Philequity Corner (September 17, 2007)
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Patience is a Virtue

Patience is one of the most valuable attributes in investing. Over the years, we in Philequity, have found out that it is best to be patient and stay with the trend until the fundamentals turn. This approach (akin to Newton's first law of motion) is all the more appropriate now that the market requires investors to have a higher degree of tolerance for volatility.

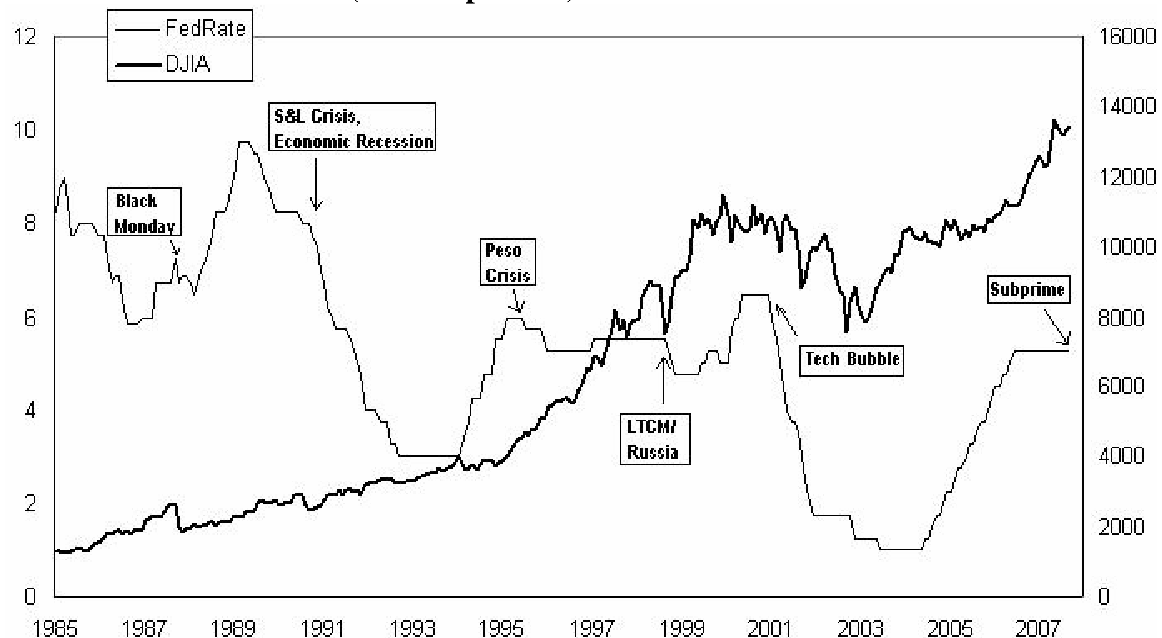
Since the carnage in August, global stock markets have recovered strongly on expectations of US Federal Reserve easing. In the US, the Dow Jones Industrial Index (DJIA) has rallied _ percent from its August low, while on the domestic front, the Philippine Stock Exchange Index (PSEI) has rebounded _ percent. In the short run, however, renewed turbulence in global stocks should not be ruled out as events in the US credit and housing markets continue to unfold. Nevertheless, we maintain our long-term bullish outlook for the following reasons:

1) There is little sign of global growth moderation. While US growth has slowed, the growth in the rest of the world has stayed very strong, with China, India, Europe and the commodity-producing countries leading the pack.
2) Global inflation remains relatively low despite rising commodity prices.
3) While the US is facing significantly weaker growth in 2H07, the probability of a recession is still low. Latest data from the Fed's Beige Book did not suggest significant broad weakening through August.
4) Lastly, major central banks (FED, ECB and BOJ) have all switched their policy stance toward the easing side. The US Fed will meet tomorrow (September 18) and we expect at least a 25 basis point cut in the federal funds rate. We are also expecting another 25 basis point cut by October, and possibly a last cut by December.

Fed easing and its effects on the stock market

Monetary conditions exert an enormous influence on stock prices. Generally, Fed easing is bullish for stocks, while tightening is bearish. On the chart below, we plot the last five Fed easing cycles vis-à-vis the movement of the DJIA so that we can gauge the odds of a stock market recovery in light of the imminent Fed rate cut.

DJIA & Fed Funds Rate (1985 to present)



Source: US Federal Reserve Board, Technistock

- The 1987 easing was largely in response to financial turmoil following the Black Monday crash when the DJIA lost 22.6 percent of its value in a day. The Fed funds rate was ultimately cut by 75 bps.
- The 1990 episode is most similar to what we are currently experiencing. The Fed lowered rates in response to real estate market (Savings & Loans) crisis while the US was also entering a recession. There was also a spike in oil prices due to Iraq's invasion of Kuwait. The Fed ultimately eased by 500 bps.
- The 1995 episode reflected another financial turmoil following the Peso crisis where Mexico faced the threat of default, with the Fed ultimately easing 125 bps.
- The 1998 easing was in response to another financial turmoil following LTCM's collapse and the Russian debt crisis. The Fed funds rate was ultimately lowered by 75 bps.
- The 2001 easing was in response to a full-pledged recession following the Tech Bubble and easing ultimately totaled 550 bps.

Performance of DJIA after Fed's first ease

	Date of Fed's	No. of	DJIA performance from first ease		
Financial Crisis	**first ease**	**basis points**	**3 mos**	**6 mos**	**12 mos**
Black Monday	Oct-87	75	-1.8%	1.9%	7.8%
S&L Crisis, Eco Recession	Oct-90	500	12.0%	18.2%	25.7%
Mexican Peso Crisis	Jul-95	125	1.0%	14.6%	17.4%
LTCM/Russian Crisis	Sep-98	75	17.1%	24.8%	31.8%
Tech Bubble	Jan-01	550	-1.4%	-3.3%	-8.9%
			5.4%	**11.2%**	**14.8%**
Subprime	Sep-07	?	?	?	?

Source: Philequity Research

In all five episodes, only in one instance did the DJIA show a negative return six months after the first Fed rate cut. This was in 2001 when the US plunged into a recession. It was only after three years (by 2004), that the DJIA was able to recover to its previous level.

What's notable, however, is that the Fed was successful in stabilizing the markets during the four other episodes. Even when the US growth contracted in 1990, the DJIA already showed positive return three months after the first Fed cut. On the average (after the Fed's first ease), the DJIA gained 5.4 percent after three months, 11.2 percent after six months, and 14.8 percent after twelve months.

Thus, it may be wise for investors to stick it out and be more patient, especially now that we have shown that the odds of a market recovery (following a Fed easing tomorrow) are high. With inflation being low, we believe that the Fed has enormous leverage to ease and reflate the economy out this subprime mess.

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