

Bernanke the Bold

Overview

In a week where there has been an obvious impact from central bank pronouncements on inflation fears and their desire to take any steps necessary to diminish that risk, we felt a bit more background on the effect of Mr. Bernanke's extended volte-face might be of interest. We have also submitted the comment below (which follows up on our previous view that the central banks are tacitly targeting the equity markets) for publication. As such, we wanted to ensure that you saw this particular variation on our recent comments (which includes part of the analysis from this morning's **TRENDVIEW BRIEF UPDATE**) prior to it potentially being disseminated to a broader audience.

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We have witnessed quite a reversal of style and substance from Mr. Bernanke. While his commitment to greater transparency was laudable in principle, it proved daunting to implement. This is likely moreso due to the interest rate outlook becoming muddled at this point in the cycle than any lack of communication skill. The best insight on this actually flowed from New York Fed President Geithner's remarks on May 31st (still available on their website: <http://www.ny.frb.org/>.)

Proactive discussion of a potential pause at Mr. Bernanke's Joint Economic Committee testimony in late April left the political class and economic analysts inferring too much. Now it seems they left him in the anteroom for a bit too long with ECB President Trichet prior to Monday's panel discussion. Less than six weeks after his dovish faux 'pause', Mr. Bernanke was obviously trying to dispel any residual sense he is a 'girlie-man' central banker; enter Bernanke the Bold.

Unfortunately, his timing on that was just as abysmal as his attempt to court the political class with proactive discussion of an interest rate tightening pause while the data remained strong back in late April. While we continue to believe interest rates will move generally higher across the cycle, the US data and current intermarket influences seem to point to greater likelihood of a pause in the up trend at the long end of the curve. In fact, the more psychologically driven long yields were not nearly as buoyant as the short dated rates after Monday's central banker Hawk-fest. Of course, the short rates are the area of the yield curve where central banks retain much more direct influence.

However, now that the Fed is signaling more focus on inflation restraint than concern about economic weakness, equity markets are reacting poorly. Whether my previous assertion that central banks are specifically targeting equity markets (which they naturally deny) is correct, or the equities are merely reflecting the targeting of the economy as a means to subdue remaining inflation influences is moot.

The reversal of the equity market bull run into an intermediate term down trend is one of the best ways to defuse irrational exuberance toward the economy. As US weakness ripples through the world economy, it will assist central banks in fomenting lower energy and commodity prices. Given the extensive economic strength in Asia, this is essential in mitigating second round inflation effects, and will also encourage continued wage restraint.

Wage restraint is always important in avoiding the most pernicious aspect of secondary inflation expectations: 'demand-pull' inflation. Previous buoyant wage trends mean the Fed needs to accomplish inflation fight goals by also reducing incentives for average workers to demand higher wages in an attempt to regain spending power lost to higher energy prices. Essentially the Fed needs to leave them more fearful of losing their jobs than upset about their diminished lifestyle.

All of which will reinforce the slippage in the economy and equity markets. This is not meant to encourage any gloom and doom. Given the overall buoyancy of the world economy, and technical support below the equity markets, we are more so looking for an extended correction of the 2002-2006 bull trend. That's the good news. The bad news is that just as the correction of the 1974-2000 major cycle bull move caused the DJIA to fall all the way to 7,200 in 2002, that same support is up to the 9,000 area into mid-2007. While that seems a long way down, if it occurs it will just be the next trend correction.

Are central banks targeting the equity markets? Possibly not. Yet more overt central bank assertion of anti-inflation determination has impressed the investment class, and a major correction will assist the inflation fight through mitigating over-confident investment attitudes.

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

-Rohr

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