

## ROHR REPORT

# *CAPITAL MARKETS OBSERVER*

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In light of the strong moves in the fixed income and foreign exchange we will be providing some of the extended technical levels in each of those markets today. However, considering how much farther this likely means the long dated fixed income (and to a lesser degree the already discounted short money) and US dollar will likely proceed after the trend decisive activity yesterday, we felt it important to also revisit the various influences that have either combined to drive the trend psychology, or illuminate a fresh aspect of it. In sum, we do not believe that even ECB President Trichet necessarily understood how pernicious his combined comments were for the long dated fixed income, and the US dollar has finally demonstrated independent weakness in spite of the higher yields fomented the President's remarks.

### **Reports and Markets, Multifaceted Fixed Income Conundrum,... ...Independent US Dollar Weakness**

#### **Reports and Markets**

As noted previous, the ability of the Bund to lead the way down below 120.00-119.85 in the wake of the ECB rate hike (and especially the opinions expressed at their press conference) was just the sort of thing the bears needed to break the critical supports in the long dated fixed income (much more on that below.) While the strong sister Gilt continues to hang on, the T-note also broke some important support, and is actually the key factor today. Whether or not it Closes the week below the bottom of the important 107-16/-10 range is going to be a significant influence on the trend activity of the other long ends.

While the Euro-zone Services PMI's (FEB) came in generally stronger than expected this morning, the weakness of Germany moderated that, as did some of the weak underlying components of the otherwise as estimated headline GDP (Q4) numbers. This leaves more than usual influence with the otherwise less than trend decisive US ISM Non-Manufacturing Survey (FEB) and University of Michigan Confidence (FEB Final.) Whether their influence is enough to put the T-note below 107-16/-10 for the weekly Close, and whether the US dollar remains weak or recovers back through important resistance at EUR/USD 1.1975 and in the US Dollar Index in the low .9000 area represent the most crucial indications right now.

#### **FIXED INCOME**

With the March **BUND** failing on recovery attempts back near its 120.50-.60 congestion in the past couple of days, the weight from the ECB rate hike and press conference information was enough to have it break its 120.00-119.85 support. While we had previous noted that its need to recover back above the 120.50-.60 area was also significant for whether the 80 point discount in the June leaves it above or below 119.85, in the event that March contract breaking 119.85 was as important for another reason: it left the June contract below important continuation support at the mid-November 119.03 lead contract low.

With the typical early March contract expiration in the Bund next Wednesday, this means that (barring a miraculous resurrection) the June contract will fulfill one of the basic definitions of a bear market: lower highs followed at some point by lower lows. While this may seem a small matter in light of the overall ferocity of the Bund break since late January, in fact the previous selloffs at many junctures in the Bund respecting previous lows has been one of the major factors leading to not just the Bund recovering, but also its ability to lead the other long ends higher when weak sisters like the T-note might have otherwise continued lower. In that regard, it is a major reinforcement for the long deferred invigoration of the more aggressive bear trend that has occurred much sooner in the previous intermediate term cycles.

Technically this also means that as far as the Bund has come, the next significant supports are in the 118.00 area (major Fibonacci retracements, congestion and weekly oscillator), with the bottom of the weekly down channel not until the 117.50 area next week. This would seem to suggest the possibility of a trading low into 117.50, with a recovery for a weekly Close in the 118.00 area. However, if 117.50 is violated, then that down acceleration and commensurate Negation of oscillator support would point to a bad enough failure to hit the next major support in the mid-low 116.00 area (i.e. right through the 116.92 major March 2005 correction low.) Due to the strength of the support in the 118.00 and 117.50 areas, we are not predicting that will happen; yet we want to be clear on the critical nature of the support in the 118.00 and 117.50 areas.

A similar picture is now in place in the overall downside leader March **T-NOTE.** While the Bund has led the way down recently at times from its previous lofty heights, the overall down trend has still been most sustained and pronounced in the T-note since the major June 2003 highs (which the Bund has still been above until just yesterday.) Now that it has cracked support at the daily Gap and UP Break (from its aggressive daily down channel from the mid-January 110-06 high) in the 107-25/-22 range, that will be resistance on any near term rally. Yet, as noted previous, the more major and critical support is the 107-16/-10 range.

That is due to the low end of that range being the Fibonacci 0.50 retracement of the entire swing from the January 2000 93-21.5 low to the 121-01 June 2003 high. That makes it a very important Tolerance for the major congestion support in the 108-107-16 area. The T-note has likely been hesitant to drop below there because that is now a superstructure of three and a half years of congestion. Below it there is only modest interim support in the 106-00 area, with the first of a series of lower major supports not until the 104-00 area. With the Bund previous assisting the T-note in holding major supports at various times, it was very hard to imagine that sort of sustained weakness. However, as noted elsewhere, that is the case no more.

The one conundrum in the long ends is the resilience of a March **GILT** that is back below 113.90 once again, yet does not desire to remain below previous support in the 113.50-.33 range, at least for now. While on past form the Gilt can remain stubborn for a while, it always does seem to eventually get in step with the major trend. With as far down as the T-note and Bund are likely headed from here, it is not likely the Gilt will hold up indefinitely. However, even when it does fail the 113.50-.33 area, it is still likely to remain somewhat resilient in the near term. This is due to the secondary support at the 113.00 area weekly Area Gap and heavy continuation congestion. Only back below 113.00 on a weekly Close does the Gilt once again become vulnerable to failing back significantly into the lower half of the previous range. Lower interim support will be in the 112.00 area, with more major support into the low 111.00 area early November reaction low.

The short money is already quite discounted compared to the long ends, and will likely continue to grind lower while the long ends finally lead the way down in the near term.

### **FOREIGN EXCHANGE**

This analysis remains much the same as previous, as the US dollar has finally capitulated markedly from its quiet churn around critical areas, including the EUR/USD Negated major H&S Breakout at 1.1900. Now that it is back above 1.2025, it reinforces the incipient US dollar intermediate term down trend, with extended resistances (US dollar support) there at 1.2200-50 (with a Tolerance to the recent 1.2320 high), 1.2588, 1.2750, 1.2900, and into the low-mid 1.3000s. All of which correlates well to levels in the other currencies that we will address early next week. If you have any immediate interest in those, please inquire.

Of course, the cantankerous Japanese yen that recently helped to weaken the US dollar psychology has chosen this moment to sag. Yet, as USD/JPY has failed its ostensible 117.00 support, that remains resistance on the rally, and daily MACD joining the weekly in its DOWN signal does reinforce today's weakness as just another yen aberration. While there had been some decisive qualities to the historic congestion in the 116.00 area previous, as we recently noted that has been overrun in both directions of late. Therefore, more likely the market revisits the Negated aggressive weekly up channel DOWN Break (from the drop to the 113.43 early January low), congestion, and Fibonacci levels in the 114.75-.40 area prior to stabilizing (reinforced by weekly MA 41 in the low 114.00 area.)

### **BATTLE OF THE MACD'S**

As noted previous, in what is one of the truly incredible confluences in recent memory, there has been a major "Battle of the MACD's" in both the fixed income and foreign exchange that reinforces the already critical nature of the decision in both of these areas. In essence, the weekly MACD's in the long dated fixed income remained nominally DOWN while the daily MACD's had gone from UP on the recent bulge to "in balance." Due to the recent weakness, those daily MACD's have turned DOWN, also reinforcing the reversion to sustained aggressive down trends in all of the fixed income.

Similarly in the US dollar, the weekly MACD's were only back "in balance" (from DOWN) in spite of the sustained recovery since the late January lows. As such, the US dollar needed a bit of a further push on the upside to confirm its ability to also sustain the reinstatement of those ostensibly Negated major bottom UP Breaks. However, due to its loss of momentum on the rally over the past couple of weeks, the daily MACD's had lapsed back to "in balance" from their early February Upturn. The dollar's weakness over the past several sessions has now turned those daily MACD's DOWN, reinforcing the likely reversion to a sustained intermediate term down trend.

The bottom line is that both the US dollar and the fixed income have confirmed their ability to trend lower out of what has been a very critical phase for the trend indications. This has additional implications for the US dollar (see below.)

The equity market is churning sideways, and the energy markets continue their push higher. As such, we suggest you refer to yesterday's [TRENDVIEW GENERAL UPDATE](#) for any of the technical levels or trend views in those areas.

## Multifaceted Fixed Income Conundrum

As we have noted quite a few times recently, bear markets rally mostly due to an inability to break supports. Often it is the case that the nature of the extended trend below that support would be very bearish due to next supports not being until much lower levels. As such, unless the market is prepared to actualize that sort of bearish activity, it will tend to find an excuse to bounce. There has been a significant amount of this sort of activity during the overall long dated fixed income bear trend since (and even from slightly before) the major June 2003 highs. In many cases it was the influence of the Bund that rescued the other long ends from weak activity at critical support. Yet, now the Bund is the psychological downside leader. The reasons for this are extensive, and we have appended a discussion of a good deal of them to the end of this report (from **CMO** 11-4, January 24, 2006.)

Likely without even realizing it, Monsieur Trichet managed to highlight the three major bearish psychological threads that were already coming together to threaten the long dated fixed income, and tie them into a convincingly bearish knot. These are the general strength of the world economy, technical aspects of the European inflation outlook (that will exacerbate the high energy prices that have already caused global cost-push inflation), and the way in which that impacts the labor cost outlook in key Euro-zone economies (and possibly elsewhere.)

Literally in one simple paragraph of his prepared remarks to yesterday's press conference he tied these three together in a manner that the fixed income bears could only have dreamed the of the day before. To wit, in paragraph four of remarks in his **economic analysis**...

"Turning to price developments,... ..inflation rates are likely to remain at above 2%,... ..changes in administered prices and indirect taxes are expected to significantly affect inflation in 2006 and 2007, and an upward impact can also be expected from the indirect effects of past oil price increases. At the same time, wage dynamics in the euro area have remained moderate over the recent past; our working assumption is that this will continue to be the case,... ..looking ahead, it is crucial that the social partners continue to meet their responsibilities in this regard,..."

Breathtaking. Stronger than expected global economic climate, continued high energy prices, additional inflation (especially in Germany) due to indirect taxes, and yet, a firm belief that wage moderation will continue indefinitely; even to the point of chiding labor to not be too assertive in catching up with the pay packet damage from previous weak economic activity and commensurately restrained wage increases. Obviously this man (and we assume the ECB governing council) believes in fairy tales. Once again, just as they failed to recognize the 2003-2004 economic weakness as an opportunity to ease interest rates in support of the Schroeder administration economic reforms, the ECB is out of touch.

In addition to the other strong factors indicating a more stubborn and accelerated form of inflation is likely returning, the true measure of this is the degree to which wage driven demand-pull inflation seeps into the equation. As Mr. Greenspan warned us on so many occasions, relatively low core inflation was only sustainable so long as the shocks from higher energy prices were temporary. As that no longer appears in any reasonable analysts' scenario for the next couple of years, it is time for a shift in the frame of reference.

The IG Metall wage demands heading into the current round of negotiations indicate a strong feeling on the part of labor that they have done their bit with wage restraint, and feel in need of immediate mitigation of the impact higher energy prices have had on living standards. With world equity markets at their highs the worker in the street likely feels the fat cats are

getting rich on the back of his willingness to absorb a lower standard of living. All of that looks about to change.

As we have already extensively expressed our views on this in recent comment, we are simply going to append those previous insights...

From **CMO** II- 8, Tuesday, February 21, 2006 (selective):

### **Long Ends (Again)**

In the overall context of the trend, the recent OECD report is still telling. Of particular note is the overview of results for the composite leading indicators (CLI's) that fit with our perspective that what most ails the long dated fixed income is the shift from pockets of weakness to overall world economic growth. As noted in the report, "The CLI for the OECD area rose by 0.6 point in December 2005 to 106.3 from 105.7 in November. Its six-month rate of change rose for the eighth consecutive month. The CLI for the United States rose by 1.0 point in December and its six-month rate of change shows an upward trend since May 2005. The Euro area's CLI increased by 0.3 point in December and its six-month rate of change rose for the seventh consecutive month. In December, the CLI for Japan rose by 0.5 point and its six-month rate of change was up for the eighth month in a row."

For more on this either see the report directly at <http://www.oecd.org/home/> or the balance of our comments in last week's **CMO** II-7 (Tuesday, February 14, 2006.) Whether the decision by the long ends to reflect this overall strength in higher yields takes place all at once after FOMC or MPC meeting minutes releases, or possibly hotter than expected US CPI numbers tomorrow or German figures on Friday is yet to be seen. However, whatever occurs in the short run, continued stronger than expected economic data is likely to take its toll.

(Our current additional comment on this is that since the release of the OECD CLI's back in mid-February there have admittedly been some soft spots in the economic news. However, on balance that news has remained very strong, and mostly points towards continued recovery in previous weak sisters Germany and Japan.)

### **Labor Costs**

We also continue to focus on the one component that might encourage a more sustained bearish response from the long ends: labor costs. While we have seen a bit of this in the US Q4 Productivity number, and January US Hourly Earnings, it has yet to impress the markets. Outsourcing and job cuts at major manufacturers have left the fixed income bulls a bit sanguine. Yet, any further sign of higher labor costs elsewhere might still create enough of a spectre of demand-pull inflation to spook the long ends. As noted previous, any militant labor action as part of pay negotiations in Europe could be especially telling.

In that regard, today's comments by Herr Weber that the proposed 2007 German VAT increase to 19% might push German CPI up by a factor of 1.1%, and Euro-zone inflation by 0.3% are likely not helpful; and that is if producers pass on only two-thirds of the increase. Amazing, isn't it, that even someone as astute as Herr Weber sits on a central bank long enough and he needs a refresher in basic market economics: *the producers are not in business to lose money*. To the degree possible, they will pass on the *entire* increase.

Major German labor negotiations in March will set the tone for labor costs throughout the country, and even influence Labor's stance elsewhere in Europe. IG Metall is requesting 5%

wage increases for their 3.4 million workers, while the Gesamtmetall employer's group is cautioning that anything above the modest 1.2% (in line with productivity increases) offered is going to cost jobs in an economy with companies still struggling to stay in profit. Yet, we can't help but consider that workers who have also been impacted by higher energy costs are not going to settle for an increase that will automatically be completely obliterated when the VAT increase hits next January.

This also illustrates the conundrum faced by an ECB that clamors for fiscal rectitude from weak economies that cannot afford the job losses engendered by reforms, while it must also deal with the added inflation classical higher taxation causes in its own right, and at the offsetting higher wage requests potential to move that inflation into the dreaded demand-pull phase. At some point, possibly in anticipation of (or the response to) a more robust than expected German pay deal, this may also come home to roost in higher long yields.

(Our current additional comment on this is that Herr Weber's analysis was for a pass through of only two-thirds of the VAT increase. As implied above, we suspect a full pass through is more likely. As such, the actual impact on German CPI might well be more on the order of 1.5%, and 0.4% for the Euro-zone.)

### **Independent US Dollar Weakness**

We do not really have much to add here, as we have already significantly expressed our suspicions about the US dollar's inability to reinstate the seemingly Negated major Inverse Head & Shoulders Bottom UP Breaks that it first left back in November against various other major currencies and on the US Dollar Index. What was most striking about yesterday's move was the fact that it occurred in a rising yield environment. Previous when the fixed income has been under pressure it was generally good for the buck.

While that seemed to support the argument that the US premium short money yield to the rest of the world (or most of it) would continue to support the dollar in spite of the return to more bulging deficits for as far as the eye could see. Yet, while we can not be sure whether this is a return to a true bear (i.e. that will ultimately violate the late 2004 lows), or only the beginning of a major correction to somewhere back near them, as we have noted previous that point is moot for now. Any broader basing activity from attempted bottom failures as significant as the ones presently evolving will likely carry the buck back through levels like EUR/USD 1.2300, 1.2600, and even likely 1.2900, with ultimate intermediate term targets in the low-mid 1.3000s, and commensurate levels against other currencies.

As that appears to be the case, we prefer to wait until the markets are nearer those important thresholds to consider whether the US dollar has returned to a full blown bear. In fact, only once the nature of the outlook when the market gets to those levels is known, and the price activity while it is testing them will inform our decision on the ultimate scope of the trend.

Reprinted from **CMO** II-4, January 24, 2006 (*in toto*):

### **The Bund**

The degree to which the Bund has been able to defy gravity by de-linking from the T-note that has been leading the way down since the mid-2003 deflation scare has been very impressive. In fact, while the T-note has repeatedly held 108-00/107-16 support since first

dropping back down to it in May 2004, it has indeed been in a down trend since the 121-00 June 2003 high. Compare that to Bund's current level relative to its 120.00 June 2003 high, and it is obvious that market must still be characterized as a bull trend, even after its sharp drop late last week. The Gilt is somewhat betwixt and between, only getting back up to near its overall 116.58 June 2003 high last week.

With the Bund still well above that high it would be easy enough to presume that it is still a bull market, and last week's break was nothing more than the next response to recent ECB sabre rattling, and somewhat worse than expected inflation numbers. However there may be more to it than that. While it is actually typical for the Bund to outperform the T-note at the tops, and even make a modest new high after the T-note begins to trend down, the scope of the Bund's out-performance in this cycle is unprecedented. And that may have something to do with both the scope of the cycle, and certain one time factors.

Previous the Bund would sustain its better tone at the top of intermediate economic upturns because the European economy tended to lag the US coming out of the bottom. As such, the return to a more inflation prone environment was also less apparent in Europe until the US recovery was clearly on track, and likely to stimulate Europe as well. This was usually accompanied by the Bund holding up and potentially making a new high across the three to six months after the trading high in the T-note.

In this case it has been over two-and-a-half years, and that is likely due in part to the correction from the 2000 equity market and economic highs being a major cycle correction, as opposed to the intermediate term ones that shaped previous T-note/Bund comparisons. This was all exacerbated by formation of the Euro currency, and establishment of the European Central Bank. In their almost exclusive focus on inflation mitigation (which quite a few observers including this writer have isolated as a key mistake in the bank's mandate), they were unable to stimulate key European economies that were navigating the shoals of significant reform. As such, they were a drag on economies exhibiting more than normal cyclically weak tendencies, with all of the fiscal conundrums that created as well.

(For those interested in more background on the major cycle, we will be happy to send a copy of our extensive March 2005 Special Market Highlight "1970's Redux: Son of Stagflation." While not all of its market projections were fulfilled in the near term, it remains of interest. The deferred conclusions are likely still moreso correct than not.)

All of which means the extended bull market in the Bund is substantially based upon assumptions of continued economic weakness, and relatively benign inflation. While we are not necessarily convinced the German grand coalition government will prove successful in solving the various fiscal and economic dilemma's which face the nation, they have stimulated a stronger near term recovery than many thought possible. This might be due in part to the reinvigoration of Keynes "animal spirits" after such a long stagnancy. Or it could relate to the one year deferral (until the first of 2007) of the rather sharp increase in VAT, which is likely to prove self-defeating.

What ever the case, this was not the economy or psychology for which the Bund is currently priced. As such, sitting up at these extended highs, it is likely the most vulnerable of the long dated fixed income markets. Even in consideration of the Euro-zone economy starting at a lower base, the "country" spreads are instructive. When the long ends were at the top of their rally into mid-June 2003, the lead contract T-note future was trading at a modest premium to the lead contract Bund (that's right, a premium.) Subsequent assumptions, and ultimately the

reality of the divergence between the US economy and major European economies has seen the Bund climb to a 12.75 point premium to the T-note, both in the fall of 2005 and again early this year.

Now this previous upside leader is back to some very critical support in the 121.00 area, with trend indicators weaker than either the T-note or the Gilt. It is therefore going to be very interesting to see whether it recovers back above its 121.40-.50 and 121.80-.85 resistances in the near term, or puts on a bigger failure below the 121.00 area that could signal a much more extensive break to follow. While a certain amount of any failure of that sort could be just so much retracement in its rather significant premium to the T-note (and the similar gain against the Gilt that has already reversed since last October.) However, if the previous upside leader gets into a sharp bear trend, on past form that could also spell significant trouble for the other long ends as well.

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

-Rohr

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