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Stocks dive after Bernanke's warning

Fed chairman concerned about inflation, meaning more rate increases are likely

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The nation's top central banker signaled Monday that interest rates might continue to rise, jolting the stock market into a plunge. The Dow Jones industrial average nose-dived almost 200 points.

Federal Reserve Chairman Ben Bernanke warned in a speech at a Washington bankers conference that he is concerned that core inflation — price increases outside the volatile food and energy areas — is too high and that the Fed "will be vigilant" to rein it in. In the carefully parsed world of Fed-speak, that seemed a clear indication that the central bank is likely to raise interest rates by another quarter percentage point — its 17th consecutive such move over two years — at its next meeting June 28-29.

At the same time, Bernanke said, the economy appears to be cooling.

"The anticipated moderation of economic growth seems now to be under way," he said.

While the prospect of higher interest rates was bad enough, combining it with talk of an economic slowdown sent Wall Street into a paroxysm of panic selling.

"It brings up for investors that old word from the '70s — stagflation, a stagnant economy with inflation," said Richard Welty, president of Welty Capital Management in Lafayette. "When the market hears that, it's run for the doors."

Wall Street is apprehensive about higher interest rates because they slow economic growth and keep a damper on corporate profits.

Another exacerbating factor on Monday was that Iran supreme leader Ayatollah Ali Khamenei threatened to disrupt oil shipments if Iran is punished for its nuclear program. Iran is the fourth-largest oil exporter in the world. That kindled fears about rising energy prices.

Investors hammered down all three of the major indexes.

The Dow Jones industrial average was down 199.15, or 1.77 percent to 11,048.72. The Standard & Poor's 500 index fell 22.93, or 1.78 percent, to 1,265.29. The Nasdaq composite index dropped 49.79, or 2.24 percent, to 2,169.62.

In less than four weeks, amid alternate bouts of gloom over inflation and slow growth, the Dow has plummeted 5.1 percent from its six-year high of 11,642.65 on May 10.

"In one month it gave up all the gains of the past six months," Welty said. "The market is notorious for doing that."

Lackluster economic reports, most notably Friday's news that employers created only 75,000 new jobs in April, had convinced investors that there was only about a 50-50 chance that the Fed would continue raising rates. Fed officials had indicated they would closely monitor data on economic conditions in deciding on rate hikes.

Bernanke's speech Monday seemed to indicate that policymakers are coming down on the side of further tightening.

"The message coming across from this speech and some other Fed speakers is that the Fed is more concerned about inflation risks than growth risks," said Haseeb Ahmed, an economist at JPMorgan Chase in New York.

That contradicts what Bernanke said earlier this year.

"If you go back to the model Bernanke outlined two months ago, (he said) the Fed is very serious about (responding to) any data surprises they get relative to their forecast," Ahmed said. "All the data surprises have been that growth is lower than expected."

In other words, recent data about a softening economy should have caused the Fed to pause its rate hikes, according to its self-professed philosophy.

"It's almost like they're ignoring their own framework," Ahmed said. "It's very confusing in terms of what tools, what framework the Fed is using in judging the outlook and how far policy needs to go."

Some of the market turbulence could be investors getting to know Bernanke, who has been Fed chair only since February. His predecessor, Alan Greenspan, was at the helm for 18 years. While Greenspan's pronouncements were noted for their cryptic nature, he was a known quantity to Wall Street and the nation.

"We don't yet have a consistent view about the current Fed chair's thinking about the outlook and the economy," Ahmed said.

John Lonski, chief economist at Moody's Investors Service in New York, thinks Bernanke should have indicated that the rate-increase campaign could pause if the economy slows in the second half of the year.

"He made it sound as though he is going to hike rates regardless of what happens to the economy — that's how the equities market interpreted his statement," Lonski said.

Lonski thinks that Bernanke could be boxing himself into a corner.

"Today's lesson is, use quantitative targets sparingly when describing the likely strategy of monetary policy," he said. "Leave yourself some slack. (Bernanke) did not allow for the possibility of not hiking rates if the economy does slow as expected."

Bernanke's pronouncements bring up the famous line from the movie "Cool Hand Luke," Lonski said.

"Ultimately Ben Bernanke might just throw up his hands and recite that line, 'What we have here is a failure to communicate,' " Lonski said.

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