fortune. Jimmy Carter left office virtually dead broke.

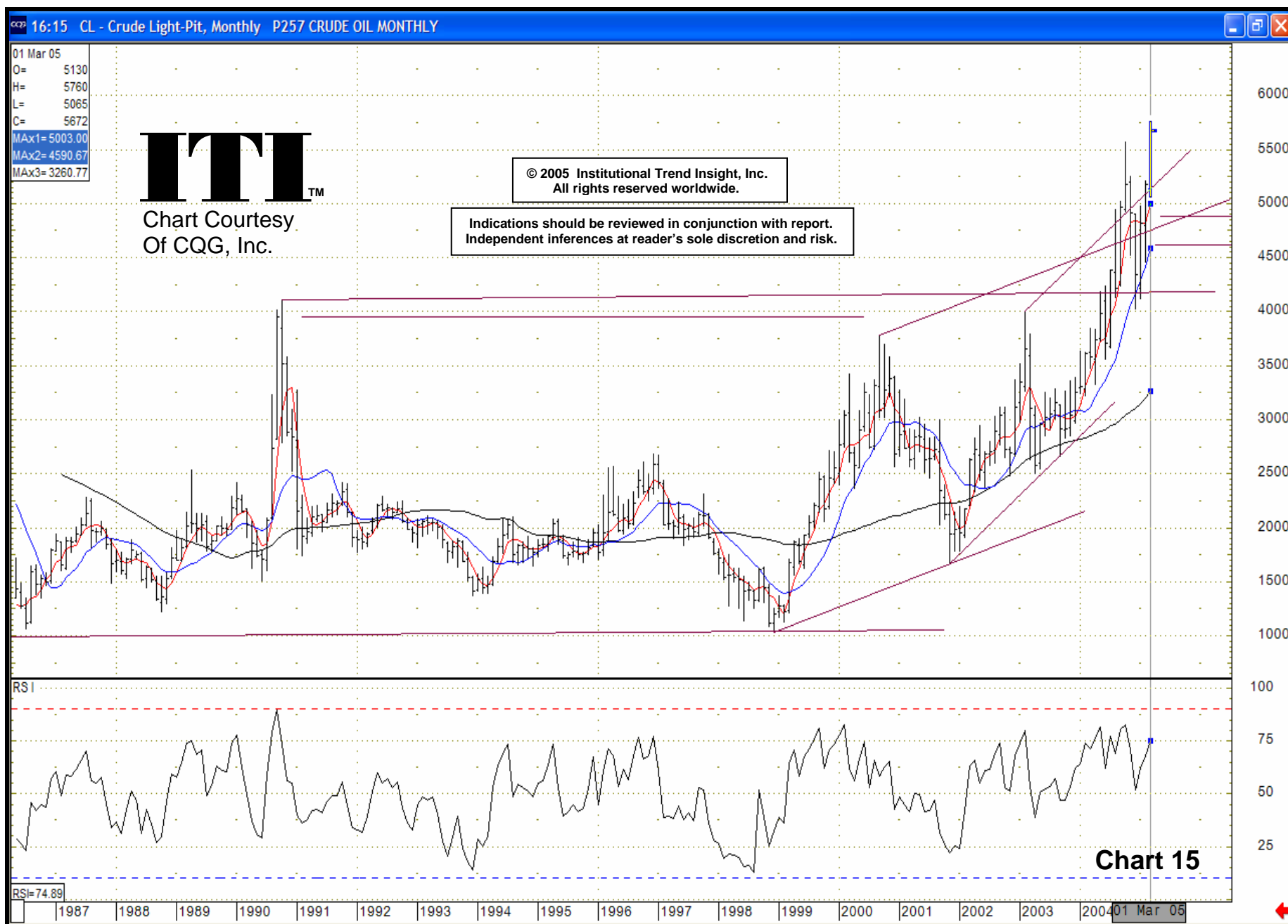
### Energy's Influence in the New Millennium

Even in light of that realistic view of the modest influence of energy on inflation, it was a bit counter-intuitive for experienced analysts to treat initial recent energy price increases as a constructive factor for fixed income, ostensibly due to the degree to which they are an "invisible tax" on the economy. After backing off from the early 2003 test of the important Gulf War \$40.00/bbl. area high (Chart 15 on the next page), they resumed their climb from no worse than the \$25.00/bbl. April 2003 low. The steady march up through \$40.00/bbl. in mid 2004 was accompanied by bouts of strength in the fixed income market, as the presumption was this would weigh on the global economy. Yet, the acceleration above the \$40.00/bbl. area was also a sign that these prices were going to continue up for some time.

Chart 16 (two pages down) illustrates the degree to which the short-intermediate term trend remains very strong. After the acceleration above the \$40.00 area, the market also Accelerated UP through weekly chart channels in the \$46.00 and \$49.00 areas. As is acceptable within the context of those types of technical signals, the market reacted temporarily below the overt acceleration levels, and "re-Accelerated" later back above them. Note that on the late February push back above \$49.00 the crude oil future left a gap (area of no trading) on the opening of the week. That gap will tend to reinforce support on any selloff back down into the \$49.00 area.

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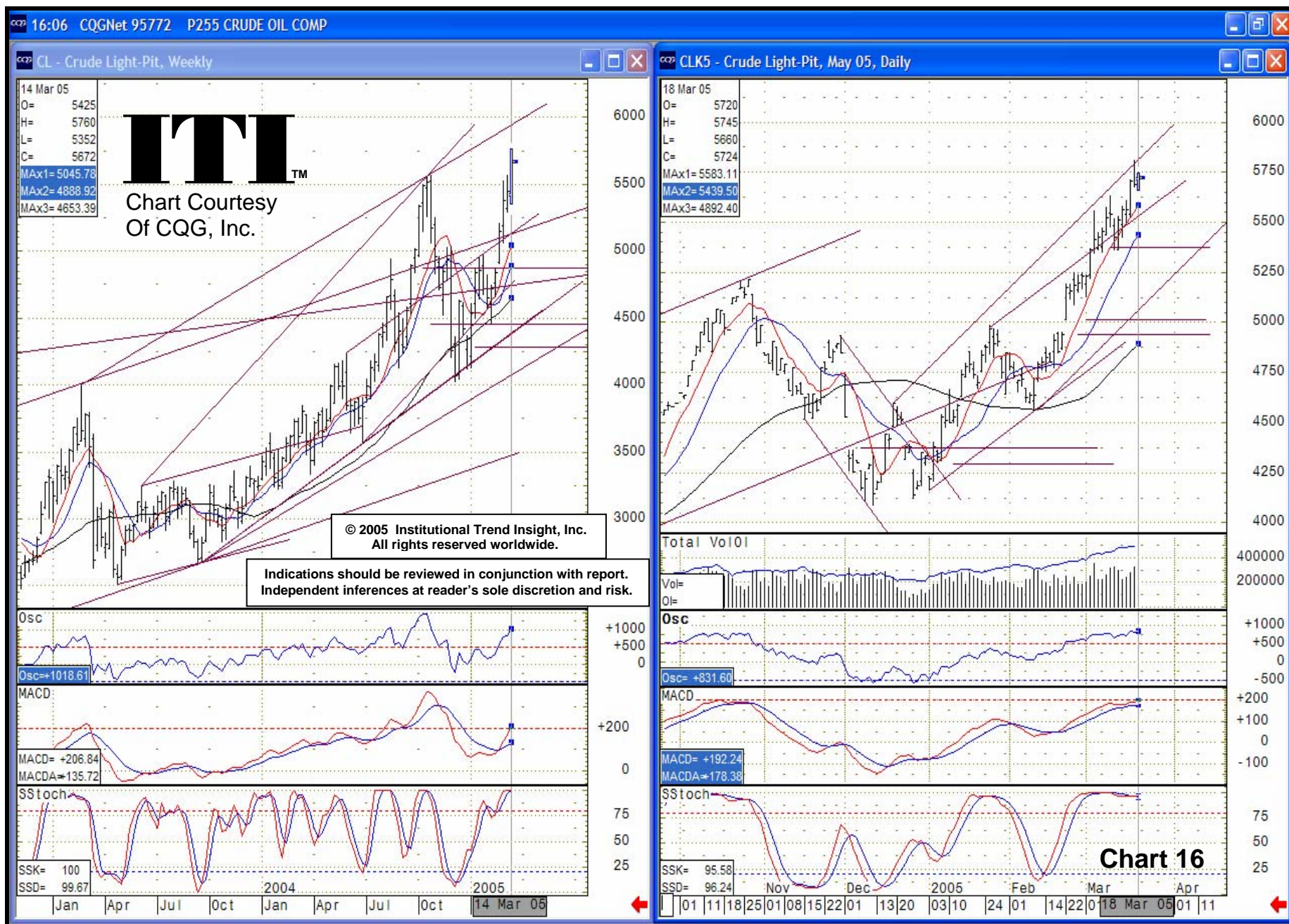
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Referencing Mr. Greenspan's comments, increased energy prices are not necessarily an inflationary problem as long as the increase is temporary. Recent activity should give pause that they are now remaining high enough, long enough that they may indeed begin to have an inflationary effect. Of course, as the history above suggests, that would likely also take a certain amount of labor militancy, and/or overt monetized currency depreciation to trigger increased prices in more than just energy. As the man in the street is now feeling the pinch of those higher prices, the labor market statistics which have seemed less than important to the trend of the fixed income at times recently might now become more relevant once again. Any tightening of labor markets, along with weakened productivity that already seems to be starting, could bring a rationale for larger pay packets that would indeed feed upward pressure on prices; especially so now, with Europeans' (possibly rightful) greater interest in going for growth, instead of minding their fiscal situation.

### **Intermediate Term Fixed Income Influences from Europe's Economic Dilemma**

The European long dated fixed income up trend last fall into the early part of this year had a profound influence back into the US long end, especially last fall during what we kindly refer to as "the Veteran's Day ambush." The Bund has been the strong sister in this intermediate term cycle, just as it has been in most previous cycles, with the possible exception of the 1989-1990 German reunification fiscal shock. It benefits partially from Europe's tendency to lag the US in both the commencement and strength of cyclical economic recoveries, as well as the Bundesbank's reputation for fiscal responsibility that has ostensibly migrated to the European Central Bank.

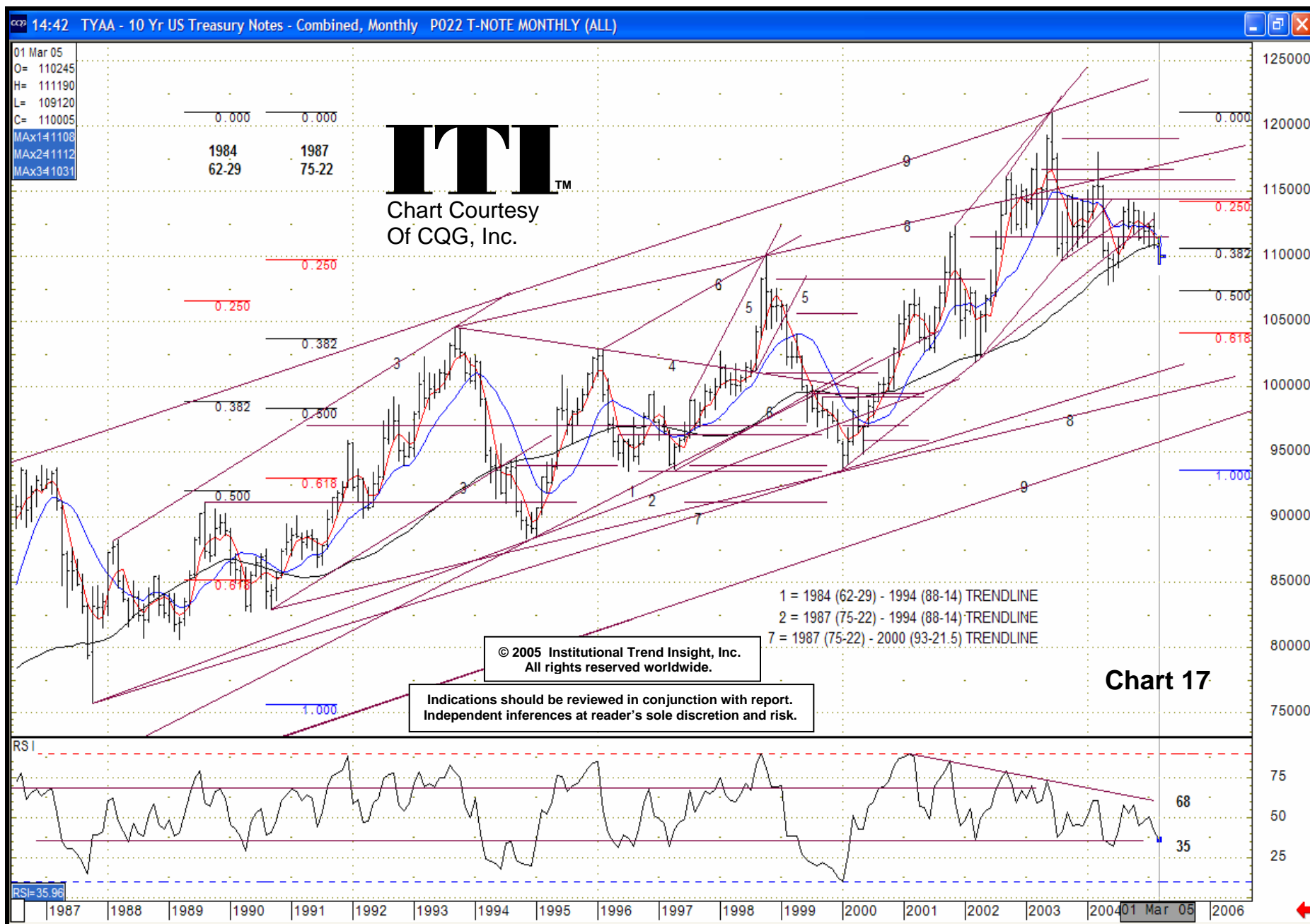
In fact, for all of the trouble the Stability and Growth Pact has caused a Germany stuck in the dual conundrum of sustained massive social support payments to its reunified eastern states (the old East Germany), and rapid appreciation of the Euro weighing on their export markets, it was originally created to assure the German people of the commitment to fiscal rectitude by previously profligate Euro-zone governments, such as Spain and Italy. No surprise then that continued weak economic conditions in Germany should foment continued low yields and the attendant strong Bund prices.

(As the charts associated with the next section of the analysis are necessarily long term and extensive, they are allocated to separate pages.) And the recent cyclical activity seemed no different, as the Bund was demonstrating positive divergence compared to the US T-note (as well as the UK Gilt.) On the long term US T-note on Chart 17, and German Bund chart on Chart 18, the Bund significantly outperforms the T-note at times. This was extensive in 1995-1998, while the T-note outperformed in 2000-2003, possibly due to some degree the Fed's disinflation scare. However, whatever the vagaries previous, the T-note has fallen farther and remained in a down trend since that 2003 high, while the Bund arrested its own selloff much sooner, and was in a sustained recovery into November 2004 (see left hand weekly chart on Chart 19.)

Also note on Chart 20 that during the week of November 8-12, 2004 the T-note (lead contract December at that time) was hanging around the 112-00/112-16 area. In fact, the T-note was not just standing still there at all: after a full point bounce from the previous week's 111-17 low (that pesky mid 111-00 area again) to finish the week at 112-17, it was eroding back down, acting quietly heavy into the Close on Wednesday, November 10<sup>th</sup>.

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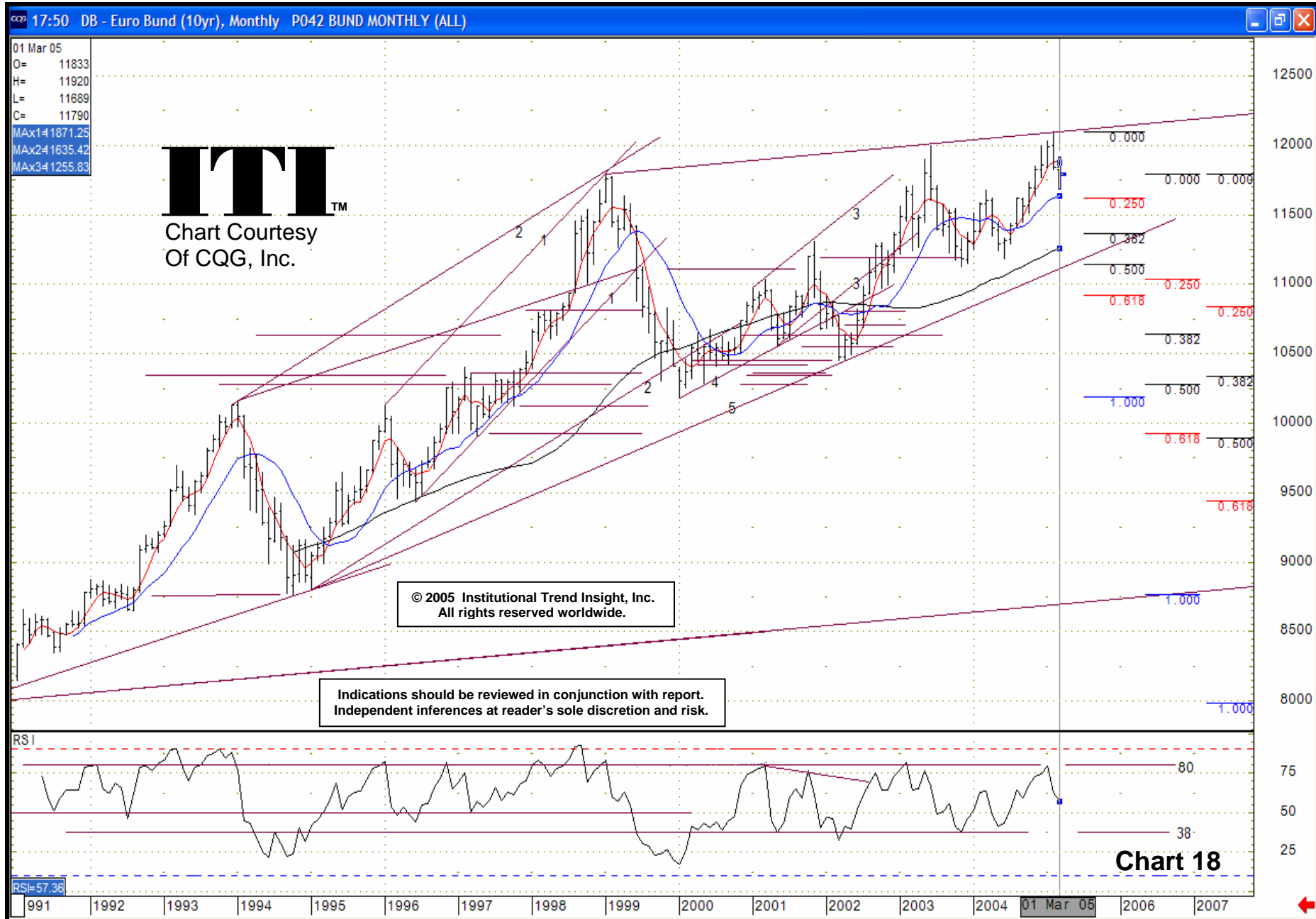
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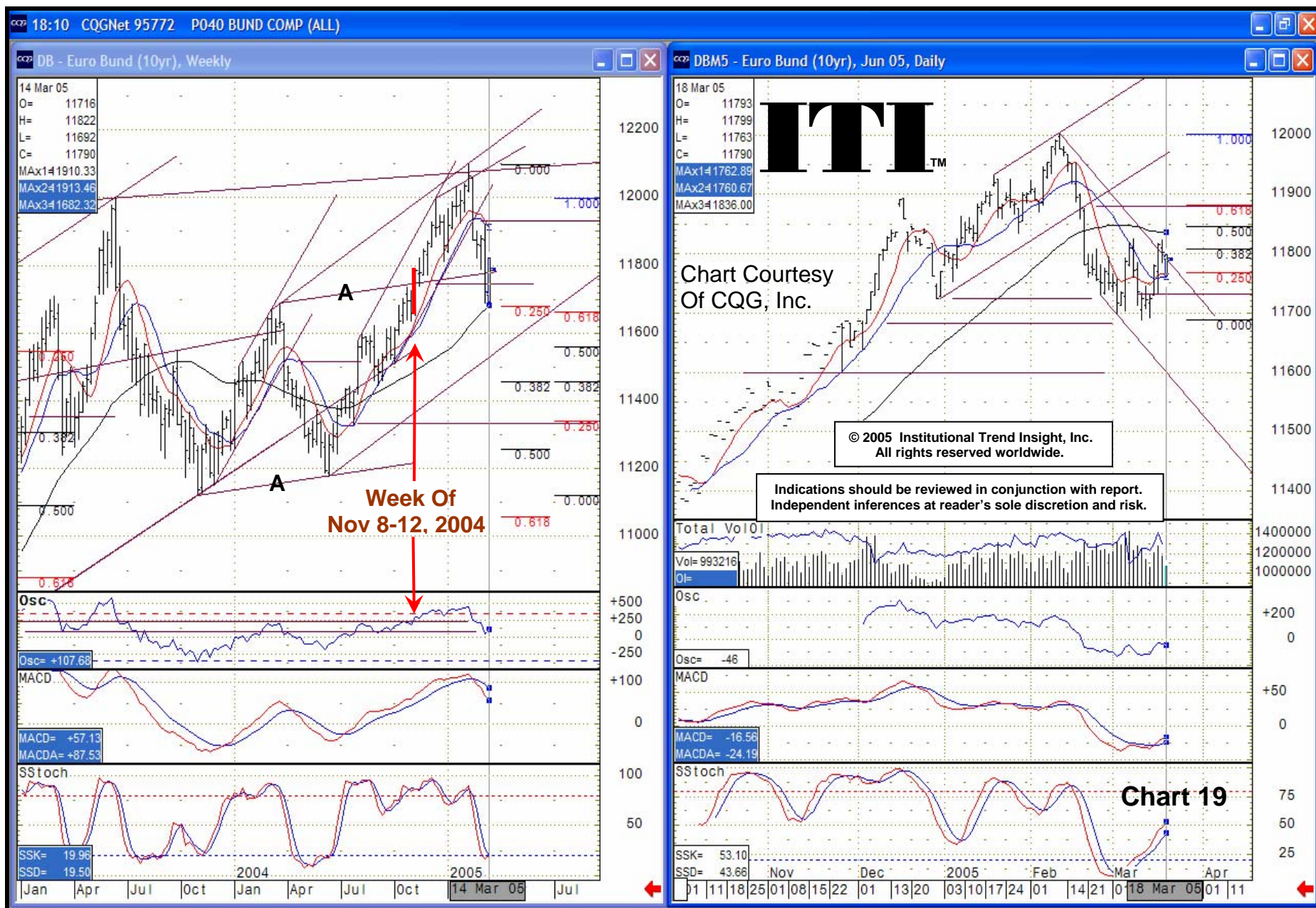
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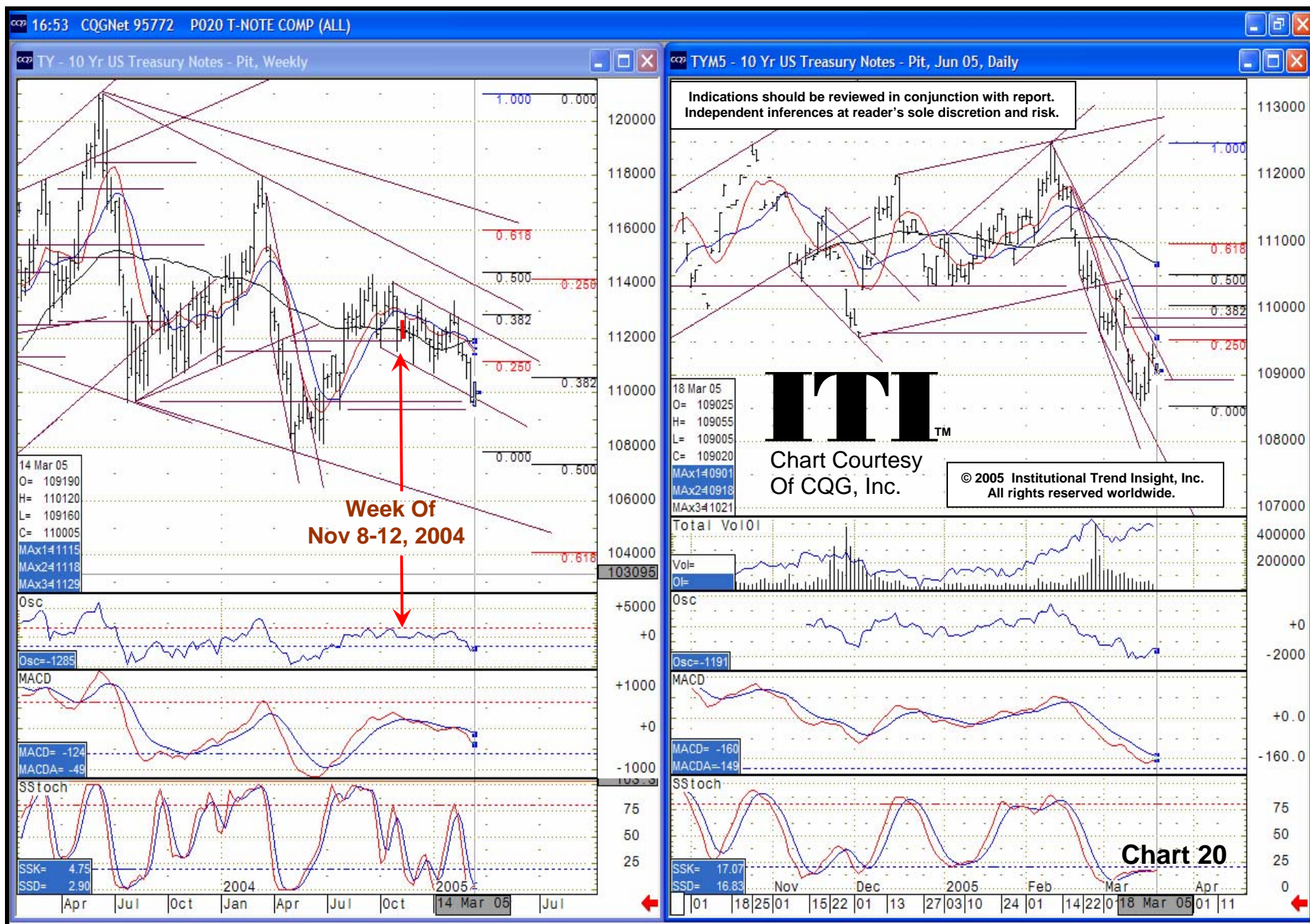
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The Veteran's Day holiday is always November 11<sup>th</sup>, regardless of the day of the week, and all US exchanges were closed Thursday. The Bund had followed the US market down on a quiet break Wednesday from near the critical top of weekly channel "A" resistance on Wednesday, and Closed just below important low 117.00 resistance. As such, there was somewhat of a presumption that it would wait until Friday to do anything important, as the T-note was going to be impacted by important economic releases. Bad presumption: in the event its own weak economic news caused the Bund to push up to 117.50 on Thursday, buffering the effect of US news that was indeed bearish on Friday, and would have normally had the T-note leading a coordinated break to assault lower support.

Yet, in an unusual turn of events, the Bund commandeered the long end fixed income leadership from the T-note, and pushed up to 117.85 for Friday's Close of the week. What was more important was the UP Acceleration through the top of weekly channel "A", reinforced by the violation of weekly oscillator resistance at MA 41 plus 02.30. All of that amounted to not just a temporary surge in the Bund, but a clear indication that a move back up to or through the 120.00 high from June 2003 was likely. This in turn mitigated quite a bit of further weak T-note phases through the fall and winter (see Chart 20.) Technical indications were such that the long delayed cyclical bear in the long dated fixed income was going to be deferred a bit further: it would be necessary for the upside leader Bund to run its course before any sustained aggressive down trend could develop.

### **German Bund Resilience at the Tops is Actually Normal**

While there may be a sense that this was an unusual, one-time occurrence, it is actually quite normal. Due to factors discussed previous regarding Europe's lag in commencement and strength of cyclical economic recoveries, as well as Germany's reputation for fiscal responsibility (until just recently), the Bund would often hold up better under the influence of the initial downturn in US long dated rate instruments. The difference here is moreso one of scope: the divergence at the top normally occurs across a period of three or four months, not well over a year. Yet, once again, that fits in with adjustments at the end of the long term cycle distorting the meter and tempo of the intermediate term cycles.

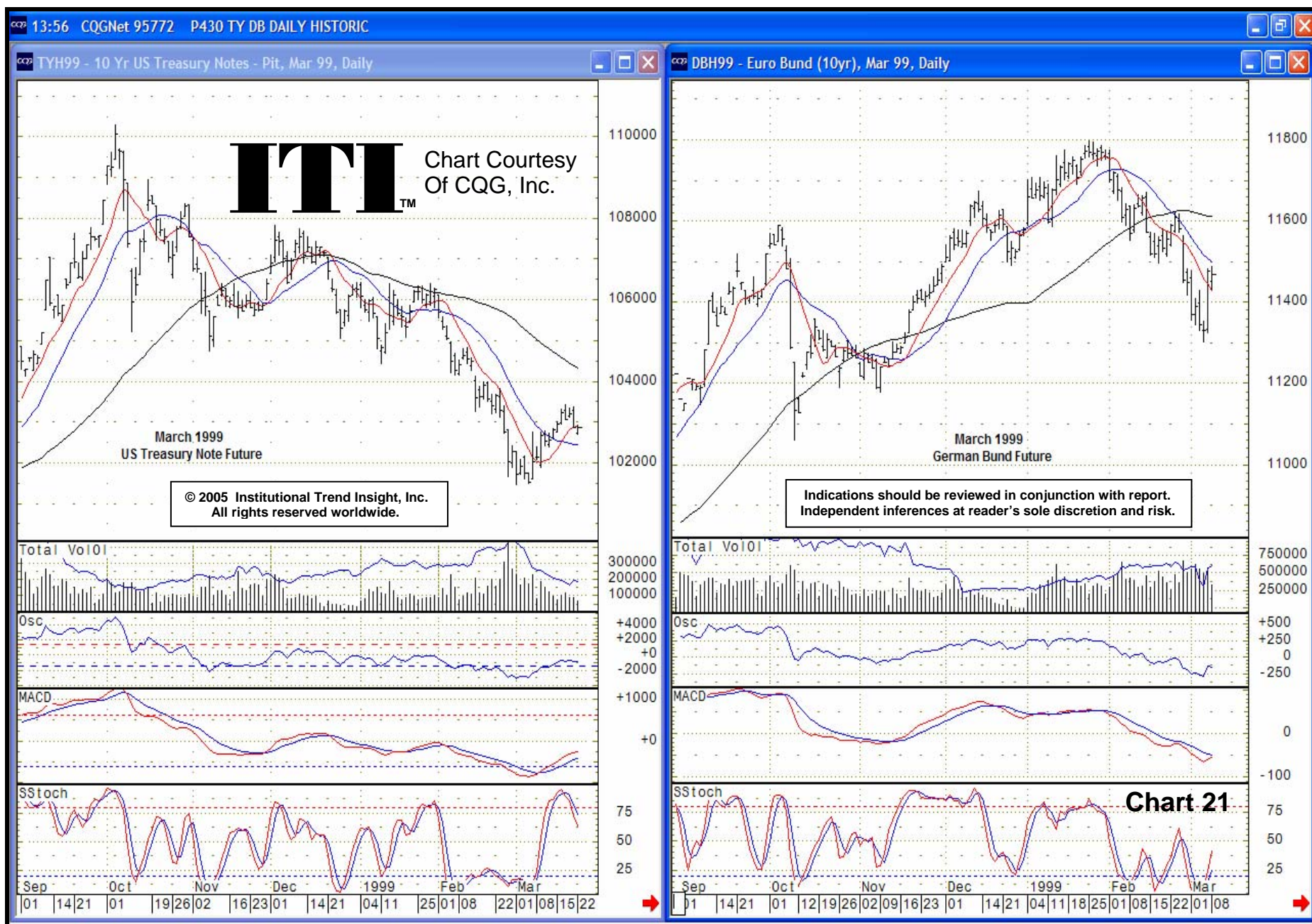
The 1998-1999 relative topping action is a good example. On Chart 21 on the next page are the two daily March 1999 futures charts: US T-note left, and German Bund right. To demonstrate their comparative strength at the tops, we could not also show the extended down trend in the Bund; yet lead contract futures did ultimately drop to the 102.00 area. More important, this is another illustration of the strength of the Bund mitigating the intermediate term down trend in the T-note as the Bund only turns down after making a new high.

As we noted previous, the upside leader would need to run its course prior to sustained aggressive bearish activity returning to the long end of the fixed income market. Yet, with the seemingly intractable weakness of the general European, and especially German, economy, what reason could there be for the Bund to ever break again? This gets back to the factor we discussed previous in the section on the inability of the US dollar to benefit from the strong US economy, regarding how the same fundamental/economic factor could evolve into a distinctly different, and sometimes opposite influence. Indeed, this has been the case for the weak German economy. As long as it was just *plain* weak, it was going to be a drag on employment, economic recovery, and by extension, inflation.



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However, as soon as it morphed into becoming *exceedingly* weak, it became a liability to the long dated fixed income. German unemployment ratcheting up to post-WWII record levels, export markets being impacted by the sustained strength of the Euro against the US dollar, and the inevitable protest vote losses in regional elections that were an unacceptable trend for Herr Schroeder all amounted to a rationale for aborting the Stability and Growth Pact fiscal strictures. He did not do this in so many words; he just insisted on an interpretation that eviscerated it. S.G.P. R.I.P. (Mid-February 2005, see Chart 19.)

### The Return of the Fiat Currency Monster

This ability and desire to extend social spending through the creation of significant amounts of fiat Euro-currency may not be the end of the world. In defense of Herr Schroeder it is important on a politico-economic level to acknowledge two facts. While it does not excuse any move to endless profligacy, and hopefully once their economy improves they will attempt to return to fiscal rectitude across the long term cycle, the Germans were very major contributors to the welfare of the rest of Europe for many decades. Indeed, it seems a bit of poetic justice that all of the other countries that took advantage of their largesse are now being forced to absorb a bit more inflation to mitigate the extreme weakness of Germany's economy.

Secondly, and possibly much more important in the long cycle, with dire warnings of credit ratings agencies about the "unsustainability" of Europe's fiscal position notwithstanding, an impoverished Germany that (on historic form) might opt for a reactionary right wing government is not a good idea. Been there, done that, and *nobody* wants to revisit. However remote a possibility, if the alternative to that is a bit more fiscal slack and inflation, bring it on. The world will survive that much easier than the alternative; it is just not what a strong Bund had in mind when it trended up to a new high.

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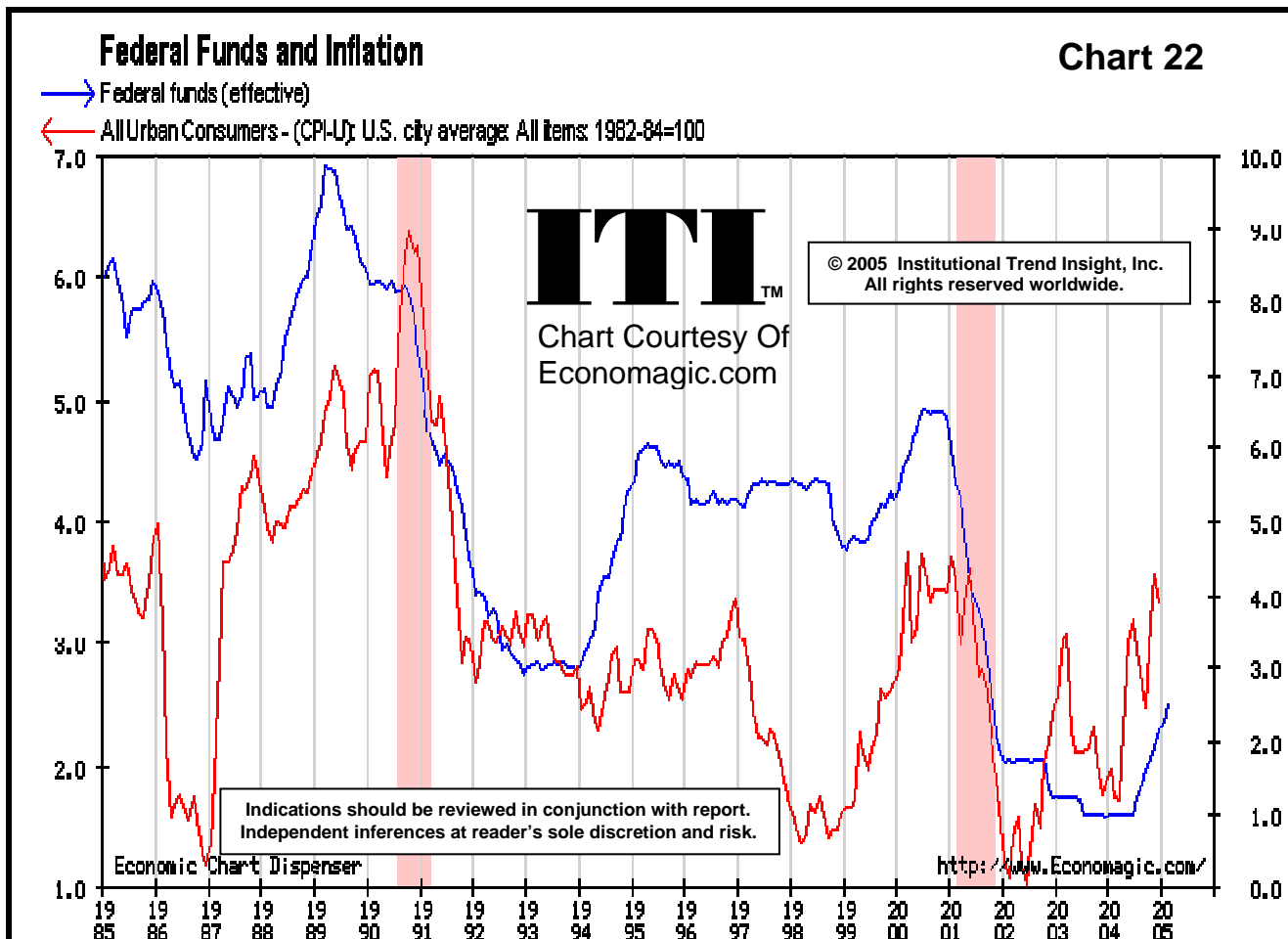
Which is why we are raising a spectre that everyone who was around last time can also say, "Been there, done that, and *nobody* wants to revisit." Too late. Consider the amount of fiat currency already created by the US government via tax cuts (that they are looking to extend again) to shock the economy out of its post 9/11-corporate scandal-Iraq Waritis, and pay for our military to continue to act as political evangelists with attitude, just as the German and French political establishments see their salvation in printing enough Euros to pay more to the unemployed while weakening the currency enough to reinvigorate their export markets, and anyone with even short term memory (forget the 1970's; think Japan) knows that on past form these various social support programs, where governments have control of more largesse through deficit spending, all end in tears, and that extreme commodity and energy prices are more likely than not to percolate up to the surface any time now. And that completes today's full paragraph, run-on sentence rant.

Even attempting to interpret what is happening through a more rational prism, it is necessary to ask, for instance, what is the Fed actually doing versus what they are saying. That flies in the face of our own recent admonition to clients, in a reversal of the old cliché, that it is not what the Fed *does*, but what they *say* that counts, and that will likely be the case in the next FOMC decision and announcement tomorrow. Especially any language which affects the repetition of the cursed term "measured" that is likely to appear again, will be the next bit of tea leaf reading upon which the cost of long term debt in the developed world hangs.

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Yet, that is all for short term market adjustment purposes, and the real agenda of the Fed must be assessed against a broader view. We perceive the Fed's real agenda is to stimulate enough inflation now to justify putting rates up, yet leave some real energy back in the economy even after the next contraction. The Fed's recent focus on PCE inflation as their measure of the underlying increase in living costs is sleight of hand. They are distracting even quite a few intelligent observers from focusing on the real cost of living, which everyone knows instinctively is increasing faster than PCE. Even the way they quote core PPI and CPI as "ex-energy" is ridiculous in phases of sustained energy price escalation such as we are experiencing at present. Understandably, they want to soft-sell problems. Yet, ex-energy CPI will only become a sensible measure the day we all stop heating our homes and driving automobiles.



A better measure is the US City Average CPI for all items twenty year history on Chart 22. While that includes, and is cyclically distorted by, energy costs and the foreign exchange fluctuations that affect energy import prices, there are some lessons. First, regarding that foreign exchange distortion, note the extreme drop in inflation in 1998: that was the last time crude oil was down in the \$10.00-16.00 range, and it started trending up in early 1999. Note how the recession and sustained strength of the US dollar into 2001-2002 restrained inflation. Also in that same time frame, even at 1.75% in 2002, the Fed's interest rate policy was not accommodative (please adjust for the inconsistency of the scales on the chart.) And that is a big key to what is happening now.

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Why would the Fed, the guardian of price stability, consciously remain behind the curve on heading off an inflation upsurge? The answer is that it suits their agenda on so many levels. While nobody wants to see the late 1970s return again, there is a strong case for why the Fed and all of the other central banks recently hit a cul-de-sac in their previous long term agenda, and are reversing course: The fear of “disinflation” (a rhetorical twist to avoid saying “deflation.”)

Mr. Greenspan took his mandate from Mr. Volcker, and extended the commitment to drive inflation out of the financial markets. The twenty year history on Chart 22 shows how successful he has been, as inflation has not been significantly above 3.50% since dropping below it in 1991. He has done such a good job that each intermediate term bulge in long term interest rates has peaked at successively lower levels (Chart 4), with the last into January 2000 only reaching 6.50%; a far cry from the 15% they reached in 1981. His success and vigilance encouraged other central bankers to also adopt anti-inflation policies, with many advocating eliminating inflation altogether: a virtual zero inflation policy. This was a useful rhetorical weapon in the psychological war against inflation levels that were in or near double digits when the effort began; much less so as it succeeded.

And then along came Japan. A big economy, with a big real estate and stock market cross-holding bubble, and the BOJ and Ministry of Finance attacked the speculative excesses of the late 1980s with a zeal heretofore unknown. And they succeeded beyond their wildest expectations; and even beyond their ability to reverse the implosion to restore a sense of wealth that would keep consumers spending. Be careful what you wish for...

That is the same sort of abyss that the Fed and ECB were staring into in 2003, and they came to a realization. Going to school on the situation in Japan, they finally understood that they knew very little about how to get consumers to start spending again if they just plain stopped. Needless to say, that would really mess up the fiscal calculus, not to mention the ripple effect that might slam through a corporate America that suddenly held a sale and nobody came. It was bad enough for a nation of aggressive savers like Japan. Thank goodness they are the ones who attempted such a crazy experiment; at least they had resources to carry them through. What would happen if the ultimate consumerist society, a nation of deadbeats who are in hock up their gills, ever came to the conclusion that there is no point in buying today what will be cheaper tomorrow? Neither the Fed, nor pretty much anyone else (whether debtors or creditors) wanted to find out.

### **A Disneyland for Dummies and the Long View Long Rate Technical Projections**

Now that we are sure the central bankers know what they do well, and that is wringing out inflation (*not* resurrecting moribund economies), we return to our overview theme that the developed nations are running a Disneyland for Dummies, and must allow the debtors to once again reflate out of their debt through allowing more significant inflation that we have seen for some time. Is it not a bit interesting that the Fed has recently left the short rates low enough to consciously lag behind the sort of broad inflation measure represented by CPI-U (Chart 22 again)? Also consider that the long term yield chart seemingly very good, consistent trend toward lower yields also masks a pernicious potential, which is...

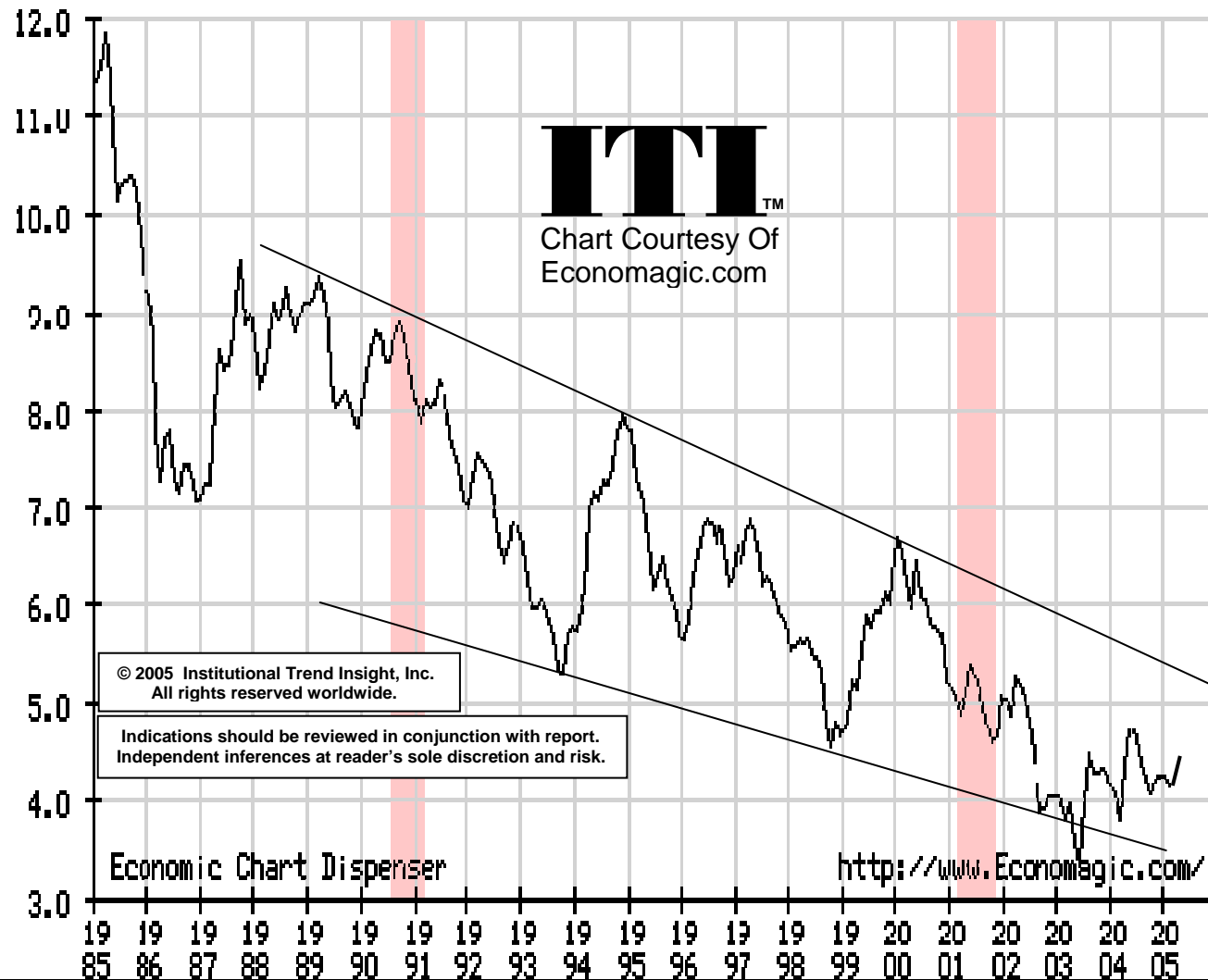


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### 10-year Treasury Constant Maturity

Chart 23



#### A Wedge.

While technical patterns are generally more actively employed for short-to-intermediate term portfolio adjustments along a trend, there are a few that are misused in short term analysis, and are really only bona fide when they appear on long term charts. Referring to the example in Chart 23, the long term constant maturity chart now has two slightly converging trend lines plotted across the major intermediate term trend lows and highs. That is a Wedge. The violation of the lower line on the yield drop in mid 2003 is completely consistent with the classical completion of this pattern. The price Objective if the yields breaks back above the higher line in the 5.25% area later this year is back to the beginning of the pattern from the late 1980s: essentially back up to 9.25-9.50% yields.

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That may seem a bit radical; and for those unfamiliar with Wedge patterns, it seems to place a lot of credence in technical analytics, about which quite a few folks are skeptical. Admittedly, there is no guarantee the yield will even break up out of the pattern, or ultimately move to the objective once it does. However, among other successful Wedge pattern projections was the weekly Short Sterling chart that predicted the move back up in UK short term yields in 1988-1989 from 8.00% to 13.75% (see Chart 24.)

Even when the market moves in the predicted direction initially, there is a risk with all Wedge patterns that the analyst is a victim of self-deception in what is actually a full trend reaction to the channel support or resistance. In this historic example that would have meant the down trend ending in the channel "A" 87.80 area (equivalent to a 12.20% yield.) While it did stall there for a while, the move ultimately

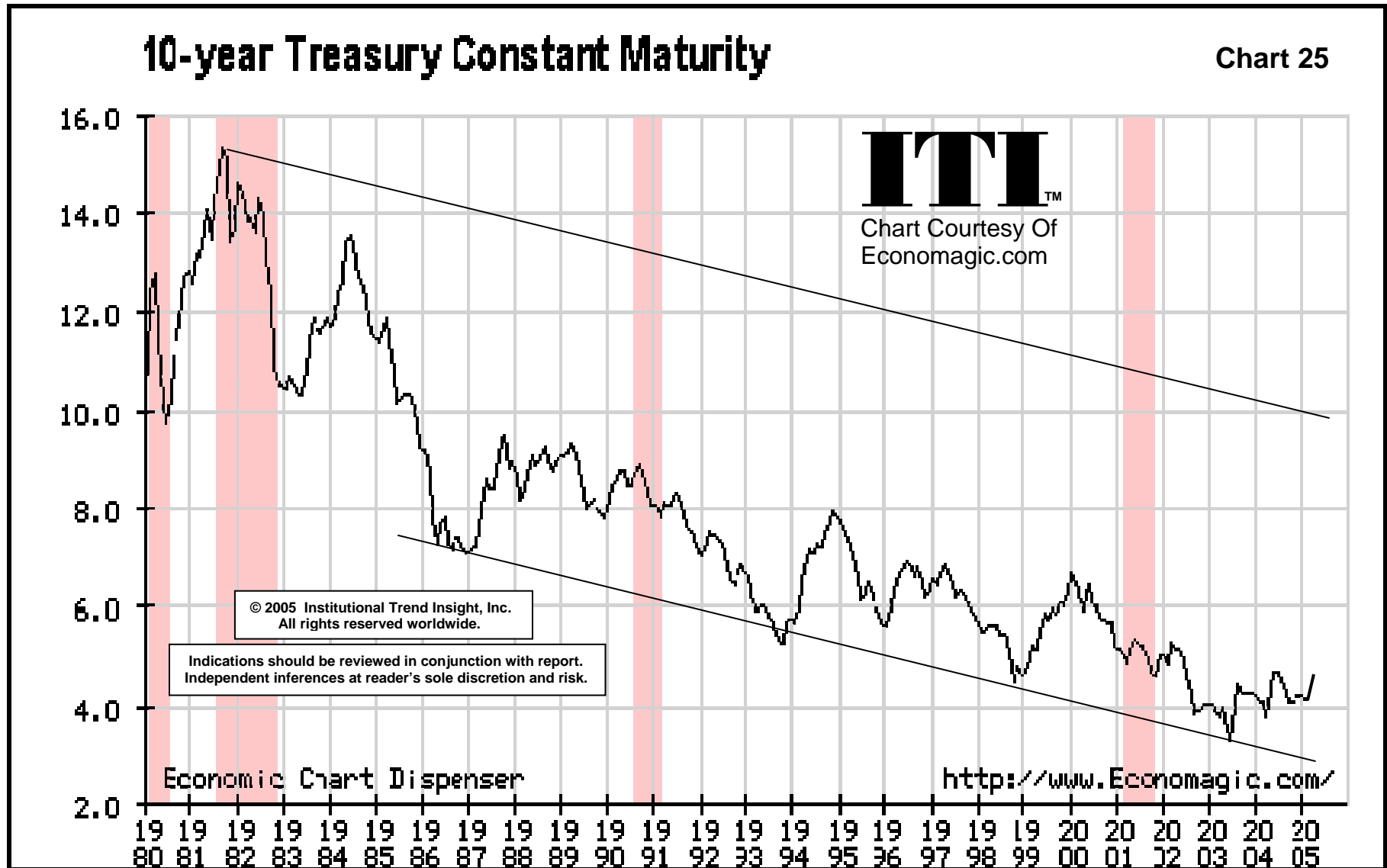
finished beyond the 86.25 downside objective. However, even that risk is a mixed blessing at worst, as the price or yield would have moved substantially in the predicted direction prior to it becoming an issue.



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In the case of the 10-year constant maturity that potential for it to fill out in the long term channel is an equally bad alternative to the Wedge Objective. As Chart 25 illustrates, the actual trend channel begins at the all time high 15.00% yield in 1981, and the channel projection parallel to the basing line is also up at 9.25-9.50% across time.



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**Technicals:** Because we have already reviewed the major long term and intermediate term trend views, and have the near term assessment of market activity available in today's Brief Update, we are going to be concise in this summary of technical projections for the major markets. Current analysis and further updates are available upon request.



**DJIA:** As long term Chart 2 illustrates, the DJIA is following a very similar pattern to its early-mid 1970s activity by returning to near the previous highs and stalling. In the broad view even an up trend could return to the 9,000-8,800 area significant weekly Head & Shoulders Bottom UP Break, congestion, and major weekly channel (interestingly from the December 1974 low) it held at

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the 2002 low. That it is likely stalled now is demonstrated by its inability to sustain the rally above that H&S Bottom 10,832 Objective (Chart 26.) That H&S Objective is such a big level it will now likely act as a cap after the weekly Close back below 10,800 and 10,700 congestion supports. Lower significant supports are 10,400-10,350, 10,000, 9,700, 9,500-9,400, and the 9,000-8,800 area.

**T-NOTE:** As long term Chart 17 illustrates, even a full trend correction of the T-note projects levels between 100-00 and 97-00 one year out. While there is a chance the market can rescue itself, the March contract DOWN Break below the 111-16/-08 recent and historic support is a real burden, as it leaves the entire congestion range since last August above the market as resistance. With the June contract (Chart 20) about to become lead contract below the next significant historic congestion in the 110-00/109-16 range, the burden of proof is on the bulls. Next lower supports are the 108 and 106 areas.

**BUND:** The long term chart on Chart 18 shows some fair support in the 111.50 area, if the Bund decides to remain strong sister. However, if it gets moreso in step with the weaker trend developing in the US and Gilt, more major Fibonacci and congestion support are not until the 105.00-102.50 range. Chart 19 recalls the failure of aggressive weekly up channel and weekly MA 13 support in February, the very week after the new all-time high. It also illustrates weekly MACD is DOWN, and 117.50 and 116.81 remain important supports.

**Euro/US dollar:** The long term chart on Chart 11 shows that long term channel support for the Euro will be all the way down near 1.2000 for the next several months. The weekly chart on the left side of Chart 12 shows how the EUR/USD rescued itself from the interim channel 1.2930 DOWN Break, and yet the subsequent recovery has stalled at the daily (right hand chart) aggressive up channel initial 1.3500 DOWN Break from early January. This is our basis for believing that the US dollar is a trading range affair for now, as neither the first retest of the Negated 1.2930 DOWN Break, nor the next surge up to near 1.3500 is likely to take the market out of its range. Lower interim support is 1.2450.

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**The Bottom Line:** The Fed is being coy about the real inflation rate, because it suits its purposes to rekindle enough inflation to assist debtors mitigate their situation, as well as insuring against another brush with the deflation that they now must admit they are less than well-equipped to address. The major European governments are also happy to throw fiscal caution to the wind, and save their electoral hides through a combination of social transfers and weakening currencies to stimulate their export sectors.

As such, look for the trend toward higher yields to continue as the inflation levels pick up in the near term, while the down trend in the US dollar goes into limbo, and has its best chance to reverse in a while via the weakening of the Euro. Crude oil prices are likely to remain high for now, with a key decision being whether they continue to hold \$49.00/bbl. All of which ultimately weighs on the equities, but not without a fight at support levels. Economies burdened by debt, energy prices high, terrorism a threat, good jobs scarce, governments profligate, and inflation looming once again: Welcome back to the future, circa 1973.

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