

## **ROHR REPORT**

# ***CAPITAL MARKETS OBSERVER***

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## **Overview, Reports & Events,...**

### **...FOMC/Equities Showdown, *Quo Vadis* Transparency?, Miscellany**

#### **Overview**

Today's overview is once again brief, as quite a bit will depend on what transpires later this week when the more important reports and events impact the markets. Today is a truly slow reporting session, with tomorrow picking up just a bit with the always somewhat delayed Euro-zone Industrial New Orders (AUG), and the more important (and very contemporary) information on UK CBI Industrial Trends and US Richmond Fed (both OCT.) Yet, that pales by comparison with the economic releases and other events from Wednesday onward that will be fully reviewed in the Reports & Events section below.

While this week would normally be the back half of the US mid-month reporting vacuum, the Federal Reserve meeting and information release calendar has conspired to eliminate this normal hiatus in US influence on the markets. This not only means that we will likely see the very broadly anticipated 'no action' and balanced statement from the FOMC on Wednesday, but that the back-to-back release of the September 20th FOMC meeting minutes and Beige Book on October 11-12 meant there has been no mid-month vacuum this month.

As is typical during the normal US reporting break, there are also a significant number of important global economic and inflation indications, as well as pronouncements from financial figures this week. Whereas last week's speeches and testimony from central bankers were on mostly benign topics, this week sees more discussion of economics and inflation. As such, it is likely that without some highly improbable big surprise from the FOMC, it is easy to anticipate their decision and statement will be overshadowed by other important influences on Wednesday. Not the least will be Australian (Q3) and German (October Preliminary) CPI, as well as the German Import Price Index (SEP) and IFO- Business Climate (OCT.)

Thursday sees an avalanche of talking heads. These include the ECB's Liikanen, Trichet, Weber, Quaden, Mersch and Stark, along with the Fed's Geithner, Kroszner and Stern; the last of which is participation in a World Bank Conference panel that leaves the door open to some interesting topics. Friday is of course the first look at an expected further modest slowing of US GDP and associated data, and the last word goes to the Fed's Stern once again, speaking at lunchtime in Minneapolis on (of all things) monetary policy. All of which foments further risks beyond the reading of the FOMC statement tea leaves.

Among the most vexing dilemmas for fixed income is the combined influence of the strong equity markets and the continued escalation of non-energy commodity prices. While there still seems to be some hope at the Fed that the US housing sector weakness will spill over into the balance of the economy, as the equity market is normally considered a fairly reliable indication of the future path for the economy, no such expectation is apparent in the markets. While we must allow that the markets can at times reflect misguided consensus views (as in the US short money forwards of late), there are indications which support the current rally.

Not the least of these is strong earnings. While the corporate powers-that-be have rightfully been quite a bit more circumspect about their companies' earnings prospects in the wake of the draconian Sarbanes-Oxley sanctions for overstating the outlook, this has meant in some measure that the actual figures tend to come in above guidance. Recent S&P data releases point out that with over a third of companies reporting, 73% are beating estimates. While this is expected to diminish somewhat as the balance of the reports are released, it will still be the 18th consecutive double-digit annualized quarterly gain.

And that is in spite of the Fed's tightening to date. It is no wonder that the doves at the Fed are hoping that further weakness in housing market spills over into the economy at large. Meanwhile the hawks are warning that without that occurring the economy is likely to expand again into early next year, when further tightening will be necessary. We have much more to say below on the observations within the S&P earnings alert, and our inferences on why it means corporate planners feel compelled to engage in further extensive capital expenditure. It suffices to say for now that the Fed must either prevent the next bubble, or let things run and deal with it later. The recent *mea culpa* by Mr. Greenspan that the Fed knew fairly quickly that the 1994 tightening exercise had failed to restrain the equity markets and the economy only reinforces all of the worst case alternatives for the Bernanke Fed.

While possibly an attempt to avoid Mr. Greenspan's rookie year tribulation and triumph (that messy little 'crash' thing), allowing further equity market escalation may leave Mr. Bernanke in a similar position before the end of 2007. '*On recontre sa destinée souvent par des chemins qu'on prend pour l'éviter.*' (Our destiny is frequently met in the very paths we take to avoid it. -Jean de La Fontaine, *Fables, Book VII, fable 16, The Horoscope.*) Extensive broad background and review of specific indications regarding the Fed's dilemma (equities and inflation remaining too hot even as the US economy cools) are still available in the various analyses on the Sample Reports page of our website at [www.rohrintl.com](http://www.rohrintl.com).

With that in mind, it was quite interesting that benign economic and inflation numbers last week did not rescue the fixed income. While the **T-note** held 107-00/106-24 range support (congestion, Fibonacci 0.382 retracement of the summer rally, and weekly MA 13), and the **Bund** held the 116.80 Tolerance of the low 117.00 area support, both remained rightfully weak in the face of equity market and commodity strength. Below those supports the two long dated fixed income upside leaders turn back into failures. Indeed, weak sister **Gilt** (which can sometimes be a leading indicator for the others) did Close the week below its own 109-00-108.80 support, leaving only the previously held historic 108.50 support and its Tolerance down to the lead contract trading low at 108.31 prior to the potential slide to next support in the mid-low 107.00s. However, if the others hold, it could foment reactions back up to T-note mid 107-00 area resistance, and the Bund mid-upper 117.00 area equivalent.

Of note, the **DJIA** has finally posted a weekly Close at the 12,000 level, which Negates the 11,950 weekly oscillator resistance. This points to the more telling oscillator resistance in the 12,250 area, or extended levels into 12,500-600 and beyond. Near term supports remain back at 11,950, and every 100 points down from there, with obvious emphasis on 11,750. The foreign exchange still seems stuck in a slow moving yet firm US dollar up trend after it held the reaction to supports at **EUR/USD** 1.2630-50, **US Dollar Index** .8600, and the **USD/JPY** 118.00 area last week. Important resistance remains in the EUR/USD 1.2500 area, US Dollar Index low .8700s, and USD/JPY 120.00 area. Energy markets remain weak in spite of geopolitical/meteorological currents, as OPEC discipline and early US snow storms still left the fresh lead contract December **Crude Oil** at the low end of 60.00-59.00 support.

## Reports & Events

As we have already previewed the most important impacts from the upcoming news in the overview, this week's Reports & Events will be a more straightforward listing of the pending economic releases and expositions by financial figures. Today sees Australian PPI (3Q) and Japanese Supermarket Sales (SEP) early, followed by the ECB's Tumpel-Gugerell discussing Europe's financial markets, and Canadian Retail Sales (AUG.)

Tomorrow things pick up a bit with French Consumer Spending (SEP), the Italian Consumer Confidence Index (OCT) and Euro-Zone Current Account and Industrial New Orders (both AUG), followed by UK Car Production (SEP, 3 month YoY comparison) and CBI Industrial Trends Survey (OCT.) In the US it's only the Richmond Fed Manufacturing Index (OCT), while the ECB's Liikanen Speaks in Helsinki and Quaden Speaks in Belgium.

Wednesday starts with Japanese Merchandise Trade Balance Total (SEP) and the Australian Consumer Price Index (Q3), which include all manner of perspectives, such as Market Prices and the RBA Weighted Median and Trimmed Mean figures, along with their DEWR Skilled Vacancies (OCT.) That is followed by German Import Prices (SEP) IFO Survey(OCT) and what could be a very important German CPI (OCT Preliminary), along with French Business Confidence Indicator, Production Outlook Indicator and Own-Company Production Outlook, as well as Italian Business Confidence (all OCT.) These are followed by the US MBA Mortgage Applications (OCT 20) and Existing Home Sales (SEP), and of course, the FOMC interest rate decision and statement. Amazingly enough, there are no talking heads on Wednesday, as they are all probably resting up for Thursday.

Thursday begins with the Reserve Bank of New Zealand Official Cash Rate decision, broadly anticipated to be 'no action' from the current 7.25 percent rate. The Japanese Corporate Service Price (SEP) and Australian Conference Board Leading Index (AUG) are next. These are followed by Euro-zone GfK Consumer Confidence (NOV), Italian Hourly Wages (SEP), and UK BBA September Mortgage Approvals (SEP.) The US follows with the always erratic yet interesting Durable Good Orders (SEP), as well as Weekly Jobless Claims, and the possibly influential New Home Sales and the Help Wanted Index (both SEP.) As noted above, at various points throughout the day there are speeches or discussions featuring the ECB's Liikanen, Trichet, Weber, Quaden, Mersch and Stark, as well as the Fed's Geithner, Kroszner and Stern.

Friday is Tokyo CPI (OCT) along with other major CPI numbers (SEP), and Large Retailers' Sales and the balance of Retail Trade (both SEP.) This is followed by RBNZ Assistant Governor Don Abel speaking in Sydney, and the ECB's Gonzalez-Paramo delivering a speech on 'Prospects for Euro Region' which could be somewhat important for the markets. These are followed by UK CBI Distributive Trades Survey (OCT), and that important first look at USD GDP (Q3 Advance), including the Core PCE. The coda to this week is the Michigan Sentiment Index (OCT Final), followed by that potentially important speech by the Fed's Stern on Monetary Policy at mid-session in the US.

In addition to all of that, there is also a goodly number of either announcements or actual fixed income auctions this week. While that may foment some additional pressure on the fixed income, most of that sort of supply is usually pre-hedged by auction participants well ahead of the event; that may explain some of the residual pressure on the Gilt last week.

## FOMC/Equities Showdown

Even as the technical finesse of the market is always at least passingly important for effective risk management, the fundamentals ultimately rule. However, as was very apparent in the wake of every bubble, and even the occasional over extension of market corrections, the near term impact of sustained weakness or strength in economic news can skew the fundamental view in a manner that masks or distracts from the broader trend dynamic. For more on this, see last week's *CMO* (II-41, Monday, October 16th) section on Reporting Cycle Oscillation.

In the current environment, the ability and desire of companies to sustain earnings through top line expansion is a driver for the continued strong bullish equity market psychology that will likely also be a sustained burden for the fixed income market. In that regard, the S&P partial quarterly earnings analysis noted above is telling. From both our previous and recent conversations with Mr. Howard Silverblatt, who analyzes the earnings reports for S&P, we can tell you he is a very adept analyst of how companies tend to "characterize" earnings at the extremes of the cycles. Our view is that they do this to defend their stock valuations.

Mr. Silverblatt provides some of the best assessments of what's really going on with US corporate earnings. In fact, we first became aware of him when he appeared on a financial news show reviewing how the bottom of a recession brings marked differentials between "dressed up" reported earnings (i.e. enhanced with one-off items) and "operating" earnings. What is likely coming next? Companies telling everyone that operating earnings are so good they should ignore those annoying write downs impacting reported earnings. However, one takes that advice at their own risk, as the latest attempts at expansion not succeeding are likely a sign that top line earnings improvements necessary to support extended multiples will not be forthcoming. Yet, that factor will not likely bite until the second half of next year.

For now the numbers are impressive, even considering most corporations tend to be more circumspect these days, in rightful respect of potential Sarbanes-Oxley sanctions. The third quarter is the eighteenth consecutive double-digit year-over-year improvement, and is projected to post a 13.4% operating gain; this should go even higher as additional earnings are reported. With an actual 38% of companies reporting, earnings are very positive, with 73% beating estimates. Weighted sales are up 17%, albeit that is expected to drop a bit with additional reporting. Sales for most companies are up, but not always filtering down to the bottom line; so margins may decline from their Q2 high of 9.40% (recent average 7.52%.)

Yet, directly related to our previous observations is one of the most telling indications in the current S&P partial Q3 earnings analysis: "With margins so high, producing a greater bottom line will need to start with (the) top line." Which gets back to the other point we have been focused upon for a long time: When does all of this corporate capital investment in pursuit of an expanded top line create enough reinvigoration of the economy and sustained inflation that the other shoe falls, and the Fed gets back to hiking rates??

Two recent factors are very interesting. After that monster BLS upward revision to the benchmark Current Employment Situation three weeks ago, the equity market has become a "good news is good news, ...and so is bad news" market. Strong or weak economic news? Stabilizing or calamitous geopolitical scene? A major acrimonious political shift in the US? No problem. The equities are like the Mexican bandits in *'The Treasure of Sierra Madre'* who could show no badges to sustain their attempted masquerade as *federales*: "Lower rates? We don't need no *stinkin'* lower rates." Corporate America has adapted to 5.25% Fed Funds.

While some perceived it as an aggressively overblown inference on our part last September (2005), Mr. Greenspan's recent *mea culpa* on the Fed's failure to restrain the economy and markets with the 1994 tightening exercise reinforces all of the worst case alternatives facing the Bernanke Fed. They can either act sooner, or deal with the bubble later. We just hope to be spared someone coming out yet again and saying, "It's different this time." Not so much. It's just like all previous cycles: As long as earnings remain relatively strong in the near term, corporate planners are compelled to spend, and eat the losses from failed efforts later.

The other major point is that all of this is being reinforced by the activity in interest rate and commodity markets. Last week saw fairly benign macro-economic news, with some US and even European numbers below estimate. Yet, the fixed income market sagged right into the end of the week, and the strength of non-energy commodities has assisted the CRB Index in recovering smartly from its August-September selloff lows. From a technical perspective, the general commodity market intermediate term up trend is not even remotely as damaged to this point as the energy market up trend (which also remains in a broader bull trend as well.)

And while seemingly nervous about heading lower in the wake of weakish macro-economic news, the stale feeling of the fixed income means it may finally be dawning on that market that a major extension of the equities bull is not indicating the economic slowdown that will mitigate inflationary pressures. Of course, there is no single analytic indication which can be used to tell just when the stock market, underlying economic tendencies and corporate expansion psychology will become an explicit burden for the fixed income in spite of mixed near term economic data.

Yet, we have been cautioning for some time that at some point a major extension of the equities bull market is inconsistent with the sustained drop in yields which many feel the near term weak news, inverted US yield curve and sustained premiums in the US short money forwards seem to indicate. Has that parting of the ways finally arrived? We continue to watch the long ends of the Euro-zone and US for final confirmation.

### **Quo Vadis Transparency?**

It's been natural for Mr. Bernanke to hope that a soft landing would alleviate the need for further tightening, which would then focus blame for the ensuing recession on the Fed. However, there was never any guarantee that modest slowing would rein in core inflation enough to avoid further rate hikes. As noted above, in attempting to avoid Mr. Greenspan's rookie year tribulation and triumph, allowing further equity market escalation could still become quite a problem.

Not only could the market become overdone in the eyes of professional money managers and dealers; in disgustingly typical fashion, the mainstream media has only now chosen to focus on the equity markets in the wake of the DJIA closing at a new all-time high. There is quite a bit more on the whys and wherefores of that in Miscellany below.

Yet, the situation that Mr. Greenspan found too fragile to address back in the late 1990's does not confront Mr. Bernanke today, due to much greater global economic strength. Given that, what if Mr. Bernanke finds himself facing overly exuberant equity markets evolving into more than a little bit of a self-fulfilling (economic strength) prophecy into 2007? That would seem to beg a further significant question: If such a hypothetical moment actually arrives, what in the wide world will the ardent advocate of transparency have to say?

The really candid remark would be to note, “Well, while we had hoped to avoid it, inflation is remaining just too darned hot, and the irrationally exuberant equities are once again to blame by encouraging far too much corporate capital investment. This is more than offsetting the previous weakness of the housing sector, which in any event is now stabilizing in large measure because of this more upbeat outlook. Therefore, in order to avoid the mistake that the Fed made in letting things carry on after they realized they had restrained neither the economy nor equities market after the 1994 tightening exercise, *we’re going to run this baby to ground with sustained hikes.*” Basically, sorry folks, it’s time to pull the punchbowl.

Even if that policy shift is forced upon the Fed at some point, we presume the Chairman’s choice of words will be a bit more balanced and elegant than that. Yet, his penchant for candor aside, hopefully he recalls that his most well-respected moment after initial missteps was the rescue from opprobrium due to his more ‘Greenspan-esque’ remarks back in July. As has been persuasively articulated by New York Fed President Timothy Geithner, there is a time in the cycle when transparency works due to broadly accepted expectations for central bank activity. And there are times to do what you need to do, and provide the ‘street’ with as little information as possible; hopefully in the form of the impressively opaque, highly technical perspectives that the public and high officials alike came to appreciate from Mr. Greenspan.

## Miscellany

### Retail Investor Equity Market Participation

As noted above, in attempting to avoid Mr. Greenspan’s rookie year tribulation and triumph, allowing further equity market escalation could become quite a problem for Mr. Bernanke. And the market becoming overdone in the eyes of professional money managers and dealers may not be his only problem if the rally continues unabated. In disgustingly typical fashion, only now that the DJIA has closed at new all-time highs does mainstream media make a mendacious attempt to appear on top of this story. Beyond that, in some cases they are explicitly inquiring whether the average investor is missing out by remaining out of the market since the pain of the Dot.Com Bubble implosion.

Of course, that is not just a passing editorial question; it is *de facto* encouragement for the public to pile back in at the top of the rally. Where were these folks when the DJIA held the setbacks so solidly in the summer-fall of 2005, or even as recently as this past summer? Because they are ostensibly only reporting news and opinion, they neither need to acquire securities licenses to discuss market ideas, nor incur any liability for either failing to assist their viewers with previous timely market entry, or any future losses their audience incurs from finally chasing a significantly escalated stock market.

Yet, taking a bit of a Machiavellian view once again gives us some comfort on three levels. The first is that the politicized nature of the US mainstream media means that they have been out of touch with the fact that the economy and markets are indeed at least in decent shape. Without making any overt political statement, it is not exactly a state secret that the major US television networks are populated by folks who would just as soon have seen the economy stumble under the current administration. Not that they wish the population at large any harm; it would simply be more consistent with their instincts and *Weltanschauung*. In the event they look seriously behind the curve in now noting the strength of the markets which their conservative peers have highlighted previous.

In the second instance, after their terrible experience with the Dot.Com Bubble, it is likely that the public indeed understands the less than effective nature of broadly available analysis from generic sources. They will hopefully take this sudden enthusiasm for the equity markets by the US mainstream media with an entire canister of salt. We would hope they have fully absorbed the lesson of the apocryphal ancient Confucian proverb, "Man who trades off of headlines today, possibly out selling newspapers tomorrow."

Within that there is at least one small ray of hope for the fixed income bulls. Possibly this sudden mainstream US media affinity for the equity markets is indeed the sign that the top is nearer than not. Might Mr. Bernanke and his dovish cohorts at the Fed actually get a holiday present from the markets in the form of the DJIA sliding back well below the old all-time high at 11,750, signaling a potential top? Possibly.

Yet, in our experience, it takes more than a mild setback in the equities to signal an economic slowdown is in fact on the way. As such, at the very least the DJIA must actually knock out support as far back down as the 11,300-11,100 area which we noted since last spring was the key to whether it remained bad or rejuvenated itself. Any selloff which respects that sort of major up trend support is not likely to reverse the strong economic scenario vexing the fixed income and assisting the US dollar.

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

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