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Overview, “Smooth Rebalancing? ...or... The Crash of ’07?”Risk Contingencies, The Fed, US Housing, Forex, Germany, Equities, Debt

Overview

We are providing a bit of a different **CMO** format for this week only. The expanded analysis of various topics upon which we have been critically focused in the past several weeks required a major report on whether it's a “**Smooth Rebalancing? ...or... The Crash of ’07?**” with subsections addressing associated themes. As yesterday's **TrendView GENERAL UPDATE** already reviewed this week's **Reports & Events**, this major discussion of the risks from cross currents in evolving market trends can proceed with just a bit of a preface.

This means that this week our typical review of which current economic data and expositions by financial figures are the most important was also reviewed yesterday. In fact, due to the broad factors reviewed below not likely coming to fruition until the early part of next year, they actually have little relevance to the current reporting cycle; except to possibly illuminate the reasons why the markets do not seem to be reacting very rationally or actively to the current economic releases at times.

The additional shift in this week's **CMO** is the inclusion of some of the key technical analysis indications with the background discussion, as we prefer to do at times when such factors are closely related to the fundamental market psychology. In the last section this will therefore include rough projections of the technical levels which the US equities will need to break to violate their up trends. As a point of reference (and *not* necessarily a specific forecast of what we expect), that was a key factor in understanding when the situation back in 1987 went from the correction of a bull trend into a much more pernicious meltdown.

Of course, those levels are far below current trading levels, and we must allow that the recent US equity market strength above resistances may foment a move to more elevated levels in the near term prior to those markets becoming over-extended. As such, any consideration of those lower supports will need to be revisited for fine tuning if the markets weaken markedly. Before that can happen fundamental influences (which ultimately always determine sustained trends of markets) will need to weaken significantly early in 2007. The most telling of these might be any unexpected retrenchment in end user (i.e. consumer) demand, for which there is already some evidence.

Smooth Rebalancing? ...or... The Crash of ’07?

Risk Contingencies

It is important to note that these are indeed only contingencies until the potentials discussed here develop further, and some event or indication releases the pressures that might activate the most radical responses. However subtle and orderly to date, due to the dislocations in various markets' trends and their seeming disconnect from views of financial luminaries, some sort of rapid and potentially violent adjustment will likely unfold at some point.

That said, any one of these influences, or the economic and market trends may or may not develop according to the projections and scenarios discussed here. It is no doubt a bit of conjecture to estimate the degree to which any of them will become “disorderly.” It requires more than a bit of additional conjecture to imagine that they might operate in concert to reinforce any truly disruptive predicament in the overall economic landscape.

Yet, each is somewhat significant in its own right. That they are all occurring at the same time in an attempt to adjust domestic and international imbalances warrants closer attention than the current sanguine assumptions on corporate and systemic economic risk would seem to indicate. Especially as there are very disparate indications from the various intermarket price trend implications in their own right, and even financial luminaries’ vision of what the intermediate term future will bring, the situation can not actually be as risk free as some of the more obvious portents from pricing and projections would seem to suggest.

As just one example, if there is going to be such a robust recovery in the US from early next year, why are the Eurodollar (US short term interest rate) future forwards suggesting easing of 75 basis points in the Fed Funds rate by next summer? While we are adamantly opposed to any presumption of “predictive” value in short money forwards, what is it that the market **thinks** it sees that the Fed is missing?

And what about the other central banks? If the Eurodollar trend proves significantly correct, then there are contingencies which may mean the ECB is wholly misguided in its current hawkish stance, just as they were when they failed to ease to bolster the weak German confidence and economy into the Schroeder pension reforms. Of course, they complained later about the lack of any appetite for further reform (of which there now is absolutely none.) Moreso than any definitive conclusions, that is the sort of contingent perspective, especially as it relates to combined factors, which we will explore in this analysis.

Confident views abound on how no one area can derail the overall global economy into next year, in no small measure because of the robust nature of the Asian and Russian growth. However, by comparison those economies are not the sort of demand drivers that can replace weakness in the US if it is combined with the other major developed economies. Quite a few observers that include governments, central banks and NGOs as well as market participants are concerned about the impact if the risk factors prove more unwieldy than they are hoping. In any analysis of this type there is an edge beyond which the situation takes on a psychology of its own that is hard to reverse: the proverbial “tipping point.”

As present international economies have domestic and linked sensitive areas that are subject to very active adjustment. The combined effect of how these unfold becomes even more important than the impact on any one economy. Chaos Theory has long postulated that overt dysfunction or even perceived failures in combination across different economies has been a key component of previous economic crises. Considering all of the major economic readjustments in process, this is not a case of a lone butterfly in the Sea of Japan providing the ‘tipping’ air current that ripples out into a major storm front in the Great Plains; there are plenty of elephants bouncing off of each other in the current jungle that allow for some major damage at the watering hole if a couple of them trigger a bit of mass hysteria.

The largest acknowledged risks are global current account and currency reserve imbalances, and how their rebalancing plays out is critical; will the adjustments be very smooth or radical?

To note the observations of just one very well-regarded source, over the past two weeks the Financial Times has had multiple relevant comments on the inconsistencies in the markets' implications for the domestic and global economies into next year. Its editorial positions and articles on the US dollar were both cautionary and benign, as well as some telling coverage of how important aspects of credit spreads, Fed-speak, and the broader fixed income and equity markets are at odds. When the financial press is clearly aware that somebody or something (one or another market) is either wholly misguided or "lying" it is time for informed and casual observers alike to tighten up the flack jackets and fasten their seat belts. It rarely ends in a 'smooth' resolution.

Two more brief words of caution on these contingent risk observations: As they are based upon factors that will not likely unfold until after the first of the year, and will need to see at least two or more of the pernicious aspects combine to create any appreciable disruption in the markets, we suggest somewhat more than the usual grain of salt (skepticism) be taken with the various scenarios discussed below. Possibly something more on the order of approximately a half canister of salt is in order.

There is also the matter of our *mea culpa* that we were wrong in suggesting previous that the extended strength of the equities markets would lead the Fed to tighten further prior to those markets entering the next bubble. While the current stock market condition is more of a major 'bulge' than true bubble until it progresses somewhat further, the fact is that we expected the Fed would have used the occasion of the exuberance engendered by the DJIA approaching (much less pushing markedly through) its old all-time high at 11,750 to hike the Fed Funds rate in a preemptory cooling maneuver. We were wrong; even though with every instinct that it is not just sour grapes on our part, we still feel it would have been the right thing to do.

That said, even if they were so inclined, it is not possible for the FOMC to turn back the clock to avoid the worst excesses of the obvious US housing market bubble by maintaining a more overt vigilant posture, and push short term rates up as a way to 'jawbone' long term interest rates higher as well. That may have also acted as a means of discouraging some of the rampant corporate capital investment exuberance while at least partially limiting the credit derivatives driven cheap long term finance for M&A activity that is one of the (atypical and perverse) factors driving extended stock market strength. The questions now are moreso whether we and they would all have been better off if the Fed *had* tightened further instead of pausing, and what effects will their tepid approach now have on economies and markets?

The Fed

And that is a good question, if only because a certain number of the assumptions allowing the corporate enthusiasm for the ostensibly guaranteed revival in the economy next year would not be as broadly accepted if the Fed had been seen previous to be (consistent with their mandate) fully concerned about inflation moreso than economic growth. That would have empowered their ability to defuse strong equity markets' tendency to invigorate exuberance in the corporate sector. As the basis for that view is the well known speech by Mr. Greenspan from September 2005, we are not inclined to repeat full excerpts here which we have noted extensively previous. The highlighted full text and our previous analyses are all available on the **Sample Reports** page of our website for anyone who would like to revisit them.

However, due to his fixation on full transparency evident since his spring US Congressional Joint Economic Committee testimony, Mr. Bernanke was giving indications that he would attempt a soft landing from very early in the cooling of the US economy. That was likely still at a point in the cycle where just keeping everyone guessing would have been a more effective brake on both inflation and any equity market irrational exuberance, and by extension corporate capital investment plans. What is a potentially destabilizing factor now is the degree to which all of the recent strong earnings are buoying the stock markets and corporate enthusiasm while the consumer seems to be developing a case fatigue not just in the US but elsewhere as well (more below.)

In the meantime, the indication from the US fixed income market is for some significant economic cooling, which means they are either stuck in a belated reaction to Mr. Bernanke's recently reversed concerns about the slowing economy, or see factors (or the combination of several of them) that are inconsistent with the rosy outlook for next year. What if the global economy is slowing faster than expected due to some combination of factors not yet readily apparent, or the markets are just discounting the risk of that? More to the point, what if the modest actual slowdown the US is experiencing does not significantly rein in inflation that is exacerbated by what may be more extensive weakness of the US dollar than many expect?

This means there is a potentially toxic cocktail brewing of a stunned Fed frozen into inertia by 'stagflationary' cross currents at a time when they should have already moved. Given various factors that have left the world with more economic risk yet little respite from inflation, the Fed may have already have lost control. As Mr. Bernanke noted recently, while the Fed sees the slowing now, it is in no position of consider lowering rates due to the potential for a rebound into early next year and stubborn inflationary pressures.

That's quite a statement; and quite an expression of further conundrums that dwarf the inane ostensible problem with the US yield curve; which is not really a conundrum at all for those who understand this phase of the long term cycle (see our March 2005 "1970's Redux: Son of Stagflation" on the **Sample Reports** page of our website.) These concerns are especially relevant in consideration of the potential for a more acute global slowdown than the Fed or other central banks seem positioned for if the looming draconian German VAT hike combines with any further extensive US dollar weakness to pressure their export sector. While it will depend in part in just how far the US dollar slips into early next year (more below), that could weigh heavily on a European economic revival which the OECD (among others) is counting on the ensure the smooth adjustment of major global imbalances.

It is possible Mr. Bernanke has been more hesitant than necessary to send the right message on inflation vigilance, and the degree to which the Fed was willing to rein in equity markets to prevent another bubble. That may have been an honest attempt to avoid Mr. Greenspan's rookie year tribulation (that messy little 'crash' thing.) However, given strong equity market activity to date and its technical signals having just reinforced its ability to head for somewhat substantial higher levels, it may soon be as extended in the current rally as in all but the most over-inflated levels seen in the late 1990's bubble, and equally as extended in its rally as into the early 2004 major peak.

As such, while it may seem hard to believe it could happen a mere seven years later, and in the wake of Mr. Greenspan's clear *mea culpa* that the Fed had not moved forcefully enough to prevent the previous bubble, Mr. Bernanke may be in a similar position at some point fairly early in 2007. Which causes us to revisit the observation, "*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, 1678.*)
Destiny will now play a hand in factors that the Fed does not directly control in the domestic economy, as well as significant international factors.

US Housing

What more can we say about the US housing slump that has not already been said? Obvious weakness which brought about a full one third drop in new construction that is the overt effort by builders to clean up what were burdensome inventories is well known. Yet the drop in long term yields now sees mortgage rates that are encouraging new buyers along with refinancing that will help existing home owners. The limited number of folks who took on low interest, no down payment and/or truly exotic adjustable rate mortgages when the short term yields were exceedingly low present a bit of a problem. While they contribute to the sharp increase in delinquencies, the overall situation looks manageable to the experts who regularly assess such matters.

The only perspective we can add is that the removal of the froth from the housing market means that even the more conservative areas which did not see true speculative bubbles will likely experience a period where prices stabilize, as opposed to moving higher. While the unsold inventories have been reduced to manageable levels, and the builders are rightfully less aggressive now that construction loan costs (tied to short term interest rates) are higher while turnover is reduced, there is not much sense anybody needs to chase the price of an attractive property or risk losing out.

As such, the ever-expanding 'piggy bank' many American consumers tapped by drawing down some bit of net worth from their accumulated asset value is not increasing any longer. While the housing market may not see any further slippage, that will just be part of the normal process in the more conservative regions. Prices never actually experience what many dealers consider the typical 'retracement' endemic in more liquid, active trends. All that ever happens is that ever increasing house prices pause for some sustained period until a new impetus toward further escalation comes along. Yet, the sustained leveling off will likely leave a goodly number of US households a bit more defensive about leveraging any more equity out of their primary asset. That may be inconsistent with further gains in end user turnover upon which at least part of the future earnings and current company valuations are based.

Forex

That previous point does not even begin to address the degree to which businesses based upon turnover of imported products may be hit by the higher prices from further significant devaluation of the US dollar. There are many voices calling for the US dollar slide to remain orderly, including a wonderful metaphor in last Tuesday's Financial Times ("Dollar dynamics are an economic danger") pointing out the difference between a dollar that is gently swaying from modest consumption of Chianti, versus "lurching like a 16-year old swigging a bottle of tequila." For reasons which in no way include a preference for tequila over Chianti, we tend toward the "lurching" camp. This is based on technical factors explored in detail below.

Even Jean-Philippe Cotis, estimable Chief Economist of the OECD, titled his editorial at the beginning of his organization's major semi-annual Economic Outlook "Smooth Rebalancing?" (which we obviously poached for the first half of our title of this report.) While he does a fine

job of articulating reasons that the rebalancing may indeed be smooth, as the question mark at the end of the title suggests there are factors which might become disruptive. One key point early in the editorial stated, "In the euro area, recent hard data as well as business and consumer confidence suggest that a solid upswing may be underway." And this is major reason for cheer that... "Rather than a major slowdown, what the world economy may be facing is a rebalancing of growth..." ...with that strength in Europe a key factor for why... "...the slowdown in (the US and Japan) should remain well-contained."

All fine and good until one considers the date of that comment, which was drafted into November 24th and released on Tuesday the 28th (notable as the same day the FT editorial noted the risks attendant to any sharp downward lurch in the US currency.) As such, it does not deal in any way with the degree to which the US dollar is back in what may well be an extensive devaluation. And that has implications for some of the OECD's expectations for how the most important economy in Europe might evolve into next year.

The summary projections for the Euro area in the table accompanying Mr. Cotis' editorial comment looks extremely sanguine for the next couple of years, with 2007 Real GDP growth slipping three tenths to 2.2 percent prior to recovering a bit into 2008. Certainly nothing could be much 'smoother' than that. Yet, a look at the specific figures for Germany is quite a bit less comforting. While Private Consumption is estimated to have expanded by 0.8 percent in 2006 from just 0.3 percent in 2005 (and up from negative ground in 2004), the 2007 outlook is for slippage back down to just 0.3 percent. While the extended projection into 2008 is a very upbeat plus 1.8 percent against the low estimate for 2007, that can only have incorporated the impact of the VAT increase, and not any significant US dollar devaluation as well.

Where that comes home to roost in the international picture is the compound effect of the potential for a weaker German export sector, which has remained the engine of growth for their economy, while their domestic economy remains weakish. This is explicitly addressed in the extended portion of the risk factors which caused Mr. Cotis to pose his opinion as at least a bit of a question instead of a *fait accompli*. To wit,...

"With housing headwinds already affecting the US economy and at risk of materialising elsewhere, it would help the world economy that domestic and household spending fully revive where they have been lagging behind. This challenge may be progressively met in economies such as Germany and Japan, but the outlook for household spending remains somewhat fragile and these countries' current account surpluses would continue to build up, exceeding 5% of GDP by 2008."

As we review below, chances for a German consumer renaissance coming in the face of the January VAT hike were always problematic. If there is concern about competitiveness of the export sector just as German workers were looking forward to their first (mostly government and industry supported) wage hikes in a long time, that could be a real burden on the very economy the OECD is looking to support the continued expansion in Europe. It is incumbent on German industry to maintain the past couple of years' competitiveness gains; any need to defend global market share with lower prices is inconsistent with wage increases that might promote German consumer confidence. The next question for the OECD is whether their hopes for a smooth rebalancing can be fulfilled if German private consumption actually contracts in 2007 instead of remaining mildly positive?

Technical indications for the US dollar do not afford much room for optimism in that regard, as there are fairly compelling signs that it will weaken further for what will likely end up being a full 10 percent devaluation against the Euro by not later than the end of the first quarter, and possibly sooner. Technical projections for the US dollar trend will be discussed first in terms of the Euro's relationship to the buck (EUR/USD.) The reason for this is twofold. In the first instance, it is presumed any sizable adjustment of US dollar exchange rate will be much more exaggerated against the free floating European currencies due to manner in which many Asian currencies defend fixed, or highly managed, exchange rates with the US currency.

Secondly, even as compared to the other free floating currencies, the Euro warrants additional specific analysis to fully review the unique aspects of a currency which has only existed in official form since January 1999, and thereby requires the use of a historic synthetic 'basket' of the composite currencies in the official European monetary unit for purposes of tracking and analyzing its long term history. The equivalent indications for the other relevant major currencies will also be covered briefly after the technical contingencies suggested by the price activity in EUR/USD are discussed. In those cases the actual technical indication and historic levels will, of course, be based upon actual historic trade.

The fact is that from the time EUR/USD did not remain below the major 1.1900 DOWN Break from November 2005, it was more likely to demonstrate the major 1.3666 December 2004 high was not the end of the US dollar bear trend. We will anticipate the howls of protest from fundamental and economic analysts who are right now spewing forth their typical barrage of brickbats that nothing as feeble as technical analysis could possibly have produced anything remotely resembling that sort of cogent long term analysis.

We've got bad news for them: not only did it do so across a range of currencies against the US dollar; that analysis is founded on the most basic and reliable of technical indications. The major technical view is very simple, albeit very long term, thereby requiring a good deal perspective and patience: The 1.3666 high was the peak of a major Head & Shoulders Top. When the 1.1900 DOWN Break from that pattern was Negated (i.e. shown to be a false signal) on successively stronger recoveries back above that area from late 2005 into 2006, the indication evolved. It became a sign that the market would confirm that old high of the pattern was *not* the end of the up trend, and (at some point) EUR/USD will trade well above it. As much as some folks do not fully understand, like or trust technical analysis, this is where its "trend logic" is a useful adjunct to a well articulated fundamental trend analysis.

As EUR/USD extends its trend above lower violated resistances (now supports) in the 1.2900 and 1.3100-25 range, there is not much further resistance from 'official' Euro trading (since its January 1999 inception) until the 1.3450-1.3550 area, and the major 1.3666 trading high from December 2004. However, even as those levels are likely overrun on a move to the new ostensible "all-time high" as part of overall Negation of the failed H&S Top, there are trading areas based on the interim congestion resistance of the pre-official Euro launch equivalent 'basket' at 1.4250 (from mid 1995) and back at the approximate 'synthetic' all-time EUR/USD March 1995 high (i.e. US dollar low) at 1.4535. That was all part of the major secular US dollar selloff against other currencies at that time as well.

Indeed the equivalent US Dollar Index indication is a failed Inverted H&S Bottom (obviously 'inverse' to the topping pattern in the EUR/USD.) The time frames are similar for that and each of the other currencies noted below. That experienced a Negation of its major .9000 area UP Break that leaves the .8039 December 2004 low vulnerable, with interim support in

the .8125 area along the way. Yet as opposed to the synthetic history necessary to articulate the further US dollar supports below that in the case of the Euro, the US Dollar Index has actual previous trading support from lows in 1995 and even as far back as 1992 in the .8000 area and .7900-.7820 range, respectively. Those supports are also consistent with the longer term moving average difference oscillator thresholds, below which the US dollar Index might be on fresh downward acceleration to levels moreso in the mid-.7000 area (similarly oversold levels were last seen on the sharp falls in 2002 and 2003.) Similar oscillator targets reinforce the higher EUR/USD resistance into the 1.4250 and low 1.4500 areas.

The point of which is not so much to demonstrate the veracity or reliability of technical trend analysis techniques. Those projections remain contingencies that may or may not be fulfilled, just as is the case for fundamental analyses which deal with shifting variables across time. The current technical projections are moreso useful as a 'most likely case' scenario now that it is ever more obvious the previous topping attempt of EUR/USD is failing to perform, and by (literal) extension they offer some well-defined parameters by which to assess the degree to which the US dollar will likely continue to fall before reaching historically meaningful levels.

Some degree of "self-fulfilling prophesy" no doubt infects this form of analysis on some level. Yet, as it applies to the major long term projections, that is no less true of the sometimes prescient and occasionally misplaced psychologies inherent in fundamental analysis as well. And the well schooled technical analysts have the luxury of acknowledging their craft exists as a perspective and risk management adjunct to trends that are driven by supply/demand relationships or fundamental psychologies.

The perspective (or "trend logic") in this case is telling: If there is any reasonable chance technical contingencies for the US dollar failing the lows of late 2004 are accurate (as has already occurred against current strong sister British pound above 1.9550 on its merry way back to 1991-1992 highs in the 2.0100 area), then the US dollar break will be very significant. Those next supports on both historic trading zones and oscillator projections from current long term moving average indications represent roughly a ten percent devaluation in fairly short order. Anything like that occurring by the end of December is not very likely with the previous trading congestion and old high buffering any weakness in the buck (unless the US economic data takes an even sharper turn for the worse.) However, that devaluation taking place by the end of the first quarter of next year is quite a bit more likely.

Even across the more extended time frame that still represents moreso what most folks would consider the FT's tequila-besotted lurch than a smooth Chianti wobble. As the OECD and many other have noted, the capacity of both US and European exporters to adjust to that sort of shock is problematic. Maybe yes; maybe not. Yet, if not, then one potential outcome of the most likely scenarios is a drop in asset prices. And foreign exchange it just one influence that might combine with others to exacerbate that tendency. This is also a perception about which most financial market participants are still fairly sanguine at present.

To complete the technical considerations we promised, the following parameters are the key levels for those markets which had H&S patterns similar to US Dollar Index and EUR/USD. The USD/CHF (Swiss franc) experience a subsequently Negated 1.3040 major UP Break, with late 2004-early 2005 support all the way down at 1.1500 and 1.1300 areas, and extended historic support not until the 1.1116 April 1995 all-time low, and oscillator thresholds into the 1.0900 and the 1.0500-.10400 area. Similar parameters do not exist for Canadian

and Australian dollars, as the US dollar remained relatively weak against these commodity centric economies, and never completed major pattern bottoms during 2004-2005.

On one hand it's incredible, and on the other hand not so astounding at all that the USD/JPY (Japanese yen) still has the US dollar holding its mid 113.00 area H&S Bottom UP Break. *That* speaks volumes about why radical risk is there for the free floating currencies of Europe, and all of the economies that would be far better served by Mr. Cotis' "Smooth Rebalancing." As the US takes some time to come out of its slowdown, and Japan remains less than robust, not the least of those economies is Europe which is also being counted on for replacement growth, and especially its most prominent economy in Germany.

Germany

As noted elsewhere in previous analysis, one factor which might well explain quite a bit of how the 'strong economy' German Bund has remained well bid along with 'weak economy' US long ends is the now imminent imposition of the draconian three percent increase in German VAT from the first of January 2007. In other words, the markets are saying that the German businesses that were polled by IFO for their recent strong survey release have it dead wrong; and well they might. There is a precedent for this which we have previously noted in passing: the Japanese consumption tax increase of April 1997, which cratered the recovery building up from shortly after the 1990 real estate bubble implosion through 1996.

Instead of plugging a fiscal hole, the degree to which Japanese consumers were disciplined enough to pre-purchase necessary items and then snap the purse strings shut had the effect of sharply lowering tax revenues instead of increasing them. In 1997, the consumption tax in Japan was raised by 2 percentage points (less than that looming in Germany), and that broke the back of the fragile economic recovery that was underway in Japan at the same time. Japanese consumption had grown by an average of 2.3 per cent annually from 1991 to 1996. In the year following the tax increase, Japanese consumption collapsed by 3 per cent, and consumption growth in the following five-year period averaged a meager 0.2 per cent. The net global effect was likely at least some significant contribution to the Asian Crisis of 1997.

So, have German consumers developed the spending "habit" like counterparts in America, or will they moreso show the discipline of the Japanese consumer? From the complexion of the debt markets, it is starting to feel like the markets are betting that they will be very disciplined. It is of interest that one of the key factors which assisted equity markets in addition to cheap finance noted above is the surprising resurgence of the German and European economies, presently growing at rates acknowledged to be above their long term trend growth.

A new dawn of Japanese retail activity was hypothesized on the back of strong consumer activity prior to their VAT increase; the subsequent slump was that much more devastating. Might the current extensive bulge in the Euro-economy just be reflecting German consumer spending in anticipation of the VAT hike?

Equity markets may be very vulnerable if evidence of a German retail shutdown surfaces in January, which would now be exacerbated by predations from a weaker US dollar pressuring their extremely important export sector (see the OECD references above.) . The implications for the markets might be that strong earnings assumptions which have spurred the current equity bull market and much quicker than expected resurgence in M&A activity after the

bloodbath at the end of the Dot.Com debacle could quickly reverse into another shockingly weak equity market.

Of course, the implication for fixed income would be that much more bullish if sudden reversal into weakness in Germany offsets anticipation of a return to a more robust US economy next year (housing market concerns notwithstanding.) The cheapness of equity buyout finance which is based on yields that are relatively lower in this long term cycle adjustment than was typical during the intermediate cycles of the 1980's and 1990's explains quite a bit about how the equities are sustaining their rally in spite of a potentially weak outlook.

However, much as was the situation with the Japanese VAT hike ten years ago, markets will have a hard time making up their minds in the face of extreme uncertainty which surrounds the actual response of the German consumer in the first part of next year.

We must also note that in quite a few recent experiences where higher taxes led to economic recoveries instead of depressions, there has been a very simple explanation: the increase in taxes was combined with a sharp reduction in interest rates and currency devaluation. If the German tax increase were combined with a dramatic reduction in European interest rates that reversed the strength of the Euro, it would certainly be possible to imagine Germany (and by extension Europe) continuing to enjoy a strong economic recovery.

However, the European Central Bank seems to be planning a rise, rather than a cut, in interest rates. They have also been among the most recalcitrant in their (albeit mandated) fixation on inflation that does not leave much room for expectations of easing in anything less than a blatant global equity market meltdown. While the Bank of England is much more responsive to facts on the ground, they have also been hawkish of late. This may explain to some goodly degree the premiums (i.e. lower short term yield projections) now evident in the Eurodollar future forwards. The markets seem to be discounting the risk that the US will be left doing all or most of the heavy lifting if some calamity does befall the global economy, much as was the case from early 2003 through early 2004.

Equities

The 'received wisdom' on equities is that low cost of finance is due to a global 'savings glut' that will continue to chase fixed income yield even in unattractive corporate debt with only the slightest premiums to government bonds, and that will allow a continued boom in corporate earnings to continue from anything modestly resembling the current turnover and earnings. Therefore, in spite of the current geopolitical challenges, and the degree to which the fixed income markets do not seem to confirm the rosy outlook, the equities remain strong. Yet, that presumption that the 'global savings glut' will continue to keep interest rates low at the same time that consumers continue to, well, consume in the face of a weaker housing market and what may be the beginning of a softening jobs market (per weekly US unemployment insurance claims), the equities must be deemed as "priced for perfection."

The last time the market was in such an overwhelmingly friendly investment psychology was directly after New Years Day 2000. The Y2K threat had been dodged without any impact. Considering that, the Dot.Com juggernaut was surely going to make continued exponential economic expansion a real possibility in the new economy, while the ancillary old economy businesses such as packaging and transportation that delivered all of the goodies purchased

on-line would surely prosper as well. Nothing but blue skies ahead, with nary a cloud on any of the distant horizons.

Of course, all of that positive expectation was in the market, along with all of the bulls' money; so there was not much appetite for further purchases when the bad news that some of the six brilliant young Dot.Com companies that all entered the same sub-sector with solid projections that each would control 60% of that 'space' within two years (for those of you who can't lay your hands on your calculators just now, that's a total of 360% of the available 100% of market share in that sub-sector) started hemorrhaging red ink. It illustrates the problem of extrapolating projections from the best periods in the economy (or the worst periods at the bottom of the cycle) out to infinity. There are always subtle changes in various activities (with consumers leading on recent form) which foment the economic ripples which prove the rosier prospects wrong. The Cassandras' predictions of the death of capitalism at the bottom of the cycle are never accurate or realistic; certainly no more so than the empire builders' euphoric outlook at the top.

The trick is to take the pulse of the underlying demand to see if it is quickening or fading, and in this we refer back to the 'animal spirits' noted by Keynes, which are as much an influence on economic activity as any deductions from analysis. The questions now seem to revolve around whether the very robust animal spirits of international corporate planners encourage the end consumer once again, or if other factors will dull the consumers' appetite in a manner which dashes the upbeat projections which have been extended *ad infinitum*.

And so we are back to the consideration of which is more telling, consumer sentiment or corporate plans? It is necessary to allow that corporate economic sentiment and consumer activity can be significantly out of synchronization at some points in the cycle. That said, recall how buoyant consumers were after September 11, 2001, while corporate executives remained very downbeat until well into the 2003 equity market rally. Might the consumers' instincts (and ultimate control of retail turnover) once again trump the corporate opinion if the end users retrench into next year?

As we have noted previous, it seems the equity market went from a "bad news is good news" market that restrained FOMC hawkishness to a "good news is good news" strong earnings driven market as part of maintaining its over all rally. Yet, even with weaker consumer expectations in the US and some questions still hanging over Europe and Japan, might there have been another rationale along with the sustained strong earnings outlook which eclipsed that as a rationale for the extended equity market up trend?

Did the market at some point use the low long term yields to become a "cheap finance is good news" market? There does not seem much doubt at this point that near term sustained strong earnings leave attractively low long term yields as a cheap source of funding for buyouts that are less expensive with borrowed funds than by raising equity. Along with that, corporate credit spreads (premium to risk free government bond yields) remain at what would seem to be perversely historic lows; especially as this is more than a bit inconsistent with perceptions that long yields are indeed low in part due to the likelihood of a slowdown in the US next year.

It is the ultimate extension of the "soft landing" hypothesis the Fed has so far successfully promulgated. Any sharper slowdown than a soft landing might spell trouble for the current crop of debt driven buyouts and corporate earnings in general. The two factors which drive

the point home on the current quasi-euphoric view of economic and equity market prospects are the combination of the surprising strength of small cap stocks outperforming the large cap competitors, and the loosely related incidence of smaller companies finding funds readily available to finance buyouts of their larger rivals. While there is always something to be said for aggressive and enlightened managements deserving an opportunity to shepherd larger concerns, when this sort of thing becomes very widespread it tends to be a sign of classic 'over exuberance.' In any event, the excesses so far seeming more of a 'credit' bubble than true equity market bubble gives us no comfort.

At present there are also very upbeat projections for the US jobs market, and these are likely tied back to the very friendly corporate capital investment plans which can indeed drive the economy for a goodly while all on their own. The cautionary view is that those are based on somewhat tautological corporate views of current turnover and earnings.

However, we have noticed a tendency in subsets of US and UK GDP, construction spending, consumer sentiment and the like, as well as some other indications for the Asian and European economies for consumers to be in a more conservative mood than the ebullient corporate projections allow. And end user demand (or the lack of it) will be the key factor. Whether the consumer RSVP's in the affirmative will likely decide whether the economic party continues through 2007. Unlike previous economic cycles, the Fed evidently may not need to pull the punchbowl; consumer may just decide they are tired of the high.

The best measure which we can readily monitor is the technical trend analysis of the US equity markets, where the equivalents of the higher end (but not the most extreme) late 1990's weekly oscillator resistances are into the DJIA 12,700 and low 13,000 areas late this year into early next. The similar thresholds for the S&P 500 (lead contract) future are in the 1,450 and 1,490-1,500 areas that are also reinforced by historic trading in 2000.

Of course, all of those overbought parameters are only good guides to where the markets might top out on the current extended rally from the major 2002 lows. More important for any calamity from the combined factors which we noted in the fundamental background is where the major lower technical supports will be, and that must allow for the move to higher ground first to be realistic.

Presuming the current up trend in the DJIA will hypothetically end with a push up into the extended resistance at 12,700 into January (allowing for the early year investment surge), the major lower channel support will be all the way back down in the 10,100 area early next year (i.e. into February and March.) However, the straight trendline support will move up into the 11,300 area into February.

This is of interest because, as you may recall, that was roughly the May congestion area the market needed to exceed on the recovery from the summer reaction to turn more bullish again last August. That area will also become the 0.250 Fibonacci retracement of any move up to that hypothetical 12,700 area top (from the 7,197.50 October 2002 major cycle low), with next significant supports below all the way back down in the 10,500 and 10,000 areas.

The S&P 500 (lead contract) future has similar indications to the DJIA, yet predictably more subdued, with the presumption of a hypothetical extended trading high in January into the 1,450 area leaving the major channel trend support all the way back down into the 1,185 area

early next year. Yet, that market's straight trendline support will also move up into the low 1,300 area into February as well.

Much like the DJIA, this is of interest because that was the March-April 2006 congestion which the S&P needed to exceed on the recovery to push through a key weekly oscillator resistance as well. That made its success that much more compelling, and contributed to the aggressive nature of the trend extension we have witnessed since September. The nearby upper 1,200 area is also the hypothetical equivalent of that major DJIA Fibonacci 0.250 retracement if the S&P moves up to that top projection anywhere around the 1,450 area.

All of which feels a long way down from current levels in markets which we suspect will still extend their rallies first. Yet, the October 1987 DJIA 2,250 major channel support projection (that's right, two thousand, two hundred fifty) from the 1,080 mid 1984 low felt a long way down from the 2,746.60 late August high. It breached it less than sixty days later. It was also the Fibonacci 0.250 retracement from the last major low below 1,000 (at 770 in August 1982) prior to the DJIA exceeding that level forever; well, at least we hope it's forever.

We seem to recall that technical factors were also driving a market that some perceived as quite overbought at that time, with major foreign exchange concerns revolving around a weak US dollar resuming an aggressive down trend after a six month trading range. While there are quite a few good reasons the current equity market should not be anywhere near as vulnerable as the 1987 DJIA, moreso than usual complacency based upon any of the received wisdom is ill-advised.

Debt

Regarding the near term trend in the fixed income, that is even more of a problematic affair than the others at present, and bit of a sideshow. It is obvious the markets are not trending in a manner consistent with the various Fed luminaries' indications for the future path of the US economy into next year. With that in mind, fixed income is likely to trend grudgingly higher in the near term as long as the (lead contract) T-note future does not break the major support all the way back down in the mid 107-00 area (interim support is the mid-low 108-00s.) Yet it has initial hefty resistance into the low-mid 110-00 area. That said, any extended sharp weakness in the equities might encourage a move to more major resistances in the low-mid 112-00 area, or even the 114-00 area.

Yet, any rally based upon weak economic indications or equity market performance will still need to be reviewed in light of whether stubborn inflation tendencies have been reversed on trend in spite of the weak US dollar. If not, then the long dated fixed income, and even short money to some degree will be vulnerable once the economy and/or equities show and signs of renewed life after the major setback. Recall that while the 1973 Arab-Israeli War was the ostensible trigger for that year's commencement of the first Oil Embargo, the commercial reason behind it was the consistent multi-year slide of the US dollar. So, even a fairly significant economic retrenchment might not eliminate the inflation in US dollar terms.

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

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