

Rohr Report

Capital Markets Observer

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Key Views, Overview,...

...Fed-in-the-Box, The Dodd Cookie Jar Conundrum, The Fiddler's Notion

Key Views

- The various news and events continue to reinforce the 'stagflation' scenario which the equity markets find so troubling, has weighed on the US dollar, and brings only temporary squeezes to fixed income markets when the equities are falling sharply. The past couple of days have seen still above (already elevated) estimates on inflation readings, while everything except some of the Japanese statistics and the European Purchasing Managers Indices of Manufacturing (JUN) have shown economic weakness; including the UK Purchasing Managers Index of Manufacturing. Of course, the US ISM Index of Manufacturing and Construction spending are out this morning.
- Added to that is the statement which accompanied the Reserve Bank of Australia's broadly anticipated 'no change' interest rate decision at 7.25 percent this morning. That reinforced the near term intractable nature of the inflation with observations such as, "The rise in Australia's terms of trade... ..will add substantially to national income and ability to spend,..." and "Inflation is likely to remain relatively high in the short term, and the CPI will be further boosted in coming quarters by the recent rises in global oil prices." Which reinforces the overall pressures on all central, regardless of their near term rate change choices. It also illustrates the massively divergent pressures on the Fed that we have highlighted previous and revisit below.
- Of course, these are just the sort of influences that will continue to destabilize the equity markets as long as the 'Street' believes that the Fed is indeed locked into its firming bias once again. As we have already seen the failure we expected into new lows in the DJIA, we will not dwell needlessly on that background here. Suffice to say that the Fed may still shock the broad 'tightening' consensus if equities remain weak, and the review of key technical aspects seems more to the point at this time.
- After the slide below the critical psychological support at the January 11,635 low, and next lower support at 11,500 (where DJIA was trading prior to Fed action early on January 22nd), it managed to hold on for a weekly Close at the next interim support level at 11,350. While it might normally not be all that critical, in this instance it is also the loose Tolerance below the 11,500 area, and any violation leaves no further support until the 11,000 area. As such, it assumes extra importance regarding whether the slippage below 11,635 and 11,500 remains relatively nominal, or the stock markets experience a rout. And that is important regarding whether the Fed might need to quickly reverse fields and provide an easing in spite of a broad belief the next move in US base rates should be up. Extended supports are 10,700, 10,100 and the 9,700 area.

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- September T-note previously below 113-00/112-24 area contract and continuation support has nonetheless managed to recover temporarily back above that level and next lower support in the mid 111-00 area. Previous slippage below that area saw lead contract June fail its own 113-00 area support, which the September contract managed to recover back above last Thursday under the influence of equities weakness. A question therefore arises over whether the previous 'haven' bid that benefited the bond markets in the first quarter might be returning. The answer is, yes and no. While the economic and credit market problems that are plaguing the equities might see some flight to the safety of benchmark "govies", the inflation influence since mid-April has been restored to a degree that likely precludes the sort of bond-mania which drove the markets to such extensive negative real yields into the mid-March Bear-Stearns capitulation.
- In general the indications are that the long ends can remain stale in spite of any near term equity market weakness. It seems that whenever the equities are not either actually dropping sharply or at least on the cusp of doing so that the fixed income is rightfully reflecting those renewed extensive inflation expectations.
- While it has reinstated interim support in the 113-00 area and at 111-16 for now, lower major T-note supports are the 110-00 and 108-00 areas, which still leaves it well above the mid-low 104-00 cyclical trading lows from the past two years' spring lows (both 2006 and 2007.) However, if the equities continue to drop in the near term, and especially if DJIA knocks out the 11,500 support extended Tolerance in the 11,350 area, the T-note can extend its recovery to the 114-08/-16 area, or even September contract congestion in 115-00 area. Additional resistance is not until the mid 116-00 and 118-00 areas.
- Reflecting their stronger economies and inflation, both Bund and Gilt had neared last summer's major cyclical lows. Of note, that also happens to be major weekly oscillator support that would normally signal a likely intermediate term trend reversal, at least for a significant upside correction. That was the case in spring of 2006 prior to resumption of the bear trend into December 2006 for the drop into last year's lows.
- Having dropped further than T-notes previous, weakness in European fixed income was still bad below extended supports. The Bund below 113.00-112.50 has also failed the mid-low 111.00 support into last summer's 110.00-109.65, and was critically only back up to the mid 111.00 area so far on the near term rally. While recovered for now, the weekly oscillator threshold (MA-41 minus 05.50) extends to 109.00. A failure below that area would indicate a swing down to 107.00 area that is also consistent with the Return (basing) Line of the major down channel from the August 2005 all-time high.
- Similar tendencies apply to the September Gilt below its previous supports in the 106.70-.50, 105.00 area and 104.00. Yet, it never quite reached last summer's cyclical low trading support low at 103.35-122.90, which is also similar oscillator support to that noted for the Bund, and below which the next support at 101.00 area is also the major trend channel bottom. Also similar to the Bund, it has only recovered back to the 105.00 area violated support, and must post a daily Close above the 105.30 level to confirm it is ready to proceed back up to test higher levels back in the mid 106.00 area.
- As is the case for all of the long dated fixed income, the degree of the rally is going to be dependent on the extent of equity market disarray over the near term, and be vulnerable to rapid reversal if the Fed should engage in that unexpected easing to rescue the equities from any overtly disorderly activity. In addition to any sheer equity market recovery, there can be little doubt that if the Fed is forced to ease, it will likely be destructive for long dated fixed income in the intermediate term.

- The real beneficiary of the higher interest rate scenario and indications of weak economies beginning to take hold in Europe has been the US dollar. Yet, we cautioned previous that the cross currents on the interest rate influences likely means there will be some fits and starts if the US equities led the way down. While the buck may still be 'bottoming' overall, the view on general view on higher rates was never as clearly constructive for the US dollar as some would have liked to believe. That is due to any hike from the Fed naturally occurring after the next well-telegraphed hike from ECB, with the Bank of England's need to sow some inflation vigilance as a wild card as well. However, even if the Fed needs to cut first, and there is near term US dollar weakness, there may be a case for the delimiters on the strength of other currencies.
- It is important to recall that the euro did not so much bottom in October 2000 as the US Dollar topped in the face of the secondary failures of the US equity markets as the NASDAQ 100 slid below 3,300(!). Considering whether the US Dollar has bottomed is now therefore as much an exercise in whether European economies are weakening enough to be over-valued in spite of the likelihood the ECB will raise rates next week. That will really confuse the 'interest rate differential' camp. It is one of those misplaced notions that interest rate influence is a primary driver of foreign exchange trends. It certainly did not assist the buck very much during 2004 and 2006, and even 2005 strength was more so due to a temporary US tax policy influence.
- With the US Dollar Index capitulating after its weekly Close above .7350-70 resistance two weeks ago, the equity market failure has also caused it to weaken below support at its .7300 area weekly down channel UP Break. As noted previous, the Tolerance of that up signal is the previous trading low at .7213. What is especially critical about that now is that any violation would also signal a fresh .7230 area DOWN Break from what can be construed as a Bear Flag. That is a somewhat questionable reading unless one is a dyed-in-the-wool dollar bear, as the downside Objective would be in the .6600 area. While the buck may indeed drop back to or even below the mid-low .7100 congestion or even the .7070 mid-March trading low, it is problematic if things are bad enough in the US equities to foster a failure of that sort whether the still somewhat 'priced for perfection' European currencies would not be affected by potential fallout for their own economies, which could limit the damage to the already depressed US dollar. In that regard, any US Dollar Index failure below .7230-13 would be akin to the DJIA UP Break above 13,700 last July that had an upside Objective of roughly 15,300: a bridge too far too late in the cycle, much as a projection for a swing down to .6600 for the buck now.
- Somewhat commensurate consideration for US dollar strength above .7350 would have been the case for any EUR/USD violation of 1.5350, which did not even occur. In stead it ran up through its interim resistance at 1.5500-50 on the equities weakness, and is back challenging its 'strong sister' resistance still back up into the 1.5750-1.5800 area. Extended resistance remains at the Negated 1.5900 mid-April UP Break, and trading highs into the 1.6000 area. Unless the euro can push above those levels, the chance of any serious extended weakness in the buck is significantly mitigated. GBP/USD could not fail back below 1.9500 to resume its weak sister taint into lower 1.9350-00 support critical this side of 1.9080-00 major support. It is instead back above resistance into the 1.9850 area with 2.0000-2.0100 above that. EUR/GBP is stagnant on the leadership shifting to secular US dollar weakness, as its previous failures from .8025 weekly DOWN CPR (Tolerance: .8050) still saw it hold .7750 and .7850 supports, yet with the .8025-50 area still representing critical resistance overall.

- However, in spite of all of the weakness of the US dollar over the near term, the real weak sister remains the Japanese yen in the face of high oil prices. USD/JPY above 105.00-106.00 resistance previous remains no worse than that range in spite of failing at higher resistance in the 108.00-.60 range, with 110.00-110.50 above that. And with the US dollar weakness as the focal point, EUR/JPY above 165.50 ran up to challenge the 168.95 major July 2007 high, and GBP/JPY through 209.00 to the upside similarly hit its 214.00 area major congestion from the series of early 2008 highs.
- As noted extensively previous, Crude Oil rebounding from 112-110 back above 120 also pushed above resistance in the 125-127 area, the low end of which was near term support with a buffer down to the 123.00 area (daily aggressive channel and Area Gap.) Even though important weekly oscillator resistance was into the 135 area previous, the 130-128 area is now the interim support on any pullback. Which also means important higher resistance is now not until the 145 area (weekly MA 41 plus 40) in spite of previous recent highs just shy of 140, and extended resistance not until 155-158 area.

Overview

Once again this is really quite an interesting week on many levels, with the key late week impetus moved up a day, due to US market closures for Friday's 4th of July holiday.

While many of the typical important early month numbers are released over the next couple of days, the broader background on the 'stagflation' tendencies which keep showing up in the economic data are more important than any particular number. It is also very vexing for the equity markets that the credit markets are once again strained after some temporary relief in the wake of the Bear-Stearns capitulation in mid-March.

We have been very clear since late last year that the only way to restore confidence on so many levels is to stop the asset value destruction which plagues the US housing market, and by extension underlying assets of quite a bit of the securitized debt market. As we just revisited a more highly focused version of that in last week's [US Housing Math](#), we only offer a bit of a further voice, albeit a very important one, on the issues in that area in this week's [Fiddler's Notion](#).

The real thrust of this week's potentially very volatile market swings are a confluence of key reports, events and the actual market

trends in their own right. As we noted in Monday's [Weekly Overview](#) (and revisited above), any further sharp fall in the equity markets will mean another round of seeming policy reversal is in order for a Fed that has already had to do so at times when it tried to put too good a face on still fragile situations, like the one we have now.

And due to the convoluted calendar this week, there is a real issue of the timing of any such move with US and international equities still weak early this week. That is because it will be very risky to wait until Thursday's ECB decision and concurrent US Employment report. In fact, the fine line view of the timing of those events is even more diabolical than it might appear on the surface. The US Employment report will be released just as ECB President Trichet begins his introductory press conference statement. Yet, unlike the US custom, he will actually read through the entire (often quite extensive) statement prior to the release of its text. Which means the full review by the good president, and the sometimes unsettling responses in the Q&A session will only unfold as the markets respond to the US report. Of course, the ECB hike is expected to be accompanied by further hawkish views as well.

All of which will only heighten any pressure on the Fed to provide an anticipatory buffer against any further bad reaction by the equity markets if they weaken sharply (i.e. the DJIA not just orderly below 11,350, but also attacking the 11,000 area support.) However great the expectation that the Fed must 'do something' about inflation and support the beleaguered US dollar as well, there is likely an even greater near term incentive to believe that it can not just sit on its hands and claim that it has already done all it can if the equity markets are back in deep trouble into such a diabolical mixture of ECB and (to only a slightly lesser degree) other central bank hawkishness. That is all reviewed in [Fed-in-the-Box](#) below.

Of course, as noted previous, the Fed can not (and indeed should not) need to address this whole mess on its own. Yet, there is a somewhat silly and minor distraction that is impeding the rightful assistance it should be receiving from the US Congress passing the very necessary and desirable US housing bailout legislation. Recent revelations that Senate Banking Committee Chairman Christopher Dodd (among others) received

a substantial preferred deal on home loans he took from the now infamous Countrywide Financial corporation (no less) are raising questions about the motives and efficacy of the entire US housing bailout package.

We explore that in some detail, and provide a link to the best article we found on the matter in our assessment of comparative importance of the bailout program and the degree of benefit that the good Senator received in [The Dodd Cookie Jar Conundrum](#) below. Suffice to say that in the first instance it is standard practice for financial institutions to offer preferred deals to some customers, that such 'gifts' which preferred interest rates would represent are not illegal as long as no obvious preference is provided the giver (as that would be an illegal 'bribe'), and further, at this point in the game Senator Dodd would need to be certifiably insane to provide obvious favor to either Countrywide or home loan industry at large. While some review of the situation should indeed be carried out by the Senate Ethics Committee, this is mostly a very sad reflection of two facts: this is the USA, and it's an election year.

Fed-in-the-Box

We are now dealing with a Fed-in-the-box economic and market situation on two levels. The first is the Fed potentially popping out with a surprise. The second is the sad way it is painted into a corner.

Yet the latter is moreso true across the cycle with equity and credit markets still so troubled. There are quite a few cross currents that go beyond the sheer weakness of the US economy in the wake of the Credit Bubble bursting. Those include the stubborn weakness of the US dollar in spite of improved manufacturing exports, and those are exacerbated by the US dollar pegs of a goodly number of

exporting nations. We have noted previous the perversity which that engenders, and there were a couple of very good editorial comments in the Financial Times last week which explore quite a bit of the rationale behind all of that. They are attached for your review.

Yet, the second potential is far more radical and potentially disruptive. While it will likely shock a world convinced the next move in US base rates must be up, there is a strong possibility the Fed will need to reverse field if current equity market weakness continues into the mid-late part of this week or into early next week.

In fact, extensive weakness in the markets can be traced back to the FOMC's misguided premature return to a more hawkish stance. While it is always dangerous to peg market price movement to specific fundamental influences, this one seems quite clear. While there was little response to the April 30th FOMC statement, release of more hawkish than expected minutes on May 21st was the initial cause of the stock market rally reversing the previous two months' recovery.

That should have been a cautionary sign. Yet, shortly after that Mr. Bernanke took the unusual step of venturing into currency commentary that was also quite hawkish. Obviously the Fed had come to believe its own press regarding a pending US recovery. Markets were never really comfortable with that, and became more focused on 'facts on the ground' which belied that notion.

While a US rate cut will certainly put the cat loose among the foreign exchange and fixed income canaries, the Fed's first job is to stabilize equity markets if they remain disorderly.

Given already low US base rate levels, that will also highlight the fact the Fed is running out of bullets and needs help from other quarters. This was extensively reviewed in David Hale's excellent FT Comment on the relationship between the US dollar and the housing and banking problems ("The Fed, the dollar and wider price concerns", which is attached for your review.) In addition to a very thorough statistical summary of the at-

risk borrower threat to the broad economy, Mr. Hale was concise in posing the problem in terms many have yet to grasp.

In the first instance he made clear that the Fed can not address the problem on its own, because the core dilemma is lack of confidence in the underlying assets of debt derivative portfolios. As such, there is a stark choice even the moralists who do not wish to reward bad decisions must face:

Either allow for "...recapitalisation of the US banking system with public money..." or sanction the US Congress' housing bailout. While each are forms of handing money to banks that created the problem, the former will only allow for them to absorb further major write downs. The latter has the advantages of maintaining homes and communities as well as the tax base, and likely restoring liquidity to interbank lending in a way current handouts cannot possibly accomplish. It certainly seems time for some 'trickle-up' economics.

All of the other reasons the Fed is constrained by US dollar pegs of developing nations and their sanguine inflation views (even if inherited from the Fed) also still apply. Yet to address the crisis will likely require at least one more surprise rate cut in the first instance if equity markets continue to be burdened by combined stagflationary indications and strained credit markets

In the second instance the Fed must get the assistance it desperately needs from other quarters for a broader address of the vicious debt market meltdown circle.

The Dodd Cookie Jar Conundrum

As noted in the [Overview](#), there is a somewhat silly and minor distraction that is impeding the rightful assistance the Fed should be receiving from the US Congress passing the very necessary and desirable US housing bailout legislation.

Recent revelations that Senate Banking Committee Chairman Christopher Dodd received substantial preferred home loan deals from the now infamous Countrywide Financial loan company (no less) are raising these specious concerns.

The best consolidated review and analysis of the situation that we have found is from specialty publisher Condé Nast, which has recently broadened out from typical travel and food periodicals into a financial focus with 'Portfolio.com'. The analysis of this situation can be found on their site at: <http://www.portfolio.com/news-markets/top-5/2008/06/12/Countrywide-Loan-Scandal#>

A brief sampling of the extensive coverage of the issues and facts surrounding the loans made to Senator Dodd includes the select observations:

"Senator Dodd received two loans in 2003 through Countrywide's V.I.P. program. He borrowed \$506,000 to refinance his Washington townhouse, and \$275,042 to refinance a home in East Haddam, Connecticut. Countrywide waived three-eighths of a point, or about \$2,000, on the first loan, and one-fourth of a point, about \$700, on the second, according to internal documents. Both loans were for 30 years, with the first five years at a fixed rate.

"The interest rate on the loans, originally pegged at 4.875%, was reduced to 4.25% on the Washington home and 4.5% on the Connecticut property by the time the loans were funded. The lower rates save the senator about \$58,000 on his Washington residence over the life of the loan, and \$17,000 on the Connecticut home. The former employee says the float-downs were free. Senator Dodd's wife, Jackie Clegg, said in a brief interview that two other lenders they checked with offered comparable interest rates."

It also covers an extensive number of other legislators' sweetheart deals on V.I.P. loans from Countrywide. However, as we must assume the statement by Ms. Clegg is in good faith, that means other major lenders were also keen to provide advantageous terms to those they viewed as 'preferred'

clients back on the heyday of their strong business expansion.

As a perspective on all of this, and whether the benefits derived by the good Senator and others amount to anything that should be considered relevant to the passage of the US housing bailout legislation is actually quite interesting.

As noted previous, it is only realistic to presume the \$300 billion program price tag the sponsors are proposing is just a starting point to get the mechanism going. If there is any success in rescuing both the at-risk borrowers and especially any salutary effect on the ability to value the debt derivatives market once again (along with the interbank lending market), more funds will likely be approved. That is what transpired in the Resolution Trust Corporation bailout of the commercial property market twenty years ago (also over the cries of 'moral hazard' and 'extreme expense' from the critics.)

For the sake of discussion, we are going to allow that the full cost of the US housing bailout will actually run somewhat closer to \$600 billion or so. At that more realistic level of assumed program cost, it is greater by a quantum factor of 8,000,000 relative to Senator Dodd's misstep by of accepting what is a \$75,000 'gift' across the life of the loans (and as such quite a bit less in net present value.)

Yet, in an election year in the US, that suspicion of some form of corrupted motives or judgment (which Dodd would be daft to exhibit at this point in the game) is holding up what is possibly the only real solution to the continued devolution into despair from the home foreclosure-based 'unpriceable' debt securities. That is also related to the interbank lending conundrum, as well as the extreme financial burdens on individuals, communities, municipalities and the states. Only in America.

The Fiddler on the Roof is part of eastern European folklore. His essence was beautifully captured in the late nineteenth century book by Sholem Aleichem, *Tevye the Dairyman*. Yet, the popular name taken by the musical production is based on the quasi-cubist painting by Marc Chagall. 'The Fiddler' is a metaphor for survival in an uncertain world that is very apt for capital markets participants at all times; especially during the more volatile, erratic phases. As luck would have it, about ten years ago I came across a unique, purple palette print of him. My wife was extremely hesitant to even allow the green-faced man in the house. He ended up on my office wall. I now realize this is just as it was meant to be, as he looks over my shoulder in the rear view mirror on my computer monitor. The Fiddler's Notion_{SM} is devoted to observations on risk that may not correlate with some of the typically market trend oriented factors in our other analysis. It is fitting that one involved in such a risky pursuit is looking over my shoulder. Whether or not you like to think about it, he is likely looking over yours as well. So welcome up to the rooftops, where you can share the Fiddler's perspective.

US Housing Bailout (revisited)

Just a very brief observation this week on the further support for the US housing bailout in the wake of the implications we reviewed in [US Housing Math](#) last week.

It appears that another knowledgeable and experienced financial observer has weighed in on the side of the US housing bailout as the primary focus of any rescue of the economy and especially the financial system that falls short of wholesale recapitalization of the banks. That is interesting in part because Mr. Lawrence Summers was not one of those who initially favored the housing bailout. Yet, in a top-of-the-week Comment in the FT (attached) he now pointedly notes:

"First, the much debated housing bill should be passed immediately by Congress and signed into law. It provides some support for mortgage debt reduction and strengthens the government's hand in its troubled relationship with the government-sponsored enterprises – Fannie Mae and Freddie Mac. While it is an imperfect vehicle... ..it would contribute to the repair of the nation's housing finance system. Failure to pass

even this minimal measure would undermine confidence." It is very good to see such a savvy observer allow that the situation is now at least as psychological as financial, as the bailout is necessary to maintaining consumer confidence.

He adds toward the end of the comment, "Fourth, it needs to be recognised that in the months ahead there is the real possibility that significant financial institutions will encounter not just liquidity but solvency problems as the economy deteriorates and further writedowns prove necessary." And it should be apparent even to high-minded moralists that the prevention of foreclosures will also avoid some degree of insolvency.

In summary he notes the need for urgency in the proposed actions to ensure general psychology does not sour: "Unfortunately we are in an economic environment where we have more to fear than fear itself. But this is no excuse for fatalism. The policy choices made in the next few months will matter to the lives of millions of Americans, to America's economic strength and to the global economy."

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

-Rohr

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