ROHR REPORT
TRENDVIEW

BRIEF UPDATE: CENTRAL BANK PSYCHOLOGY

Wednesday, May 3, 2006 (07:00 CDT; 08:00 EDT; 12:00 GMT)

OVERVIEW

The somewhat surprising rate hike by Reserve bank of Australia this morning is a firm step by a central bank that perceives the party is getting just raucous enough that it is time to start pulling the punchbowl; or possibly just ease back on the alcohol content a bit. Given that Australia's economy has a significant commodity base, some special circumstances might apply. Yet, a quick review of their accompanying statement (attached) illustrates the degree to which their action was also based on general economic buoyancy that is evident in the other major economies.

With the global economy on track across the board, escalating commodity and energy prices, and geopolitical factors contributing to an unstable environment, they seem to have taken the view that it is better to get out in front of any inflation curve than wait until it is too apparent. Central banks that attempt to avoid near term opprobrium by waiting until inflation is so ingrained that it is obvious that they are reactive risk needing to take draconian measures later. The Fed and ECB would be well advised to take this lesson to heart.

The best path for the FOMC still might be to raise Federal Funds by 50 basis points next Wednesday, even if they are now distancing themselves from the misimpression that they definitely plan to pause in June. This will accomplish two important objectives. The first is to eradicate any lingering doubts about Mr. Bernanke's authority after the credibility slippage from allowing a misguided inference to develop last Wednesday. The second is to establish the Fed's clear understanding that the combined strong trends in commodities and equities require some address prior to exhibiting "irrational exuberance."

In that there is a very vocal chorus that is warning the central banks about lags in effect which mean they should take a breather sooner than not, the pressure to go softly is compelling. Yet, with the technical picture in the strong commodity and energy markets having no effect to date on the extended bull markets in equities, the RBA notes that, "The world economy is growing at an above-average pace… …and, significantly, forecasts have recently been revised upwards." This is the very tendency we have been highlighting in all recent OECD Composite Leading Indicator releases. The RBA further observes, "High profitability and rising share prices are indicative of a favourable business environment in which investment growth is likely to remain strong." Current global earnings releases and guidance support this view, and the corporate sector seems ready to offset any temporary energy inflation based consumer retrenchment.

As we noted last Friday, "…the risk is Mr. Bernanke may allow too much anticipation of Fed hopefulness instead of action in the face of untenable conditions. While mostly all prior and subsequent chairmen have been much more competent, this was the mistake that G. William Miller made back in the late 1970's (on the back of a late Arthur Burns' era lapse of judgment) that required Mr. Volcker's remediation. While undoubtedly Chairman Bernanke and his FOMC will be more diligent, some of the similarities in the description of that era in the academic paper from two University of California, Berkeley professors and National Bureau of Economic Research Associates are fairly scary; especially the bit about… 'The Federal Reserve does not consider a recession desirable.' (The Miller era analysis begins on page 15 of: http://emlab.berkeley.edu/users/cromer/draftpost.pdf)"

The bottom line is that incremental rate increases have not worked. Equity market strength continues in spite of the base rate hikes to date, which have been augmented by significant increases in material cost inputs. This demonstrates that the heavy and continued global liquidity infusion used to variously mitigate deflation potential or weak economic performance has taken on a life of its own. This is also evidenced by the trend in long dated fixed income. In most cases the only address of this is through stronger than expected central bank action.

To employ a gaming analogy, the FOMC is sitting at a poker table where the other players in the hand are holding strong cards (i.e. the aggressive up trend in almost everything *except* fixed income instruments and the US dollar.) A 25 basis point hike on May 10th is the equivalent of throwing a modest raise into the pot when they do not really have much of a hand (insofar as it is not likely to mitigate the global commodity price trend and corporate earnings/investment growth.) This assumes the attitude that by indicating (in their statement) they might push yet another 25 basis point raise into the pot after the next card is dealt, they are confident things are about to cool down on their own. If they are right, well and good; the other players just may begin to fold their hands.

However, if they are wrong, the subsequent sharp price escalation will amount to a massive raise by the other players. That will call for an even bigger raise from the Fed at the June meeting to mitigate the impression that their incremental approach has left them woefully behind the curve. While it's a tough call, the Fed might be well served by pushing a big raise into the pot next Wednesday. This will both give the other players quite a bit of incentive to reconsider their position (i.e. the ingrained assumptions regarding ever-escalating commodity and equity prices), and possibly allow for that pause in June without losing credibility.

Otherwise, they may be under quite a bit of pressure to put rates up 50 basis points in June, right when everyone had previous hoped they would be able to pause. Especially the political class will be howling if they raise 25 basis points now, and even more in June (right into the heart of the election campaign.) If energy, commodity and precious metals prices continue to climb, and equity markets remain immune to both that influence and incremental base rate hikes, the Fed will eventually need to grasp the nettle. In our experience that is best done sooner than not, both for the best economic effect from cooling prior to a hard landing being necessary, and the attendant credibility of the central bank. We shall see.

The big difference between now and 1997-1998 is that global crises do not diminish the Fed's latitude to address strength in the US economy. Similarly, this is not 2004, when weakness in Germany and Japan was also a deterrent to restraining US growth. Global growth is now strong enough that any misstep on the side of restraint will likely be easy enough to reverse, while too much ease potentially entrenches inflation effects that will require much stronger action later if ignored today.

As the technical projections and trend views remain exactly the same as yesterday's ***TrendView*** **GENERAL UPDATE**, we refer you back to that for any technical ideas. If any of you missed either that or the extensive Fed focus in Monday's ***Capital Markets Observer***, please let us know timely and we will be happy to send another copy.

We hope you find this helpful.

-Rohr