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Markets, Reports/Events, European Long Rates, Central Bankers, Politics

Rather than issue another technically specific **BRIEF UPDATE** today with projections that are mostly consistent with our previous analysis, it seemed more useful to combine a review of the most telling of those indications with considerations that will provide a context for the very important market responses from critical levels (the equity market churn notwithstanding) as the ECB rate announcement and other important reports are released late this week.

Markets

While we normally try to keep the *Capital Markets Observer* background segregated from the more so technical analytic focus of the *TrendView*, as noted extensively of late the markets are ignoring the impact of specific reports as they more so respond to overall concerns about inflation and interest rates. As such, it is likely productive to review the current market trends in light of some of the broader fundamental and psychological influences. In line with that approach, a brief review of the technical contingencies facing the markets is in order prior to relating our observations on the factors that seem to be driving recent and prospective trends. Quite a bit of this is consistent with the analysis in our most recent **GENERAL UPDATE** (from last Friday), as somewhat amended in yesterday's extensive **BRIEF UPDATE**.

FIXED INCOME

Our fixed income view was very clearly articulated over the past several days, culminating in yesterday's observation that, "Any inability of the December T-note to continue to improve by sustaining a recovery back above the 108-22/-24 range after the FOMC is done today likely spells trouble for all of the fixed income, the Gilt included." Frankly, yesterday's market reaction was a technician's dream: the market reacts by going directly to the 108-22-24 resistance and fails before the daily Close. It doesn't get better than that. Further, our additional projection still stands that "...any December T-note failure below the 108-00/107-24 support should be significant enough to motivate extensive weakness elsewhere..." as well as "...the next shoe to fall must be the T-note, as its decision at 108-00/107-24 is a huge influence regarding whether it will head directly to the 106-00 area interim support, or even the major 104-00/103-00 area that is the real bottom of the historic range below 108-00 area."

As noted previous, while the lower Bund support is ostensibly in the 120.00 "big penny" area, the actual technical projections point to 119.50-.30 (low end of which is the Negated weekly channel DOWN Break from February) and 118.00 (significant Fibonacci and congestion) areas as likely targets if the T-note significantly challenges the low end of its 108-00/107-24 major support. Similarly, having failed from mid 112.00 resistance the Gilt does still have some residual support at current levels, and must prove it can demonstrate more sustained weakness from the bottom of the 112.20-111.80 combined weekly up channel DOWN Break

and DOWN channel (from the major late July high) Acceleration to capitulate to lower supports in the upper-mid 110.00 and mid 109.00 areas (another example of the “big penny” not being very technically relevant.)

Yet, the real question is what happens to the other long ends (and even the now destabilized short money forwards) if the T-note actually puts in a weekly Close below the 108-00/107-24 support? To put that into perspective (especially for the weak sister Bund), consider this: a T-note failure below that support is a violation of both the May 2004 and March 2005 major reaction lows, which is also the more significant portion of the congestion generated below the market between November 1998 and June 2002. In addition to the 38 month technical superstructure that a failure would leave above the market, being back in that entire lower range is part of what drives the projection that 106-00 is only interim support with the major support not until the 104-00/103-00 area.

The commensurate March 2005 low in the more bullish Bund was 116.89, and 108.55 in the Gilt, with the June 2004 lows at 111.81 and 104.86, respectively. While we are not necessarily projecting that the European markets must necessarily fully equalize with the previous contemporary lows of the T-note, it does seem reasonable to inquire what a destabilized Bund and capitulating Gilt (based on comparative yield pressure in spite of the likelihood of a weakening UK economy) are worth if the lead contract T-note does print progressively at 106-00 and 104-00?

EQUITIES

Apologies for the same old analysis here, yet this area is operating under such convoluted influences we really do expect more of the same until the S&P 500 can sustain activity out of its recent trading range. While the equities appeared more vulnerable once again after the sharp selloff last Wednesday into Thursday, the near term indicators that would have signaled an ability of the S&P 500 to knock out lower critical support in both the 1,180-78 area, and again at the 1,172 recent lows never occurred. As a result the markets experienced another sharp recovery, extending the top of the trading range to the 1,215 resistance. Our best recent observation on the equities may have been relating the advice of the seasoned floor scalper after the initial post-Beige Book squeeze and meltdown two weeks ago: “The water’s fine fellas; c’mon in and ride the whip.”

And the cross currents of relatively strong economic news that is also keeping upward pressure on yields is likely to keep the equities in an erratic mode. That said, with the US and European markets recovering from extensive tests of (including some modest slippage below) significant supports, and Japan still the tower of strength, daily MACDs being UP does create a near term bullish bias in spite of the likelihood that the equities are most likely in a topping mode. However, any confirmation of a more sustained rally (even if that is part of a broader top) still requires the December S&P 500 future to post a Close above the 1,208-10 area, with interim resistance in the 1,215 area just above that, and extended resistances in the 1,225-30 range and the 1,245 area. Near term December S&P 500 support is into the 1,200 area low end of Monday’s daily and weekly gap higher (reinforced by weekly MA 41 and the reinstated Fibonacci daily 0.50 and weekly 0.382 support of the entire swing from the April lows to the late July major highs.) Where the S&P leads the other equities are likely to follow, with some hefty allowance for divergence along the way.

FOREIGN EXCHANGE

Undoubtedly, the most contentious and (in its way) interesting area of late. The failure of **AUD/USD** below the .7450 support leaves yet another Pacific Rim currency weak against the buck. That this is not a pure "commodity" play is at least partially evidenced by the relative weakness of USD/CAD that remains challenged against its low-mid 1.1800 Negated daily H&S Bottom UP Break, weekly MA and channel resistance (with no clear sign of a sustained trend reversal short of a weekly Close above the low 1.1900 daily DOWN CPR, Fibonacci retracements and significant congestion.)

That failure of AUD/USD combined with the weakness of the Japanese yen (as **USD/JPY** remains above its 116.50-.70 resistance, along with yen weakness elsewhere) conspired to put the **December US Dollar Index** into a vigorous test of last Tuesday's .8985 DOWN Break (out of its aggressive daily up channel from the early September lows), flirting with a violation of its .9025 Tolerance.) Yet, as the Pacific Rim weakness is such a distorting factor compared to the strength of Europe on the cross rates, any broader implications of the near term US Dollar Index movements may be problematic. In any event, this was not supposed to happen this way, as China loosening control over the renminbi was supposed to allow it to lead other Eastern currencies higher against the buck.

The further dilemma here is that there may be some overactive imaginations at work regarding the likelihood of an ECB rate hike tomorrow in the wake of such a strong signal from the FOMC that they are going to continue with a further significant "removal of accommodation" over the next six months. We feel strongly that the ECB is much more likely to continue to only rattle the saber, as opposed to actually skewering a German economy that is already weak, and now beset by political turmoil (more on all of that below.)

Yet, that does create what should be a real test of just how good the US dollar can be in anticipation of a definitive further significant increase in its short term yield premium over both continental Europe and Japan. The likely lack of any ECB rate hike tomorrow should be illuminating as to whether or not the Euro and other European currencies will join the Pacific Rim parade to lower values against the buck.

The foreign exchange near term reversal of further erosion of the US dollar trend on last Friday's recovery back through EUR/USD 1.2100 area, still left near term trend resistance around the 1.2000-1.1950 area (with the ultimate support remaining the 1.1870 July low.) That the US dollar decision has become disjointed once again, with a particularly strong influence from the USD/JPY and AUD/USD decisions, is still apparent from the lack of strength elsewhere. While **USD/CHF** still held minor slippage last week below the major weekly down channel (from the 1.8305 major October 2000 high) UP Break above the 1.2735 level (which remains critical), it is also not really back near next resistance remaining in the 1.3050-1.3100 major Fibonacci and congestion that stalled the market back in July. Similarly, while **GBP/USD** has stalled at interim resistance in the 1.7850-1.7900 area, including weekly MA 13 and oscillator resistance (still not even coming close to its daily up channel 1.8100 DOWN Break), it also held very well at no worse than the mid-low 1.7600 support.

Reports/Events

As the anomaly of the calendar put us back into the important late and early month reports this week, the market has also navigated a series of central bank influences that will culminate with the ECB interest rate announcement and press conference tomorrow. Yet, even beyond that likely "no change" and hawkish statement, there is the consideration of the

fact that the markets have tended to be driven more so by the degree to which central banks have been sending up warnings about indications that energy and commodity price inflation might insinuate itself into future inflation expectations.

As such, unless there is actually a radical departure from the estimated levels predicted for the October Services PMI's, and US Productivity tomorrow, or the European numbers and US Employment report (Nonfarm Payrolls estimated at plus 80,000-120,000) on Friday, on recent form the markets are more inclined to just want the numbers out of the way so they can get back to trading psychologically and technically (more on this at the end of this report.) As such, whether the December T-note finishes the week below 108-00/107-24 support, and the December US Dollar Index violates or respects the .9025 Tolerance of its .8985 DOWN Break (and this ultimately leads it to Close above its .9066 July high), along with EUR/USD failing its 1.1870 July low will be much more telling than any of the specific content of the reports.

This is especially true in light of the return to the rather stark mid-month US reporting vacuum that ensues after Friday's Employment report. While there are three, five and ten year US T-note auctions through the course of next week, the next significant US economic releases are not until the following week's Retail Sales, PPI and CPI.

European Long Rates

The key consideration here is just how the Bund could have gone from being such an overwhelmingly successful strong sister to the complete mess that it has become since the last push up into mid-September. While the seeds of a strong reversal for any market that defies the news and relative trend of its important peers are always in place, the Bund has characteristics at present of a market in the early phase what might become an even more aggressive meltdown. When Mr. Greenspan articulated his cautionary view that overly enthusiastic assumption of long term interest rate risk was unhealthy he forgot to add one thing: the special notice to the Europeans on the one-way psychology of the Bund.

The dilemma is that the Bund remaining a true bull market (achieving serial new highs after the initial sharp mid 2003 selloff) relative to both the T-note, and even the Gilt (which never quite made it back up to the mid 116.00 high of mid 2003) was significantly overextended both psychologically and technically. This has actually been a reasonably normal short term phenomenon in previous cycles, where the Bund would hold up for three to six months after the US long end peaked, and only then get in synch with the bear trend. However, this time it not only held up, but overtly counter-trended for over two years.

As we have already reviewed the nature of the technical overextension in the MARKETS section above, a review of the psychological dimensions seems in order. The continued Bund bull was built on three pillars that were loosely related to each other, as well as being forces that had similar influence in some cases on the other long ends. The first was the idea that the European economy would continue to suffer its long term "sclerotic" weakness, as reform in Germany and Europe in general was less than effective to stimulate domestic economies. This was in opposition to the rather more dynamic recoveries in the UK and US from the 2001-2002 recession.

The second was the degree to which the influence of higher energy prices was more so a drag (invisible tax) on the economies that an inflationary factor. Of course, while those energy price increases were limited in scope and duration, that was also the case for the other long ends as well. Of course, extremely experienced traders and analysts who had

seen the ultimate influence played out in the 1970's inflationary bubble knew this would change at some point. The third pillar was an intransigent central bank that refused to stimulate economies even when the preliminary reforms in Europe were accomplished, yet were of a nature (social safety net cutbacks with little change to labor practices) that were only a drag on the economies: yet another good reason for continued economic sclerosis and weak consumer demand.

The pillars began to fall when the sustained higher energy prices finally did leak through into extensive "cost-push" inflation factors that turned up in all of the economies headline producer and consumer prices, lending more credence than previous to the ECB's hawkish admonitions on inflation and the lack of further economic reform. And, lo and behold, in spite of the economists dire projections (always a crew that is happier being dismal), the German and French economies began to show much better indications over the summer on many levels (with recent IMF projections even upgrading the 2006 outlook for weak sister Italy.) And that mixed summertime economic strength is the sort of input the Bund managed to ignore initially as the general technical momentum assisted it in holding every selloff to technical support.

Yet, the failure of lead contract (September) T-notes back below important 112-00/111-24 trend support just prior to expiration, as well as the immediate subsequent late week failure of the December (fresh lead) contract below 111-00/110-24 support was enough to leave the December Bund (already lead contract) vulnerable to gapping below its 123.40-.20 near term trend support in the week beginning September 26th.

And that was the proverbial straw that broke the up trend's back. Since that time the Bund has been a weak sister, and has had more trouble than either the T-note or the Gilt in even recovering to test its near term resistances at its various previously violated support levels along the recent extensive slide. From European tiger that confounded both its own and other markets' bears, to a series of ugly "dead cat" bounces over the past six weeks. Not a pretty sight; and it may just be getting warmed up if the T-note violates lower major support.

Central Bankers

MONSIEUR TRICHET

As long as we are on the topic of European long rates, we might as well start with Monsieur Trichet. After the goofy Duisenberg years there had been some hope that President Trichet was going to more of a pragmatist, supporting a strong commitment to fighting inflation across the cycle, yet allowing (with the wink and nod we used to get from Otto Pohl and the other more enlightened heads of the Bundesbank) for a reasonable degree of inflation when necessary to revive the economy from the bottom of a trough.

In the event, we got Duisenberg II. While we might have hoped for a moreso deft touch, in their defense both of these gentlemen were admittedly constrained by the specifics of the ECB mandate that only includes draconian inflation fighting particulars. This was the German demand for surrendering the Bundesbank's competent stewardship of the deutschemark to the Euro and ECB, and reminds of one of those proverbial admonitions we recall from time to time: Be careful what you wish for; you just might get it.

That narrow mandate naturally shifted the ECB's emphasis to economic reform as the exclusive engine of growth. Not a bad idea in general. Just not appropriate for economies

that scrape along near the bottom of the cycle; they should have provided some timely assistance when inflation was still low enough to allow for it. That might have encouraged the second round of reforms that are now not even a remote possibility (more on this below.)

The sad truth is that we suspect Monsieur Trichet might now use the event of the extreme weakness of the Bund to admonish the German (and other European) governments on the just desserts of a lack of reformist zeal and fiscal discipline. If so, he would miss the point that any further premature attempt to reform a still weak German economy will initially only result in exacerbating the fiscal deficits he deplures, will also further burden a destabilized long dated European government bond market, and for the second time in recent memory bring into question the rationale behind the entire European Monetary Union project.

MR. OLSEN

Interesting that FOMC member Mark Olsen was on board for this week's hike after being the only dissenting vote back in September. Possibly the hotter than expected Advance Q3 GDP number convinced him the others were right about the storms' limited economic impact; or Mr. Greenspan finally took him aside to explain the political implications of the handover of the Chairman's office (see point #2 below); or his September vote was a contrivance to allow everyone to feel at least one Fed official felt some compassion for the storm victims, because it was politically expedient to do so. Of course, we'll never know; love those inscrutable central bankers.

MR. GREENSPAN

The Fed is always burdened by the fact that the Federal Funds rate is a very blunt instrument to control economic activity. As Mr. Greenspan noted in his September 27th history lesson, this has become even moreso the case since commercial banks have been disintermediated as major corporations primary funding source.

Essentially, the Fed wants to create a slowdown to preclude any secondary effects from recent energy price inflation, and is definitely willing to risk (although is not specifically planning to create) a recession to do so. The plan seems to be keeping labor defensive enough that they will be more concerned about keeping their jobs than demanding their employers make up the entire deterioration in their living standard caused by increased travel and heating expense. It's not pretty but somebody's got to do it prior to a round of good old demand-pull inflation superseding the current cost-push variety.

As noted previous, after the September decision and announcement, and late month cryptic history lesson from the Chairman we were clear he was attempting to communicate that "...it is taking ever more extensive (Federal Reserve) action on short term rates to effect changes in equity market and economic sentiment." (Our text, not his.) That the markets were surprised in early October by the hawkish comments from Fed Governors Fisher, Poole and Santomero was (frankly) surprising to us. Yet, now that has been made clear to everyone, and is reflected in the short money forwards, although not yet in the equity markets.

The retention of "removal of accommodation" language yesterday is a clear sign that (barring any precipitous decline in the equity markets) the Fed is on a glide path toward a 4.75% Federal Funds rate by the end of Mr. Bernanke's first meeting as Chairman at the end of March. If you feel that's an audacious assumption, consider these five related points:

- 1.) At 4.00% the current Federal Funds rate is still accommodative by historic standards that imply it has not become restrictive until it is at least one-half to one full percentage point above projected GDP growth;
- 2.) 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. Greenspan was stuck with when Mr. Volcker handed over the reins);
- 3.) In any event, the Fed will not be signaling that it has put through the *penultimate* rate hike until it eliminates the "removal of accommodation" language. On current form that means the earliest they might hold steady will be Mr. Greenspan's last meeting as Chairman in January;
- 4.) Yet, to hold steady in January would create an expectation that they had finished the tightening cycle, and leave quite a bit of pressure on Mr. Bernanke to make his first move as Chairman an easing;
- 5.) Which is an untenable position for a new Chairman, as regardless of anything else (short of an obvious recession beginning in February or early March) Mr. Bernanke's first task as Chairman is to establish his anti-inflation credentials, and worry about the full employment portion of the Fed's mandate only once that is addressed.

MR. BERNANKE (and the markets)

As noted previous, the rationale for weaker fixed income markets (i.e. higher yields) at the same time that the US dollar might also weaken is the rather straightforward suggestion that the Bernanke appointment brings a supply side inflation hawk to the head of the Fed. This is likely also good for the equities in the near term. Previous concern by some other analysts that he might not be an inflation hawk was completely misplaced in our view. That analysis was based upon a narrow range of opinion that he issued during what was an actual deflation scare back in 2002-2003, and shows his sensitivity to that major conundrum faced by all central banks: they know exactly what to do about inflation, and almost nothing about how to reverse deflation. If anything, this demonstrates a clear grasp of the limits of the central bank's powers.

As to his supply side inflation hawk tendencies, lower tax rates are not necessarily a problem for the fiscal picture in the initial phase when they stimulate the economy from the bottom of a recession. Yet, the present situation is one of a mature economic cycle where the fiscal balance has already experienced the benefits of a more robust economy. As we shift from that phase to a more anticipatory inflation fighting role by the central bank, a cooling economy will experience reduced revenues, and the commensurate return to larger deficits and excess currency creation to cover them.

With the caveat that the sheer short term interest rate differential might assist the US dollar in overcoming a surfeit of greenbacks in the intermediate term, we believe that this is in any event bad news for the fixed income market. While we believe that the fiscal picture is less important for bond yields than sustained real yields in the long run, concerns about significant deficits can upset long dated fixed income markets in the short run.

Having had almost no assistance at all from higher long term interest rates (until recently), the Fed will succeed in cooling the economy by moving short term rates to whatever level necessary, at the same that Mr. Bernanke will have the Fed lobbying to make the Bush tax cuts permanent. This is in addition to the Republican Party's political incentives to do so. This should continue to be both bearish for the fixed income and friendly to the equities in the

near term. If we are right about the foreign exchange picture, the attendant oversupply of US dollars should also pressure the US currency in the intermediate term, setting up the rationale for a larger correction than many believe is possible because of the anticipated support they expect premium short term US interest rates to provide the buck.

Politics

The two major front page headlines of this morning's US edition of the Financial Times were, "Senate showdown over Iraq," and "Bid to build German coalition in turmoil." How fitting. What a lot of folks forget, or never lived through in the first place, is how pernicious the appearance of political ineptitude and seemingly endless contentious controversy can be for the fixed income markets. While there were quite a few other factors created by previous administrations that culminated with his poor overall politico-economic management, one of the major problems for the US bond markets in the late 1970's was the almost complete ineptitude of the Carter administration.

The current fuzzy fondness of his supporters notwithstanding, we believe most folks would rather avoid 10% inflation and 14% long bond yields. The problem now is that the ineptitude is not all with one party; it is the deadlock over inane issues that seem to plague the political classes of most of the developed world. The only way to vote the bums out is to empower a new set of individuals who seem to get just as caught up in the same mindless pursuits.

GERMANY

The German political classes recently engaged in their most partisan round of post WWII politicking, creating a US style narrow (almost imperceptible) election victory for Ms. Merkel, and are (not surprisingly) being plagued by the sort of post-election shenanigans that have been moreso the province of the warring parties over here. The attempt at Grand Coalition is looking decidedly more like a gran mal seizure, and this may be a further part of what plagues the Bund.

We can not say we are surprised, as parliamentary governments are even more prone to these types of failures than the US congressional system (which has its own drawbacks.) As we noted shortly after the election, "... as the electoral deadlock was so insurmountable that a meaningfully right of center government would not be formed, the potential for further economic reform also dissipated. With the ECB still stuck in its self-imposed inflation hawk role, that means the only other potential source of German (i.e. core European) economic stimulus and recovery is not viable in the near term."

As bad as that may have been, degeneration of their process into true American-style nasty machinations has now eclipsed any initial concerns. Much like their Democratic Party kindred spirits on the political left in America, the SPD decided to talk centrist but run "left" to appeal to their base. As such, the resignation as party head of Herr Müntefering (one of their more centrist members) was fomented by the selection of a "prominent leftwinger" as SPD general secretary. This in turn has caused Edmund Stoiber, the powerful head of the CDU's Bavarian sister party to pull out of his cabinet post, for the ostensible reason that, "...the direction and predictability of the SPD is no longer clear..." and has changed the basis on which he planned to enter the cabinet.

This is the equivalent of parodying W.C. Fields' famous line: "On the whole, I'd rather be in Bavaria." We have a sneaking suspicion that Herr Stoiber suddenly realized that his leader was so weak that the grand coalition might never take office, and new elections (with a new

party leader) might ensue. We can't blame him for rightfully reasoning that he'd rather be a big fish in Bavaria than a part of a failed effort that soon might allow him to have a more prominent role on the national stage. In any event, the disarray is not good for a Bund that is already burdened by inflation concerns, and no prospect of any further economic reform.

UNITED STATES

Of course, in light of the German activity, their American counterparts could not possibly allow such relative newcomers to the politics of mutual self destruction co-opt their long held title as the ultimate champions of ignoring the real needs of the nation while engaging in mindless condemnation of each other. Rather than go through the litany of mindless legal, legalistic, public relations and private derision issues that masquerade as a political process in the USA these days, let's just examine the most recent examples.

The Republican president puts forth a very credible stealth candidate for the vacant seat on the Supreme Court after his successful insertion of the obviously conservative John Roberts as Chief Justice. A woman, a very competent attorney, a right wing loyalist, and lacking enough of a record for the Democrats to inflict any serious damage during confirmation hearings (in spite of their rightful suspicion she would find an excuse to revisit the abortion issue), Harriet Myers should have been very acceptable to his party. But they were not going to be happy with anything less than a sharp stick in the eye of the liberals. How nice.

Peevish that Mr. Bush then *did* nominate a real conservative, the Democrats response was to take the Senate into a rare "closed session" to push for the completion of that house's report on the use or abuse of WMD intelligence during the debate and vote fomenting the Iraq War in 2002-2003. Once in closed session they did not even bother to discuss it. Our guess is that they figured Mr. Bush was recovering too quickly from the lack of any higher officials being indicted by the undercover CIA operative leak grand jury that a guy named "Scooter," and needed to get the country back onto a topic that was a sore spot for the president.

Not to get off on too much of a rant, but here in the good old USA (as the rest of the world unfortunately becomes increasingly similar to us) it basically comes down to failing to address the breakdown of our education system (that Mr. Greenspan himself has repeatedly reminded us is the only real solution to maintaining our social compact), having no idea what to do about the global warming that even Mr. Bush now acknowledges might have something to do with the hyperactive weather systems that plague the world, spending billions on avian flu vaccines the political classes feel compelled support (even though there is no guarantee any of it will work on the specific virus that finally becomes highly infectious), while the central bank is creating a recession as the only blunt instrument at their disposal to offset a shortage of energy supplies, even though that (along with the multiple storm remediation expenditures) will create ballooning deficits, and our political leaders are mostly concerned about who knew what and when about Saddam Hussein's non-existent WMD, and feel that whether or not people support a woman's right to choose is the *real* key to the future.

And people still want to know why the long yields are finally going up in spite of the prospect of a weakening economy in Q4.

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

-Rohr

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