ROHR REPORT

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…Bernanke Blinks, Wild FOMC Thought, Transparency, US Dollar

Overview

In deference to the May Day market holiday in Europe and Early Spring Bank Holiday in the UK we are limiting the extent of our **Markets** section today. While it will include some mention of today's response to the US reports, we felt it best to leave the expanded technical discussion for a full *TrendView* **GENERAL UPDATE** tomorrow. In fact, the market holidays today significantly distort what is already the major early month reporting week, as the US and European manufacturing and services Purchasing Managers' Indices (US ISM Indices) will be released on different days. Of course, the advantage to US market participants is their ability to respond in their markets to the rather significant US news today.

The markets are likely to maintain overall trends that were exacerbated by Mr. Bernanke's sudden shift to a somewhat more sanguine approach to the Fed's inflation diligence mandate (a bit more on this below.) The bottom line is likely that which we noted last week, regarding long dated fixed income being the best indication of whether that modulation of the previous approach is perceived as effective. Even Mr. Bernanke noted that maintaining low long term rates is the third leg of the Fed's mandate. If not, then his shift will be regarded as an attempt to satisfy popular concerns about the Fed not interrupting the current strong economy that amounted to nothing more than a bad bet that could influence the commodity and energy markets with a nebulous signal that the Fed was confident things would calm down.

With that in mind there will be an extra measure of volatility infused into the May 10th FOMC decision if real world conditions move toward aggressive inflationary indications. Precious metals, commodities and energy markets have already violated some key trend resistances, and equities seem willing to ignore the potential drag from those influences. As noted previous, the performance of the long dated fixed income will likely be a good arbiter of just how much pressure the FOMC is under now that Mr. Bernanke reinforced the impression that it could be "one-and-out" from here. And that is the factor that specifically engenders the more radical potential for the next FOMC meeting (quite a bit more on this below.)

In the meantime, the short dated fixed income is modestly underpinned by the Chairman's pronouncement last week, with the caveat that could be reversed by any aggressive meltdown in the long ends. The long ends remain vulnerable in spite of the modest rally in the wake of somewhat weaker than expected US news last Friday (after strong European news in the morning.) However, one of the keys now is indeed the economic and inflation news calming down to reinforce the sense of a second quarter slowdown. If not, the more sanguine view from the Fed is more pernicious than if Mr. Bernanke had not addressed the issue, and simply weathered the subsequent questions. The US dollar remains weak after the differential in US and European news on Friday, and this is consistent with the driving forces we had previous articulated; look for more of the same (more on this below as well.)

Reports & Events

It is the usual important early month reporting week when Monday is the first business day of the month, including Thursday's interest rate decisions by the ECB and Bank of England (albeit both are expected to hold steady.) Yet, due to the FOMC meeting next Wednesday, the calendar does not lapse back into the normal mid-month reporting vacuum next week. Also of note next week will be Thursday's US Retail Sales and Business inventories (both APR), as these further important early Q2 numbers will reinforce or counter certain underlying tendencies not consistent with the very modestly weaker than expected US Advance Q1 GDP released last Friday. As we noted in Friday's *TrendView* **MARKET ALERT**, one of the major anomalies in that report was the degree to which the lack of inventory replenishment suppressed the headline number by what was estimated to be roughly 0.5 percent.

Of course, it's a long way from here to next Wednesday and Thursday, and today we have already seen stronger than expected US Personal income and Consumption (MAR), with a Core PCE Deflator that was above expectations as well. As Construction spending (MAR) and ISM Manufacturing (APR) also significantly exceeded estimates, it is not surprising that the T-note is sagging from the near term resistance it failed to recover back above on Friday, and the equities and other markets remain strong. Especially the strong ISM prices paid component reinforces the strong prices in last Friday's otherwise weak Chicago Purchasing Managers Index. Further insights into real world conditions abound throughout the week.

Later today, the first of the insights from financial luminaries begins with the Fed's Guynn on economic outlook, and the Fed's Stern discusses 'Pursuing Effective Economic Policy' this evening. Tomorrow is of course the European Purchasing Managers' Indices, along with UK CBI Distributive Trades (all APR.) Wednesday begins with the Reserve Bank of Australia rate decision (expected to be steady at 5.50%), and then sees the Euro-zone Unemployment Rate and PPI (both MAR), UK Consumer Confidence, PMI Construction and BRC Shop Price Index (all APR), followed by the US ISM Services Index (APR) and Factory Orders (MAR.) Of note, Mr. Bernanke speaks again, although various calendars place that at different times between 09:30 and 12:00 CDT (10:30 and 13:00 EDT; 14:30 and 17:00 GMT.) We are sure that his remarks will be even more closely scrutinized than normal for any reinforcement of the "one-and-out" inference for future FOMC activity.

Thursday is even more interesting with the release of European and UK PMI Services (APR), Euro-zone Retail Sales (MAR), and the ECB and BoE rate decisions. Especially interesting will be the customary ECB press conference if indeed the previous "über-hawk" of central banks decides to hold steady in the face of any further inflation pressures. Of course, it will be equally interesting if they decide to surprise the markets with a hike. Later Thursday we see US Nonfarm Productivity and Unit Labor Costs (Q1 P.)

While Friday is short on European economic releases, talking heads abound. 'The ECB and Its Watchers VII' meeting includes comments from Herren Issing and Weber, ECB President Trichet speaks at a conference on 'Financial Statistics For A Global Economy', and the ECB's Papademos speaks regarding 'On The Road to the Euro? Progress and Prospects of New EU Members.' And all of that either prior to or right into the US Employment numbers (APR), where we feel once again the Average Hourly Earnings and Average Weekly Hours will be as important as any headline Non-farm Payrolls number that is anywhere near the estimates. Especially any further sign that "skilled labor" costs are escalating is likely a negative sign for the fixed income markets.

Markets

FIXED INCOME

The fixed income seemed to pause from its previous decisive statement about reinstating its aggressive down trend after Mr. Bernanke's more sanguine observation Thursday. Yet, it is still vexing to any residual bulls that the markets only recovered to the Negated support at June T-note 105-16 (with a resistance Tolerance to yesterday's high at 105-20), and Bund 115.50 (with a resistance Tolerance to 115.70) that are also aggressive near term down trend resistance. The renewed weak sister Gilt never got anywhere near 110.50 (which we always suspected could quickly lead to much lower levels), and has near term resistance into the 109.50-.70 range.

As the short money might be underpinned in the near term by Thursday's missive from the Chairman, the ability of the long ends to hold yesterday's minor daily UP Closing Price Reversal Bottoms in the wake of today's US reports will be the more telling sign for the fixed income trend, ultimately even the short ends.

Those near term bottom technical levels (and Tolerances at the lower end of the specified range) are T-note 105-04/-01, Bund 115.27-.10, and Gilt 109.33-.31. If the markets fail back below those near term bottoms (i.e. Negate the basing signal) we suspect they will quickly head for the next supports in the 104-00 area in the T-note, the low 109.00-mid 108-00 area Gilt, and the 115.00-114.50 range in the Bund, with the low end the more likely target.

EQUITIES

We have been noting that the equities remained constructively choppy in spite of recent signs they were finally taking heed of the activity in the fixed income. However, last Friday's strength that has been reinforced by the strong US News this morning has reinvigorated the up trend. June S&P 500 had not been able to significantly violate the key support at the low end of the 1,300-1,294 range, and is even back above interim support in the 1,310-08 range.

The low end of the 1,300-1,294 is now reinforced by the daily Area Gap higher (1,295.60-1,292.90) from two weeks ago. Extended S&P 500 trend support remains as low as the 1,280-75 area. The next significant resistance is still in the 1,324 area (at which the market stalled late week two weeks ago), with extended resistance now up to 1,340 area. In spite of the current weakness, the international equities are not really capitulating either. They have held back at their own previous critical resistances (including the NIKKEI), and they will likely generally follow the overall trend lead of the US market. Yet, the holding actions still include **DAX** respecting 5,860 (and now back above 6,000), and **FTSE** remaining above 6,000. As noted previous, each of those has next objectives in the 6,250 area. Even the weak sister **NIKKEI** is not back down to fully testing the higher of the near term supports back at 16,650, with extended near term support at 16,400.

FOREIGN EXCHANGE

The additional upside follow through the previous 1.2320 high has also carried up through the September 2005 1.2588 high in a manner that is compelling. This leaves short term support back into the 1.2500-1.2450 range. Capitulation

of USD/JPY from 118.50 resistance below the 115.50 support (now resistance) has now also violated the major January reaction 113.43 trading low to begin to Negate a major UP Break; this still requires a weekly Close well below that level to confirm. Yet, the general rout of the US dollar is now well established after frustrating the US dollar bears previous since the first EUR/USD push above the 1.2250 area back in late January.
As such, **EUR/USD** is likely headed to at least a test of the trend resistance (from the major 1.3666 2004 high) in the 1.2800-1.2900 area, with commensurate extended reactions in the US dollar against the other currencies as well. However, that is not the only potential upside target (i.e. downside target for the buck.) As noted previous, if EUR/USD is going into a larger version of the same sort of triangulation as part of a topping action as the base it left back in 2000-2002, then higher targets in the 1.3250-1.3450 range are also entirely possible.

Reinforcing continued nominal general bearishness of the US dollar is the degree to which previous weak sisters like **Canadian** and **Australian dollars** have now also strengthened (with another new USD/CAD current major trend low today.) As we have noted many times previous, in spite of the extreme divergence at times, all other US dollar relationships will likely fall in line with the decision of the EUR/USD.

ENERGY
The energy markets finally weakened a bit last week, yet recovered into Friday to respect near term support on the pullback of a still very strong up trend. The previous lead contract May Crude Oil push back above the 68.00 area UP Break above the weekly down trendline and oscillator resistance. Its extended move above daily congestion and gaps, as well as exceeding the old 70.85 all time high left the June contract (now the lead) above 73.00 (weekly oscillator resistance) at the end of the week two weeks ago. While the market has slipped temporarily back below that threshold, the signals remain that any inability to fail back below the 68.00 area still point to an extended target in the 80.00 area.
May **Unleaded Gasoline** held the reaction back near the important 1.8500 area in early March, and never looked back. It has now pushed up through higher resistances that were every five cents up from there, as well as the more major psychological and technical weekly and daily resistance in the 2.0000-2.0400 gap, congestion and Fibonacci range, which it has still not quite tested on the reaction. While the market did Close the week two weeks ago above the interim resistance in the 2.1500-2.2000 range, the June contract is now back below that area. That may also portend a test of lower support in this market as well. Whether it eventually recovers back above it likely determines whether an extension to the late September 2.3700 high is likely (based upon weekly oscillator indications.)

Bernanke Blinks

While we have reviewed this in piecemeal fashion previous as it related to evolving events, we felt the Chairman's pronouncements, a general inference by the "street" about what the missives mean, and the ultimate influence of real world conditions are creating the potential for a most unsettled situation into next week; with a potentially radical result.

As noted previous, the Chairman's indication that, "In particular, even if in the Committee's judgment the risks to its objectives are not entirely balanced, at some point in the future the Committee may decide to take no action at one or more meetings in the interest of allowing

more time to receive information relevant to the outlook" was not that radical in and of itself. We have already acknowledged (last Thursday's ***TrendView*** **MARKET ALERT** right after those comments) that it is "…the actual working model of the Fed and all highly qualified central banks toward modulating their activity. Under other conditions simply stating that fact would not have much of an effect." Yet, as we went on to note directly after that, in this case it is offered as long dated fixed income has entered a new and more pernicious state since the weak Closes at the end of March.

To wit, "Amidst all of the talk of strong global growth, inflation pressures and strength of the equities markets, it is not only *not* constructive for the Fed Chairman to sound either dovish, or at the very least potentially sanguine, it is bearish for the long dated fixed income. We have already commented on the backward influence of the recently less hawkish ECB. If the Fed also allows itself to appear behind the curve because it has been overly influenced by either populist sentiment and/or its own misguided assessment that there are a number of rate increases, or is an overt level of Fed Funds that temporarily precludes further increases, they risk appearing behind the inflation curve."

In the current circumstances this is not only a general guide to the timing of his insight on a normal part of the central bank approach to inflation mandate. There are very specific real world influences that are accelerating into the FOMC meeting that is little more than a week away, and will come after what are expected to be 'no action' ECB and BoE meetings later this week. As such, if the other banks have already ceded the field to what might be pernicious influences, there will be that much more pressure on the Fed to do something significant. Chairman Bernanke's more sanguine statement may have left the Fed with the next 'conundrum', and one that is much more vexing than the previous lack of long yield escalation which Mr. Greenspan found so annoying.

We can appreciate that he was expecting quite a bit of inquiry on the future path of FOMC activity after fifteen consecutive base rate hikes. And the committee was appreciative of his more flexible stand. Yet, his attempt to defuse aggressive questioning by the committee may have misfired. He may indeed have blinked at just the wrong time.

Wild FOMC Thought

While we will extensively discuss the reasoning behind this potential below, consider this: The FOMC may decide to raise the Federal Funds rate 50 basis points on May 10th, and use the statement to signal that they are then prepared to take at least a temporary hiatus.

Of course, quite a bit of that assessment is based upon what we view as accelerating trends for many inflation indications. One of the things that was unusual about the market activity last week was the temporary forbearance of the energy market that seemed to also restrain some of the other inflationary inputs. Yet, with 20/20 hindsight, last week does appear to be only a bit of a pause in otherwise strong energy and commodity markets.

After all of the sadly typical US election cycle talk of "doing something" about energy prices that included suggestions to tune automobiles, car pool, check tire inflation and the like (the equivalent of putting a Band-Aid on sabre slash), now the US Congress is ready to write reimbursement checks for excess energy expense. Well, that'll surely bring the price down; love those US election years. That the shortage is related to problems that are as intractably geopolitical as they are economic, leaves the situation that much more volatile.

The bottom line it that the only chance to cool world commodity and energy demand is for western central banks to create the slowdowns they could not implement previous due to weakness in Europe and Japan. As Asia and India can not (or will not) overtly cool their economies, only less demand from the west will get the contraction rolling. However, this flies in the face of US consumer desires, which are inextricably linked to the political class agenda into this fall's election. Neither wants the Fed to restrain the current expansion, and indications from Mr. Bernanke have now reinforced their expectations. As noted previous, it seems both corporations and consumers remain rather confident.

Given the impetus this has provided various markets to believe the Fed will not tighten enough to restrain the economy, it is time to consider the scenario that might face the FOMC next week. As part of that we need to indulge in some technical projection scenarios. While these can (and indeed do) change without notice, certain aspects seem fairly clear at present. In order to create the most compelling picture we are also going to indulge in the unseemly role of a Cassandra painting a worst case (albeit not altogether unreasonable) scenario by postulating extensions of current technical tendencies.

Due to Gold just overrunning a major retracement percentage (the 637.00 Fibonacci 0.618 of the entire down trend from the 875.00 January 1980 high to the 252.50 August 1999 low), it is a candidate to see the 690.00 and/or 720.00 levels. As noted above, the Crude Oil above 68.00 does not get overbought again until 80.00. The CRB commodity price index has also surged to an extensive new high that suggests it will reach the 400 level prior to pausing, and all of that seems to have no lasting effect on equity markets that should be at least a bit concerned about higher costs for both materials and finance.

Consider that May 10th could very easily see Gold at 700.00, Crude Oil at 80.00, commodity prices that are continuing to accelerate to new highs, and equity markets that take it all in stride, with DJIA back near the old 11,750 all-time high from 2000. Under those conditions does anyone honestly believe that a 5.00 percent Federal Funds rate will be sufficient to cool the markets if the perception is also afoot in the land that the Fed will hold steady in June?

If not, how do the pieces of the puzzle fit together? The Fed has signaled that they also would prefer not to incrementally continue with endless incremental (and ineffectual) Fed Funds hikes, seemingly just as everyone else desires as well. Yet, if 5.00 percent is clearly not adequate to quell swelling commodity price acceleration, how does the Fed deal with the potential for an equity market bubble that forces them to burst it from a major new DJIA high? In that case (or substantially even where markets stand at present, without the further price escalation assumptions), the only "one-and-out" that works is a 50 basis point hike.

Transparency

We can hear the wailing and gnashing of teeth already, with epithets to follow. Betrayal. Misdirection. Lack of Transparency. Yet, if one closely scrutinizes all of the available information from Mr. Bernanke and the Fed since his campaign to more clearly signal future intentions, there really is no contradiction for a "data driven" FOMC. As a very good Financial Times editorial noted (and we must be clear they had no previous indication of our radical scenario expressed here, and have in no way endorsed it), the suggestion that the FOMC will possibly pause after next week's meeting creates uncertainty on both sides of the future rate decision potential. The FT aptly observes that the US is coming out of one of those lengthy periods where there is a clear trend to central bank activity into naturally foggier terrain.

Under the circumstances, it is likely that the Fed members are cognizant that any premature pause could have more pernicious consequences than the much feared 'overshoot' in this strong an economic situation. While any restrictive policy back in the very weak 2003 period had the potential to create an intractable bout of deflation (witness Japan in the early 1990's), a spill from this point in the current global cycle will likely be eminently addressable. Less so an escape to truly runaway inflation, and an equity market bubble. The latter will call for the sort of unnerving brake-slamming exercise we presume the Fed would rather avoid.

In fact, for all of the howls of the political class and concern among consumers, they will likely fare better with more restraint now as well, even if they bemoan it in the moment. We return to our party metaphor as we suggest that the Fed can either pull the punchbowl now, or suffer even greater opprobrium for everybody's hangover later.

US Dollar

As the trend here has now clarified along the lines we have expected since the beginning of the year, we will be brief. As noted above, the US dollar remains weak after the differential between weak US and strong European news on Friday. Quite a few folks still relate this to yield differentials that we almost always find a very short-sighted view of currency markets. Historically inward investment has been a much better gauge of foreign exchange trends, and that is supported by the activity from Friday into this morning. If yields really do drive the markets, then how can the Euro continue to gain on a US dollar that maintains such a premium short term interest rate?

Even assuming there is a modest degree of pre-positioning for anticipated shifts in short term rates, is it really possible that anyone is borrowing dollars dear for the privilege of selling them to allow for investment in Euros that carry yields full two percent below US dollar equivalents (much less yen that still carry no effective yield at all)? More likely the reinvigorated economy in Europe, the natural over-supply of US dollars flowing from the US twin deficits, the lapse of other technical support factors from 2005 discussed previous, and sudden risk to those who have maintained (and previous rolled over) long US dollar positions from attractive early 2005 levels are all fomenting the current weakness. As also noted above, on that basis look for more of the same.

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

-Rohr