Philequity Corner (August 20, 2007)
By Valentino Sy

Global Stock Market Meltdown

Sometime in June this year, Washington Sycip, the sage of Philequity's board, called up Wilson Sy to voice his concern on the high price-earnings multiple and unusual volatility of Chinese stocks. He also expressed alarm on the proliferation of high-powered multi-billion hedge funds, particularly on the amount of leverage they use, their investments in derivatives and the increasing risk that these complex securities pose on the financial system. He reiterated the same apprehensions during our board meeting last August 1. Back then, most markets were just coming off their new all-time highs. Several weeks later, we find global stock markets teetering at the edge of a market meltdown. While we heeded the sage’s warning and anticipated a prolonged correction, we did not foresee the pace and extent of carnage that followed in such a short time.

During last week’s volatile trading, all the major US indices (DJIA, Nasdaq Composite & S&P 500) fell as much as 10 percent from their recent peaks before rallying late Thursday and on Friday. The DJIA closed at 13,079 last Friday, down 6.7 percent from its peak of 14,022. Meanwhile, the Nasdaq Composite Index has dropped 8.1 percent and the S&P 500 Index has declined 7.1 percent as of Friday’s close. Other major markets fell an average of 12.3 percent from their recent peaks.

	Year High	Current Price	%Drop
US			
Nasdaq	2,725	2,505	-8.1%
S&P 500	1,556	1,446	-7.1%
DJIA	14,022	13,079	-6.7%
Average			**-7.3%**
Other Developed Markets			
Japan (Nikkei)	18,300	15,274	-16.5%
France (CAC)	6,169	5,364	-13.0%
U.K. (FTSE)	6,754	6,064	-10.2%
Germany (DAX)	8,152	7,378	-9.5%
Average			**-12.3%**

Source: Bloomberg

In Asia, markets have dropped an average of 17.2 percent from their recent peaks, with Philippines having the most exaggerated drop of 24.5 percent.

	Year High	Current Price	%Drop
Asia ex-Japan			
Philippines (PSEI)	3,821	2,884	-24.5%
China (Shanghai B)	381	300	-21.4%
Indonesia (JCI)	2,406	1,909	-20.7%
Korea (KOSPI)	2,015	1,638	-18.7%
Taiwan (TWSE)	9,808	8,090	-17.5%
Thailand (SET)	896	758	-15.3%
Singapore (STI)	3,669	3,131	-14.7%
Malaysia (KLSE)	1,392	1,192	-14.4%
Hong Kong (Hang Seng)	23,558	20,387	-13.5%
India (BSI)	15,869	14,142	-10.9%
Average			**-17.2%**

Source: Bloomberg

Hedge funds de-leveraging

Investors have been puzzled why prices across a wide spectrum of assets moved sharply down last week, especially stocks. This has something to do with de-leveraging. When a hedge fund owns “tainted” assets that are going down in value for some fundamental reason, say mortgage-backed securities whose underlying collateral are defaulting subprime mortgages, and the fund is levered, its creditors start to make margin calls. The fund, then, has to sell assets to raise cash. The fund might end up selling relatively high-quality and liquid assets (“safe” assets) in order to raise the maximum amount of cash quickly to meet its margin call. This puts downward pressure on the prices of assets not tainted by risk. This explains the fierce and volatile drop in the Philippines and most other stock markets.

Light at the end of the tunnel?

In a surprise move last Friday, the US Fed lowered the discount rate it charges banks from 6.25 to 5.75 percent. This came a day after St. Louis Federal Reserve Bank President William Poole said that they would do nothing despite the credit problems. This had an immediate impact of calming the stock market panic, with the Dow Jones average closing up by 233 points. It remains to be seen if the fed action will be enough to reverse the downtrend. The Federal Reserve may have to cut the fed funds rate in their next meeting to restore order in the market. For now, we expect the market to continue being volatile.

In retrospect, during the LTCM crisis, which started August 18, 1998 (when Russia defaulted on its debts), the US Fed did nothing until September 29 when it lowered the Fed funds rate by 25 basis points, but not the discount rate. By October 15, 1998, the Fed lowered both the discount rate and the Fed funds, which further boosted stocks that were starting to rally. A 50 basis points cut followed on November 17. The stock market, however, was well on its way to recovery after the first discount rate cut.

Don’t Fight the Fed

From our experience trading stocks and currencies, it is never wise to fight the Fed. It has numerous monetary tools at its disposal to intervene and change the course of the economy and markets. **It may take time, but the Fed usually prevails.** In all likelihood, the Fed and the world central banks acting in consonance will bring back order in this volatile market and restore the economy to its growth phase.

Back to fundamentals

After the US Fed’s cut in discount rate, the S&P 500 has rallied 5.5 percent from its lows to close down 0.5% week-on-week. In contrast, the PSEi closed on its lows of the week (before the US Fed announcement) and is down 12.1 percent.

Taking a cue from the US markets and the performance of PLDT ADRs in the NYSE (which rallied as much as 10.2 percent before closing up 6.7 percent last Friday), we expect a rally this week in the Philippine stocks which are way oversold. We are also finding extreme bargains now in many blue chip issues which have declined between 25 to 35 percent from their recent highs.

During times of risk aversion and market panic, the rule is to go back to fundamentals. Stock-picking is the best strategy for now. Do your homework and your own research as Tony Samson highlighted in this column last week. Then pick the right issues you are willing to hold on to. Since it is difficult to pinpoint exactly where and when the markets will bottom, it is best to retain a long-term investment horizon.

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