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Federal Reserve may still have to pull the punch-bowl at the party
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From Mr Alan Rohrbach.

Sir, There has been a strong desire among the broad trading and investment community that the Fed end its tightening exercise. A sense that this may be closer than not is now reinforced by wishful interpretation of this week's release of the minutes of the March meeting of the Federal Open Market Committee.

I continue to disagree with this misplaced notion, which has already fomented some self-limiting effects. On a fundamental basis I continue to believe the Fed is tacitly targeting the equity markets as proxies for the general level of economic confidence. While hopeful participants are counting on the Fed anticipating the point where it has provided enough restraint to underlying economic and inflationary forces, I believe it will require some real world indication that it is not stopping too soon. In that regard, I remind everyone again of Alan Greenspan's admonition in September last year regarding how the Fed viewed the previous significant tightening exercise: "*Yet the significant monetary tightening of 1994 did not prevent* what must by then have been *the beginnings of the bubble* of the 1990s" (my italics). I have no reason to presume that the current Fed chairman has forgotten this observation.

I fully expect that there will never be the slightest whiff of targeting the equity markets in their minutes, and they may indeed not even discuss this off of the record. However, the ability of buoyant equity markets to funnel "irrational exuberance" back into the economy at large cannot be very far from the Fed's intuitive sentiment about avoiding another bubble.

In that regard, they are now facing extensive strength in other world economies, and attendant explosive pricing for everything from commodities to energy, as well as the impressive ability of equity markets to ignore the latter. Inconsistencies in the broadly accepted logic of the investment community are always of extreme interest.

As noted previously, most informed observers believe that as soon as there is any sign the Fed is done with the tightening exercise equity markets will become even more explosively bullish than the current, seemingly base-rate immune, bull trends. As this was reinforced by the US market response on Tuesday afternoon, how can anyone be so very sure that the Fed will be done at any given interest rate?

The Street celebrated the indication that most members of the FOMC feel that ". . . an end to the tightening process seems likely to be near". Yet, more telling was the introductory phrase of that sentence: "Several members were concerned that market participants might not fully appreciate the extent to which future policy action will depend on incoming economic data . . ." The Fed was encouraged by underlying inflation abating in February. I can only wonder how it feels about current conditions. These are now economically strong enough to encourage an accelerating price spiral, and are also geopolitically unstable.

Of all the market responses to the FOMC minutes release, the most interesting was the long-dated fixed income.

If inflation is going to remain so subdued that the Fed should be comfortable with current short rates, why were bonds and notes so ambivalent?

While the bulls party at the ball, the belle has responded with regrets. Soon enough the Fed will likely need to perform its ultimate central bank duty, and pull the punch-bowl.

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