

The Agony and the Irony... Reports, Rollovers, Katrina, Energy Expense, and Central Banks

Reports

There is quite a bit we found anywhere from modestly to very ironic as we head into the next two weeks in the markets. While the extent of topics above may seem expansive, as we have previously expressed strong views on most of them, today we will touch only key aspects that are relevant at present. We begin with further comment on the unusual nature of this month's calendar. While we would normally have been into the first half of the US mid-month reporting vacuum after the Employment report, the Beige Book last Wednesday, along with five-year and ten-year T-note supply into Thursday made it more important than usual.

While this week sees the normal midmonth punctuation with US August inflation numbers, Retail Sales, Industrial Production, and September Federal Reserve Bank indices, next week hardly becomes the back half of the mid-month reporting vacuum with the FOMC announcement looming on Tuesday the 20th. That pending decision is the subject of heated debate, and we will have some further views at the end of our observations. Suffice to say that the distortions created by Katrina will likely leave an expectation that headline inflation numbers will be skewed to the upside, and thereby may mitigate any overshoot.

The reports in Europe are also focused on inflation this week, along with UK Employment and Retail Sales. Yet, as with the US, any energy related inflation overshoot does create a bit of a conundrum: does the ECB take the headline impact as cause to raise short term rates, or do they take the advice reiterated by the OECD last week (among many other qualified sources), and respect the degree to which those higher costs are a burden on the still fragile EU economy. One such acknowledgement of the burden higher energy expense places on business as well as consumers came from a fairly unusual source that we will revisit in the central banks commentary below.

Rollovers

So far the switch to long dated fixed income December futures contracts has proceeded as expected, especially in consideration of the general tendencies of the individual country markets. The December Bund officially became the lead contract last Thursday (whereas September contracts remain in the T-note and Gilt), and was able to hold its 123.00 area support in spite of the Beige Book and supply pressure in the US T-note. Therefore, we are in the typically ironic rollover quandary of the strong sister Bund approaching lead contract interim resistance at 123.60-.80 while the December T-note languishes at the mid 111-00

support in the wake of last week's supply. (The Gilt was stuck in the middle, recovering only back to its own 113.80 daily DOWN Break area.)

Now the question seems to be whether the Bund can surge through its resistance first, which likely squeezes the T-note bears, or does the T-note weigh on the rest of the world with slippage down to its own 111-00 area support? If the Bund does manage to Close above the upper 123.00s, it is likely good for a push back to the previous lead contract high 124.60. Responding to inquiries as to why the Bund was so strong, all we can say is that it is likely due to the degree to which the ECB still just doesn't get it. (More below.)

Katrina

As we have already extensively noted our reasons why Hurricane Katrina and the Great New Orleans Flood will be atypically GDP negative, we offer only limited further views here. There is a rather interesting open source attachment from damage assessment experts Risk Management Services that confirms our views about the worst aspect of the damage: the extent of the housing stock that will be a total loss, and the amount of time it will take to even begin meaningful rebuilding in New Orleans.

The unusual aspect of the overall situation is the degree to which there is still wide disagreement as to the actual length of the delay in cleaning up New Orleans. The US Army Corps of Engineers originally projected at least three months until the city proper is fully drained, yet now allows it may be quite a bit sooner. One thing that is not even mentioned in the RMS report is the degree to which the "solution" of removing contaminated water from the New Orleans "bowl" is to pump it into Lake Ponchartrain, which will destroy seafood breeding beds that were critical to the entire area's seafood industry.

Also encouraging the sense or irony is sometimes totally contradictory information as to what business is back to any degree of commercial normalcy. Last Thursday's New York Times definitively stated that disruptions to river traffic in the lower Mississippi delta meant that... "...hundreds of barges have been backing up on the Mississippi River with no place to go." However, when Gary LaGrange, President and CEO of the Port of New Orleans was interviewed on Friday regarding the situation, he said flow-through traffic was up at 60% and looking to pick up further as soon as the Coast Guard could stabilize the center channel buoy navigation aids. While this was exclusive of cargoes that actually required processing at the port, pending the arrival of various seaborne equipment and fuel, the port itself may be up to 40% functional by this week.

Energy Expense

None of which mitigates the loss of refining capacity and general economic drag of the reduced spending power and general upheaval in the lives of a couple of million evacuees. The loss of refining capacity alone will keep end product prices at levels likely to be burdensome on consumers for at least the next several months. According to Friday's Financial Times, "Five US refineries, with a combined capacity of more than 1.1m b/d, 5 per cent of the country's total, were still closed yesterday. Samuel Bodman, US energy secretary, said it would take 'at least three months' to get them producing." This reinforces our focus on unleaded gasoline prices as the primary indication of the impact of energy expense on US consumers, and the FT article also explicitly stated, "...refinery executives and analysts say there is too much crude oil in the market, while petrol is scarce.

Central Banks

While we have repeatedly noted the failure of the ECB to understand that whether it is specifically spelled out in their legislative mandate, or just part of the *real politik* of the situation, they should indeed be more attendant that political dimension of their mandate. What is now astounding is their tacit admission that the degree to which constituent governments' failure to meet the Stability and Growth Pact fiscal deficit restrictions are due to a lack of revenue. As noted previous, many well regarded analysts and observers have encouraged the ECB to ease interest rates modestly in the wake of some fairly significant reforms, and not gripe about what else needs to be done. While there is indeed more to be accomplished in European economic reform, perhaps the extended weakness at the end of a long term economic cycle is not the time to exert sustained draconian pressure.

Now the cat may be loose among the canaries due to two steps the ECB took in their September Bulletin. In the first instance they took the unusual step of commenting on individual country conditions that led to the failure to meet Pact restrictions. The terms "disappointing growth performance", "revenue shortfalls", and "drastically reduce its GDP forecast" abound. Perhaps their attempt to be critical on a country-specific basis will backfire when the broad pattern of depressed economic activity is seen as much to blame as a lack of completion of final reforms. This is possibly the beginning of the ECB being hoisted on their own petard; hopefully the form that takes will be less than the ruin of the Euro.

In the second ironic development that may yet give the ECB an escape door from their self inflicted inertia, we have a most unlikely player: the EU wide labor movement. In a most unusual turn of events, Officials of the ETUC European trade union association will meet with ECB president Trichet and chief economist Issing on October 24th. Oh, to be a fly on wall at that conclave. The ECB has been very vocal lately that one of the major risks from higher energy prices is their potential to encourage labor demands for sharply higher wages to offset the burden on their members, thus triggering a repeat of the sort of entrenched demand-pull inflation last seen in the 1970's.

If the labor unions are both unequivocal and open about the degree to which they will be very restrained because they understand those energy costs are a burden on business as well, it does seem to remove a current major tenet of the ECB hawkish rate regime. While we are not necessarily big fans of the European corporate model that includes labor on their boards of directors, if this is one of the results, kudos to them. Yet, the bigger summary question is what does the ECB do if faced with a clear commitment to labor negotiation moderation, weak economies, and the only real inflation in sight due to higher energy inputs that actually act as a brake on economic activity? Hopefully they see the light; the degree to which the markets still believe they will not is one of the forces behind continued strength of the Bund.

As to the other central bank conundrum, we have heard more than a few well informed observers opine that the impact of Katrina will leave the FOMC on hold on September 20th. While we do feel the overall impact of Katrina will be GDP negative, and that may well cause the Fed to finish the tightening cycle a bit sooner than they otherwise would have, the chances they do not further "remove accommodation" on September 20th is slim. There are many arguments and reasoning on both sides of the debate, some intelligent and some inane: They don't want to burden homebuilders with another quarter point expense on construction loans; as if they are not going to make a fortune on the project profits(?)

Yet, at the end of the day, there are three primary reasons that the FOMC will hike again next Tuesday regardless of what they decide to do later:

- 1.) They will not want to be hostage to the micro-analysis of the progress on the hurricane and flood recovery, which they rightfully view as a modest part of the overall economic picture in spite of the scope of the human tragedy;
- 2.) They will not want it to appear that the damage was indeed so dramatic that it warrants an end to the removal of accommodation, as this might send a very bad signal to the equity market at a seasonally sensitive time;
- 3.) The Fed wants rates as high as possible prior to Mr. Greenspan's retirement so that his successor does not need to raise rates in a way that brings disdain upon the Fed for causing a recession (which is exactly the situation that Mr. Volcker stuck Mr. Greenspan in when he turned over the reigns.)

The ironic aspect of this is that all of the folks who are saying the Fed will pause or stop are also very bullish the equity markets due to that expectation: things are so incredibly bad that they are actually very good. Of course that's actually a fairly common bit of market perversity, so maybe it should come off of our ironic developments list.

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

-Rohr

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