PRESS ARTICLE
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With the US Federal Reserve firmly expected to raise interest rates again this week, the key question is whether monetary policy is already over-restrictive. Indeed there is a valid argument to be made that the recent spike in inflation concerns is a reflection that interest rates 12 to 18 months ago were too accommodative and that with the economy now beginning to show signs of a slowdown, which will moderate pricing pressures, and investor sentiment having corrected significantly, US policymakers may be over-reacting and are running the risk of turning a typical mid-cycle slowdown into a more severe bout of prolonged economic weakness.

There is little doubt that Fed Chairman Ben Bernanke has been stung by question marks over his inflation fighting credentials and he is, to an extent, paying the price for comments made in 2003, well before his succession to Alan Greenspan was seriously considered, that in a dire enough deflationary scenario, policymakers could respond by dropping money from helicopters. In some quarters he has thus assumed the moniker "Helicopter Bill". This is perhaps a touch unfair and it is noticeable that over recent weeks, a number of his Federal Reserve colleagues have stated that inflation remains at a somewhat higher level than they are totally comfortable with. The upshot is that Central Banks remain concerned that pipeline price pressures could yet leak into broader consumer prices if growth remains resilient. An important point to consider is that, at some stage, if the US authorities are to avoid a sharp slump in economic activity, they will have to countenance a pause in the interest tightening cycle <u>before</u> inflation has shown unequivocal signs of cresting, reflecting the lag with which policy moves take effect. Given Ben Bernanke's somewhat clumsy attempts at communicating the Fed's thinking previously, this will likely prove a challenge if financial markets are not to further question his commitment to controlling inflation.

In terms of the equity market, this week's expected 0.25% hike has already been discounted, but there is little doubt that investors remain nervous and on edge as they try and assess how policy develops from here; sentiment which is unlikely to improve until clear signs emerge that rate tightening has come to an end. That said, US indices have held up relatively well in the face of hawkish rhetoric and mildly disappointing economic data, and several factors would seem to point to limited price downside from here for the time being.

According to Investor's Intelligence, there has been a dramatic deterioration in sentiment, with the ratio of bulls to bears having collapsed. This sentiment indicator has proven to be a remarkably reliable contrarian measure, with stocks typically rallying sharply whenever the ratio reaches a level not dissimilar to that currently in evidence. Similarly, share buy backs have accelerated, while corporate insiders are not rushing for the exits, which implies confidence in valuation levels and the long term corporate profit outlook.

While the downside may be limited, a rebound usually requires some sort of catalyst; in this instance a pause or easing in Fed policy appears the prime candidate. Currently this appears some way off yet and thus the stock market is likely to remain choppy until the threat to the economy and corporate earnings from an overly aggressive Fed is seen to be past.

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