ROHR REPORT

CAPITAL MARKETS OBSERVER

Volume III Number 18

Tuesday, May 1, 2007

Overview, Reports & Events, Markets,…
…Multiple Cycle Divergences, 'Falstaff' Equities

Overview

Other than the US Employment report (APR) at the end of the week, the real focus in this week's calendar (right into next week) is… the calendar. Due to the displacements created by early May holidays there is a significant disruption of the normal monthly flow of markets influences, and that is important enough to revisit in the lower half of today's Overview.

While we had much more to say on the sources of the extended support for the US equities trend in last week's *CAPITAL MARKETS OBSERVER* III-17 topical discussion of 'Long Tails', after yesterday's setback it is important to note that the near term **DJIA** support is back down around the previous late February 12,800 area highs. That is also now aggressive up channel support from the mid-March reaction low, and short of a violation of that level the market maintains its aggressive upward momentum. The equivalent level for the weaker **S&P 500** future is in the 1,460 area (i.e. right around the low end of the previously noted UP Runaway Gap.) That said, the setbacks yesterday reinforced important oscillator resistance, especially in the DJIA that left a One Day DOWN CPR after setting a new high.

Due to its Tolerance being Friday's 13,148 high, it will both be reinforcement for resistance, as well as lend extra momentum to any violation of the ultimate sign of whether DJIA is reigniting into a more accelerated up trend above weekly oscillator resistance above 13,150 this week. S&P 500 future lead contract equivalent this week is 1,515. On current form, any strength in the US will likely mean that Europe leads and Japan lags. The only way there can be a major reversal of the equities is for the weak sister US market to break extended lower support, most critically DJIA 12,600 and 12,500-12,450.

What was striking about the market response to equity strength last week was not that the US rallied, but moreso that it did not proceed further in the wake of such weak news. The June **T-note** ability to provide a more telling violation of the 108-08/-10 resistance is now being retested, and that will have an influence elsewhere. Yet, whatever transpires in the equity markets, below trend US growth seems to be weighing on a US dollar where **EUR/USD** remains nervously on the verge of violating its 1.3666 trend high from December 2004.

Yet, all of these decisions will take place in the context of displacements in report releases, the first of which is the delay this week of the continental European Purchasing Managers' Indices due to today's Labor Day holiday, while the UK Early Bank holiday is next Monday. Of course, Japan was closed yesterday, and will do so again on both Thursday and Friday. The holidays are definitely having an effect on central bank schedules as well that leave the Reserve Bank of Australia as the only rate decision this week, along with the release of their Quarterly Monetary Policy Statement on Friday. That leaves the Bank of England and ECB early month interest rate decisions pushed off until next Thursday, and (as luck would have it) that means the less regularly scheduled FOMC decision precedes them next Wednesday.

Reports & Events

Some of what follows will be as noted above in the calendar preview. Japan is closed today for Greenery Day, so economic releases began with a raft of weakish data out of Europe on everything from Italian CPI (APR Preliminary) to German Retail Sales (MAR) that virtually imploded. That was followed by mixed US Personal Income and Consumption (MAR), which in spite of mild upward revisions to last month's data had constructively weak overt spending and Personal Consumption Expenditure (PCE) Deflator figures. All of which has assisted the fixed income and weighed on equities and the US dollar (after its initial strong activity in the wake of the weakish European numbers yesterday.) The very weak Chicago PMI was also a mixed indication, as the Prices Paid component was higher, which was reminiscent of the dichotomy on last week's Advance US Q1 GDP figures. US Construction Spending (MAR) came in about as expected, yet there was a strong upward revision to the February numbers (from +0.3 to +1.5 percent), with some strength in residential housing having an impact. Yet, it is important to keep in mind that all of this was heavily influenced by weather extremes that are likely distorting the month-on-month figures.

Today began with the weaker than expected Australian AiG Performance of Manufacturing Index (APR) kicking off the early month round of purchasing managers' indices, followed by weak Japanese Labor Cash Earnings and Overtime Earnings (both MAR), as well as Vehicle Sales (APR), after which it was back to Australia for Reserve Bank of Australia's Commodity Index (APR) that came in quite strong at up 2.0 percent on the month. That was both not very surprising due to increased base metals prices, and a further illustration of the budding stagflation dilemma facing central banks. With continental Europe closed for Labor Day (or May Day for the die-hard Communists) holiday, the data shifts to the UK for the HBOS Plc House Price Index (rolling quarterly figures for APR), and the Purchasing Managers' Index Manufacturing Survey (also APR.) Then it's over to the US for Pending Home Sales (MAR) and the ISM Manufacturing Index (APR) along with its important Prices Paid component, as well as Fed Chairman Bernanke speaking on free trade in Butte, Montana.

Even though Japan is open on Wednesday, there are no critical economic data releases, so the day kicks off with the Reserve Bank of Australia Rate Decision (a broadly expected 'no action' at 6.25 percent), followed by their DEWR Skilled Vacancies (APR.) Europe follows with the German ILO Unemployment Rate (MAR), and French Housing Starts and Housing Permits Change (rolling quarterly figures for MAR.) Then it's on to German Unemployment Change and Unemployment Rate (APR) along with the slightly delayed various Euro-zone Manufacturing PMI's (APR), and UK PMI Construction (also APR) along with various of their Money Supply and Lending figures (MAR Final), which include Net Consumer Credit, Net Lending Secured on Dwellings and Mortgage Approvals.

All of that is followed by the Euro-Zone Unemployment Rate (MAR), prior to shifting over to the US for MBA Mortgage Applications (for the week ending April 27), Challenger Job Cuts and the ADP Employment Change (both APR), Factory Orders and Inventories (MAR), as well as EIA Crude Oil Stocks (for the week ending April 27) that may become more prominent once again in light of the recent recovery in energy prices. The talking heads in the morning US time are also very interesting, beginning with the Fed's Poole speaking at a community development conference, followed by potentially more critical market influences from the ECB's Papademos speaking in Athens, and especially US Treasury Secretary Paulson discussing China's economy, and trade issues in general in Washington.

Japan is closed again on Thursday for Constitution Day, so economic releases begin with the OECD release of their international CPI figures (MAR), followed by UK Official Reserve Changes and Purchasing Managers Services Index (both APR), Euro-Zone PPI (MAR) and the ECB's Stark speaking in Frankfurt as a prelude to the US Monster Employment Index (APR) and more telling Nonfarm Productivity and Unit Labor Costs (Q1 Preliminary), Weekly Initial Jobless Claims and ISM Non-Manufacturing Index (APR), all rounded out by the ECB's Tumpel-Gugerell speaking in Santa Fe.

Friday is yet another holiday in Japan (the always useful generic ”National Holiday”), so economic releases begin with the Australian Trade Balance (MAR) and their (always interesting) Reserve Bank Quarterly Monetary Policy Statement, followed by the various, once again holiday-deferred Euro-Zone Services PMI’s (APR), as well as Euro-Zone Retail Sales (MAR.) All of which is the prelude to the final decisive news of the first week, the US Employment report (APR.) After that, it’s the “Revenge of the Financial Luminaries.” Remember last week, when we noted what a joy it was to not need to deal with random pronouncements after the release of the US economic data? No such luck this week!

From early to late morning there will be exposition from the Bank of Canada's Governor Dodge speaking on floating exchange rates, followed by the Fed's Geithner on the global economy (both in Montreal), with the Fed's Hoenig speaking at the conference in Santa Fe, and all concluding with Reserve Bank of Australia Assistant Governor Philip Lowe. The last bit may not be very trend decisive, as the Assistant Governor is speaking on ‘Non-Banks in the Payments System: A Central Bank Perspective’ at that Federal Reserve Bank of Kansas City Conference on 'Nonbanks in the Payments System: Innovation, Competition and Risk' in Santa Fe. That will be at 11:00 CDT (12:00 EDT; 16:00 GMT), which we note is at the decidedly inconvenient 02:00 Australian EST, and wonder if anyone there will be watching? Possibly a good pay-per-view event for Down Under insomniacs.

Markets

EQUITIES

The **DJIA** was indeed as over-extended on classical oscillator threshold indications from late last week into early this week as during November-February on its various tests of (gradually rising) oscillator resistance at 1,000 points above weekly MA 41. As noted previous this week that has risen to 13,150. If it can get through that resistance, now reinforced by yesterday’s modest Daily DOWN CPR, it might mean a revisit to extended overbought levels

The next of those above the 1,000 point premium to MA 41 is 1,250 (i.e. at least 13,350-13,400 on a weekly Close.) The near term DJIA support is down around the late February 12,800 area highs, as that is also now aggressive up channel support from the mid-March reaction low. The equivalent level for weaker **S&P 500** future is in the 1,460 area (i.e. right around the low end of the previously noted UP Runaway Gap.) Also as noted above, the only way there can be a reversal of the equities is for the weak sister US market to break support, most critically DJIA 12,600 and 12,500-12,450.

S&P 500 future lead contract (June) equivalents for critical oscillator resistance is 1,515 this week and 1,520 next. Of course, that assumes it is also not ready to ‘accelerate’ (often the case when the up trend is sustained for a long period); extended resistances are not until the 1,530 and 1,545 areas.

The interesting aspect of the S&P future is its Runaway Gap higher on the week two weeks ago above the previous late February high. That was a leap above the previous high of the aggressive rally since the mid-March significant low. While this was somewhat impressive on the daily chart, it was even more telling on the weekly continuation chart. Due to the premium in the June contract to the previous lead contract (March), while it only 'traded' through the February previous high on the contract after that gap higher, on the continuation chart it gapped the old late February 1,464.50 high; a very telling sign.

Unless the bears can get the proverbial genie back into the bottle (which now includes breaking that current aggressive up channel support) by having the June contract post at least a daily (and ultimately a weekly) Close back below the bottom of that 1,466.90-1,461.50 Runaway Gap, it enhances the potential for that acceleration to occur. In fact the Objective projection attendant to the Runaway Gap is a lead contract target of 1,565.40. Interim support is the 1,477.50-75 range, which is the congestion around the contract's violated February high.

Similar conditions are evident in the other equities. Viewing it through the prism of developed economies' upside leader, the DAX is just getting up to its own resistance at 1,000-1,100 over weekly MA 41 for the first time in this cycle; that allows for the extension of the current trend to the 7,500 area mid-2000 congestion we noted was possible once 7,085 was exceeded. Again, that presumes it is also not ready to accelerate; if perchance it is, those same late 1990's into 2000 extensions project to 1,250 or even 1,400-1,500 better than weekly MA 41 (i.e. 7,750, or even 7,850-8,000 on a weekly Close.) It will also be interesting to see how well the DAX holds lower support tomorrow after posting a strong Close yesterday due to that occurring prior to the late session US market weakness.

FTSE is still back above 6,315-30 and 6,355-80, yet has continued to falter from modestly above the next interim trading resistance in the mid 6,400s reached in February, which did not quite reach extended historic congestion resistance in the low-mid 6,500 area finally hit early last week. Yet, due to it lagging the DAX, it is not really overbought at all. Extended resistances above current highs are not until the mid-6,600 and low 6,700 areas.

The **NIKKEI** still seems burdened by the return to somewhat weaker news in Japan, and has struggled with the 17,500-600 area from which it is now grinding slowly back toward lower supports in 17,050-16,880 and possibly as low as the 16,600-500 areas. It still seems only a further push through resistance in the DJIA will assist Japan in Negating the 17,500-600 area resistance, and 17,750-850 range, with extended resistance at the 18,315 February high.

FIXED INCOME

As noted previous, more critical trend support tests unfolded in Europe due to the relatively stronger state of the European economies and equity markets which has once again been demonstrated on the most recent price swings. All of which keeps the pressure on its already weak fixed income. Downside leader **Gilt** was already well below support in the 108.00 area and below the 107.62 previous contract lows, as well as mid-March continuation chart trading congestion at 107.42, which are now the key current resistances. Lower interim and major supports are the 106.40-.00 range that was barely tested at the bottom of selloffs the past two weeks, below which the market is into a major new continuation low with next support not until the June-July 2004 105.14-104.86 congestion into that major 15 year trading low.

Similarly, the **Bund** was in trouble slipping below its low 115.00-upper 114.00 area support on the contract (discounted to premium continuation levels set up by the March contract prior to expiration) from its Inverse Head & Shoulders Bottom UP Break was . Of note, the failure below 114.46 violated the Tolerance of that UP Break at the low of the right shoulder of the June contract pattern. That was also the last interim continuation chart pullback low from September 2004, which the lead contract missed hitting during summer 2006 intermediate term bottoms, and again on the tests earlier this year. That is why the weekly gap in the 114.44-.57 range is so critical. All of which is also very critical for whether the daily MACD in the long ends can turn UP in a more convincing manner, and especially whether the weekly MACD in the T-note can rescue itself.

The much more critical Bund support is at the major Fibonacci, congestion and weekly oscillator support is not until the 113.35-.20 range, which is not likely to be violated unless and until the Bund is ready to proceed down to at least the 111.80 interim support, or the major weekly congestion and oscillator levels in the low 111.00-110.50 range.

All the while the more resilient (not exactly 'strong') sister June **T-note** drop exhibits what was a very orderly, modest selloff below intermediate term 108-08/-00 support (now resistance), with the support Tolerance at 107-22 that remains critical for the short term trend decision (congestion and identical contract and continuation gaps.) As we expected, the T-note inability to once again violate that Tolerance was the reason that the scope of weakness in Europe was fairly problematic as the Gilt and the Bund hit their more major lower supports.

While next T-note support is 107-00/106-24, major support is not until the 106-08/-00 range, and all trend indications remain DOWN pending whether it can post daily (and weekly) Closes back above the fine line 108-08/-10 resistance. Much above that the T-note is back into its higher range from late February through late March. That would create a very strong potential to at least head up for another test of resistance that would include filling the gap lower after from the post-FOMC statement euphoric rally daily Close at 109-00.

Of course, that sort of strength would most likely also encourage the Bund to vigorously retest that post-Easter 114.44-.57 gap lower below major historic congestion. Any Close back above that resistance by the weak sister would likely signal more impressive intermediate term basing and more of an extended upside correction than the bears have in mind. It would be equivalent to the November 2005 T-note recovery back above the 108-00 area after the singular late October Close below it. While that still left the T-note in a bear trend, it fomented a recovery to the 110-00 area into early 2006 prior to the bear trend reasserting itself. An equivalent rally in the Bund might see the 116.00 area.

All of which points out the degree to which these massively disparate trends since the last major cycle turn in early 2000 come back into synchronization at times. It all seems at present to be heavily contingent on whether the T-note can post daily (and ultimately weekly) Closes back above the 108-08/-10 fine line resistance. That will very likely be a strong influence on all of the other fixed income markets, and short money as well.

Speaking of the short money, it has also been dropping below key supports in the wake of the various developments last week into this week, with September **Short Sterling** previously failing the 94.24-.22 range, and **Euribor** dropping below the long held 95.85-.80 area.

Most tellingly, the effective strong sister September **Eurodollar** which had maintained the hope of central bank easing was not only below its 94.95-.92 range support, it also obliterated next support in the 94.86-.82 range, which has been resistance on recent rallies. That left it vulnerable to revisit the low end congestion support in the 94.70 area as mostly occurred, which essentially reflects the market actualizing the reality of a very low percentage potential for an FOMC rate cut by as early as their early August meeting. Which should make this week's next US Employment Report that much more interesting.

Next supports elsewhere are under pressure as well, with September **Short Sterling** still grinding its way below the recent historic congestion at 94.10-.08 (contract low), and still vulnerable with extended support at daily oscillator levels in the 93.85-.80 area. September **Euribor** next interim historic congestion is in the 95.70 area, yet with the major 95.60-.57 historic (May-June 2004) congestion and daily oscillator support.

FOREIGN EXCHANGE

The foreign exchange view remains the same weakening US dollar trend in spite of softness in the co-weak sister yen modestly buffering the US Dollar Index support levels. In spite of that continued weakness of the yen, extended weakness elsewhere has finally seen the **US Dollar Index** last recovery to the .8300 area fail below previous near term .8250 area basing action Tolerance and the .8224 December trading low.

That is becoming worse for the Index as the overall active trend channel since the last major highs in the mid .8500 area (back in January) is experiencing DOWN Acceleration on the drop below .8180 two weeks ago. While that allows for a mild 'cleanout' squeeze back above that level to the low .8200 congestion as a Tolerance, so far the buck has failed multiple tests of .8180 on rallies. Unless the US dollar Index can recover to Close back above that soon, further weakness would point to violation of recent historic lows as well. Those are the .8128 March 2005 low, and.8039 December 2004 major trend low (equivalent to EUR/USD 1.3666 that is currently under attack.) The difference for the US dollar Index is that the all-time low is much Closer than for EUR/USD: the September 1993 .7819 low.

The more active trend in **EUR/USD** was only very temporarily interrupted by the previous Employment report, as well as any of the minor setbacks along the way. The continued expectation of US growth remaining weaker than Europe and Asia leaves the buck under pressure in spite of a new all-time high in the DJIA. While a few years ago many observers would have considered that crazy, the huge US deficits and relatively weaker inward investment differential at various points along the cycle have made this a weak dollar equity bull ever since Europe began to recover in 2002.

The EUR/USD gradual violation of 1.3350-67 resistance (from back in December) during late March into early April was the real test of whether the market might fail back below previous resistance (reinstating it), or hold that area as support. The latter was the case, and that has fomented the subsequent further weakness in the buck. While currency trends against the US dollar are somewhat disjointed, if Euro leads the way up, the rest are likely to follow. Notable exceptions are the weakest of the weak sisters Japanese yen, and the Australian Dollar still leading the way up overall against the buck in spite of last week's reaction. Next resistances above the 1.3666 level are up into 1.4000, 1.4200-50, and 1.4500-35 (the all-time high of the pre-1999 official launch synthetic 'basket.')

USD/CHF is, interestingly enough, still respecting its 1.1900-1.1880 UP CPR reversal bottom from December, which also reinforces the basing action from May 2006. Yet, after failing the near term resistance in the 1.2250 area without even reaching the more important trend resistance remaining in the low-mid 1.2300 area, weekly MACD remained DOWN throughout the entire trend down since early March, and below 1.1900-1.1880 there is not much further support until the interim 1.1750 area, and more major 1.1500-mid 1.1400 area.

Previous weak sister **GBP/USD** regained the bid in the recent stronger than estimated UK inflation numbers. Yet, its rally above the 1.9500-50 and extended resistances at 1.9750 and more major recent resistance at the 1.9850-1.9915 congestion only yielded a modest push into the 2.0050 and 2.0100 early 1991 and September 1992 (respective) highs. It will be very interesting to see if it can push through those for a chance to extend the rally to the more distant historic resistance at approximately 2.07.00-21000, and every ten cents higher from there (back into the 1970's through early 1981.)

Of note, that will likely still need to occur in conjunction with EUR/USD strength. In spite of the British pound strength after the stronger than expected inflation numbers, this is reinforced by a relatively firm performance of **EUR/GBP** holding the retests of its .6760 UP Break (out of its weekly down channel from the major April 2006 high.) Based upon heavy congestion, and weekly MACD and MA 13, it would actually take a weekly Close below the .6700 area to fully reverse the upside leadership of the Euro. Higher EUR/GBP resistances remain in the .6900 and .6960-80 areas.

USD/CAD is another of the key influences on the weak overall US dollar performance, as it reinvigorated its sustained weakness in the past month as well. After failing badly on the last test of 1.1800 area congestion resistance back in mid-March, the market was hovering below trading congestion at 1.1600-1.1566 until three weeks ago. Yet, the subsequent drop below that major congestion, weekly up channel and MA 41 in the 1.1500-1430 range was telling. Trend indications remain heavily DOWN as the market violates hefty weekly congestion at 1.1250 and its 1.1180 Tolerance. Much below that its interim support at 1.1050 (already seen at yesterday's trading low) and major support at 1.0931 (major May 2006 trend low) with a tolerance to the 1.0900 area December 1977 pullback low that does not have much beneath it until the 1.0400 area.

Meanwhile, the strong sister **AUD/USD** is well above its previous .7980-.8000 resistance (now intermediate term support), which was much more than just some sort of "big penny" level: it was also the major February 2004 and March 2005 Double Top (with a break to .6776 in between.) It has now also made it through the .8212 high (now short term trend support) from December 1996 to a more than sixteen year high. Next resistance above that is not until the previous major August 1990 .8493 high.

And poor co-weak sister Japanese yen remains under pressure, albeit with **USD/JPY** churning back around the top of the previous 118.00-.50 trading range. Yet, it would still take a failure of major support in the 115.00 and 113.50 to signal secular yen strength, albeit near term support is the 117.50 up channel (from the 115.00 area March low.) Next resistances are the recent and historic congestion area at 120 (heavy), 121 (interim) and 122 (heavy), with next resistance into the 123.25 DOWN Break form the June 2002 major weekly channel.

Of course, that also means the cross rate strength of the other currencies against the yen continues to lead the way up, and refute any sense that the carry trade 'crisis' is anywhere to be seen. While that may re-invigorate itself if the equities lapse back into weakness, it is now glaringly apparent that the carry trade liquidation had been moreso in response to the equity market (and other asset class) weakness that the cause of it.

As the **EUR/JPY** pushes well back above its 155.00-154.50 previous weekly channel DOWN Break and congestion, it has already been up through next resistance in the 159.00 area and old high at 159.63. Yet, even this tower of strength has stalled (not surprisingly) into the next extended historic resistance at the 1998 summer-fall highs in the 162.00-.40 range (also historic weekly oscillator resistance), with the further historic levels above that not until the 170 and 175 areas. Similarly, albeit a bit less so in spite of the recent return of the bid to the British pound, **GBP/JPY** is also back above its previous 229.00-228.00 weekly channel DOWN Break and congestion, held on a retest three weeks ago. Also through interim resistance in the 232.00 and 235.00 areas, quite a bit of resistance remains in the upper 2.3000s. However, any Close above the previous major 240.88 August 1988 high would facilitate an attack on the 241.51 late January trading high, above which the historic congestion and weekly oscillator projections allow for a rise to 247.00-248.00 prior to reaching the next resistance.

ENERGY

As noted previous, energy market weakness to mid-March had been seasonal weakness, and the shift to a focus on summer cooling (at least we hope so) and driving needs would begin to favor the bulls, as had the geopolitical impact of the Iran-UK standoff over the return of the UK sailors. Even though that has been resolved, geopolitical worries continue to bolster the price, as worries over the situation in Nigeria, the Saudi Arabia terror plot and continued confrontation with Iran over various issues influence the trend.

That has assisted the June **Crude Oil** in holding bid well above lead contract support back in the 60.00 area (now reinstated support extending down to congestion in the 59.00 area.) Even after previous lead contract (May) fell back below congestion areas in the upper 63.00-low 64.00 area and 62.50, the June contract has now recovered back above those levels. If it holds, extended resistances remain up at 67.50-68.00, and not again until the 71.00 area.

Multiple Cycle Divergences

Quite a few folks seem to be fairly impressed with the ability of the US long dated fixed income to hold in the face of the weakness of its European sisters. Yet, that may all be a normal part of the evolution of the second phase of the fixed income bear since the major highs back in 2003. The distortions over the next couple of years after that were extreme by historic standards, and continue to reverberate through the economies and markets today.

In the fixed income that meant the normal lag of the European economic recovery out of the bottom of the contraction took much longer. For various reasons which we have reviewed at length previous (and will therefore only mention in passing here) related to the January 1999 introduction of the Euro, German pension reform, the parsimonious stance of the ECB during the extended economic weakness fomented by those reforms, and many other factors the general European economy was much weaker for longer than normal in 2001-2004.

That created a commensurate market distortion which was also much more pronounced than during previous cycles. While the typical European economic and equity market lag behind the US recoveries from previous recessions was not much more that a quarter or two, the extended weakness during the adjustments after the major economic peak into the top of the US Dot.Com Bubble also had a distinct impact on long dated fixed income markets. While the US recovery was at least partly reinforced by Mr. Greenspan's need to loosen markedly into 2003 (due to the ECB stinginess noted above) to prevent a global slide into deflation, that also obviously expanded the degree to which the US economy led the way up and US long dated fixed income led the way down.

In fact, the US T-note has remained a bear trend on balance ever since the June 2003 highs. However, that was very grudging and erratic at times, and the primary culprit in derailing the attempts at further weakness below support in the T-note was the Bund, which demonstrated from late 2004 that it was indeed still a bull market. This was natural in light of the German economy remaining so weak that it was a drag on the European economy, which remained so weak as to feel recessionary even if the formal statistics pointed to a very sluggish form of growth for most of 2001-2004. In essence, as we have pointed out many times, the normal several month lag in the Bund peaking out and following the T-note lower in a bear trend from a major top was distended into a several year full divergence.

Yet, the German economy did finally recover after Herr Schroeder took the fall for previous reform-inspired weakness, and the conservatives coming to power (of sorts) under the current weak Merkel coalition seemed to reinvigorate the economy. Was it her ability to push through further radical reform, or an enlightened tax regime? It seems to us that it was moreso the extensive growth of the world economy already spilling back into Europe in the form of France refusing to put Stability and Growth Pact strictures ahead of job creation that finally reinvigorated German 'animal spirits' (to borrow a term from Lord Keynes.) And as is natural across the cycle, the US economy became bloated with its own growth excesses, and has finally reacted by ratcheting down to lower growth in the wake of the housing market peak and subprime mortgage problems.

However, last Thursday's Financial Times contained an article which relates how extensive strength in the German export sector that was serving the needs of a strong global economy have evolved into powerful domestic demand that will continue to grow even if export demand weakens to some degree, just as had occurred previous in China. To wit,…

"After five years of sluggish or zero growth, Germany's economy bounced back into life last year to expand by 2.7 per cent. The turnround (*sic*) first became visible in the fast-growing export sector but it is clear from the optimism at Hanover Messe that the recovery has now spread throughout the economy. A key indicator of how things will go in the next few years, say economists, is the willingness of companies to invest in expensive new production capacity at home. If domestic investment is strong, outside shocks such as a change in exchange rates or a slowdown elsewhere in the world will be less troublesome."

And therein lies the reason behind the degree to which the German equities lagged the US on the way up, and are now leading. It also explains why the Bund was able to remain a bull market into its August 2005 peak, whereas historically it was usually only several months behind the T-note bear trend, and is now burdened by the until the spectre of an economy that is growing above trend, potentially generating quite a bit of inflation risk.

As there does not seem to be much chance that the German economy will lapse into overt sustained weakness or even below trend growth anytime soon, we expect the Bund will remain a bear even if it does manage to Close back above the mid 114.00 resistance in the near term. As noted above, any Close back above that resistance by the weak sister would likely signal more impressive intermediate term basing and more of an extended upside correction than the bears have in mind. That would be equivalent to the early November 2005 T-note recovery back above the 108-00 area after the singular late October Close below that important previous congestion. While that still left the T-note in a bear trend, it fomented a recovery to the 110-00 area into early 2006 prior to the bear trend reasserting itself. An equivalent rally in the Bund might see the 116.00 area.

Still considering the general importance of the 108-00 area to the T-note, if it is indeed going to evolve into a bull market from the summer 2006 lows in the 104-00 area (which is not conclusive as yet), it would mean that the break below the 108-00 area in early 2006 was indeed the completion of the second wave of its bear trend. Due to the extreme divergence of the economies as well as the long dated fixed income trends, the early 2006 sharp break in the Bund, and Gilt for that matter, was obviously the first major wave of their bear trends after the economic recovery could no longer support high valuations (i.e. low yields) which had been extended during the benign period of lagging data even as the German economic recovery became more robust into late 2005 (as originally noted in the 'European Long Rates' section of ***CMO*** I-10, Wednesday, November 2, 2005.)

As the Gilt had been the weak sister during the recoveries from last spring's lows in any event, it was able to begin the second wave of its bear trend early this year on the violation of it previous mid 108.00 area lows. However, as the Bund has just breached the mid 114.00 deep historic and more recent important congestion since the return from the Easter holiday weekend, it would seem to have quite a ways to go prior to fulfilling the completion of a proper second major wave of its bear trend. And that is related to the equity markets relative trends, as well as the extensive stubborn divergences of the fixed income (especially the long ends) going back to the inception of the bear from the extreme highs back in mid 2003.

'Falstaff' Equities

Of course, one of the other questions which abides is just how the US equities have managed to maintain their strong up trend in the face of such pernicious expectations of diminished earnings, higher energy prices, fallout from the subprime area spilling over into a disaster for the rest of the mortgage and ultimately the housing markets at large, etc., etc., etc.?

Easy. It's the 'Falstaff' market: hail equities, well met. A bully bull for the masses. As noted in last week's ***CMO*** III-17, trends which last long enough tend to attract more participants who assume the more pronounced background influences that have driven the trend to that point will either maintain or actually expand. While there are many specific factors which we could explore, it all relates back to one key element: Mr. Bernanke allowing the next risky bubble to develop since the Fed failed to head off budding US and global exuberance as DJIA approached old highs last summer. It's not a matter of 'targeting' the stock market; the Fed could easily have made a case for heading credit market and housing excesses, the subprime fiasco, and other domestic factors. They should have realized and acted upon the degree to which the Fed is 'The World's Central Banker' that sets the tone elsewhere as well (which Mr. Greenspan seemed to appreciate much more than Mr. Bernanke.)

'Long Tails' in *CMO* III-17, considers how the confluence of factors is merging into a mighty (albeit artificial) stream. This is much like technical indications all reinforcing certain levels; or providing a chain reaction style ratcheting of the trend into new psychological ground, such the serial reinforcement of the global equity market strength has of late (until early this week) assisted each other in breaking through previous resistance levels. Considering the shift of leadership to the DAX that is perfectly entitled to proceed higher, this is all …

…No Surprise Whatsoever… after markets held previous tests of support. As trends tend to remain dynamic, eliminate the indication that they are ready to go down, and they find excuses to extend their up trends. While not meaning to sound too-clever-by-half, that can all be related back Sherlock Holmes' investigative methodology explanation from the story 'The Sign of Four.' As he said to Watson in a typical dismissal of any attribution of 'genius' to his prodigious skills, "…when you have eliminated the impossible, whatever remains, however improbable, must be the truth." Unless support is broken soon, expect there will be further extensions of the equity bull market; which all gets back to our trend view shift back to a bullish stance once it became apparent back in mid-January that the German VAT hike from the first of the year was definitely not going to fracture their (and the European) economy. At least now we have a better idea of why that unfolded as it did.

Now the international big cap 'halo effect' from the weak US dollar profit repatriation windfall seems to leave the DJIA upside leader once again among the US equities, and that explains the final divergence that is part of the previous topic. DJIA pressing up into its 13,150 critical oscillator resistance, while the June S&P 500 future cannot keep the similar pace up into its 1,515 equivalent resistance points up how any DJIA escape to the next significant levels into 13,350-400 might only assist the S&P in achieving its initial test of 1,515.

While a minor technical variation on how a further extension of the up trend might unfold (making the leap of faith that's what will indeed transpire), it highlights the manner in which markets which fall far enough out of synch into their major technical levels can actually get right back into synch on an 'adjusted' (modestly perverse) basis. Admittedly our readers are within their rights to observe that only a technician's sick mind could possibly have markets going both out of and back into synch at the exact same time; but that's sometimes the way it works on the trend adjustments within a 'complex' (i.e. closely related group of markets.)

We look forward to providing further comments as the situation warrants, and hope you have found these perspectives helpful. Our previous extended *Capital Markets Observer* comments and trend views are now available on the **Sample Reports** page of our website.

-Rohr
(www.rohrintl.com)
