Philequity Corner (January 25, 2010)
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Bulaga!

In our article last week (see *Our Outlook for 2010* in the January 18, 2010 issue of **The Philippine Star**), we warned investors of a bumpy ride for stocks in 2010. We said that we expect volatility to increase and corrections to happen, particularly given the strong advance in stocks over the past nine months. We also mentioned the possible risks that may cause a substantial correction. True enough, three of the risks we mentioned took investors by surprise last week, causing stocks to tailspin.

Out of Nowhere

Just as the markets made new highs last week, out of nowhere came President Obama with a "bulaga!" During trading hours last Thursday, Obama delivered a speech to the US Congress proposing that banks be prohibited in owning or making investments in private-equity and hedge funds. In addition, he suggested that banks be prohibited from running proprietary trading operations solely for their own profit.

Even while he was delivering his speech, the stock market immediately started tanking. Obama's plan aims to prevent financial firms from running speculative operations while operating a bank backed by taxpayer's money.

Volcker Rule

Obama's proposal to curb the trading activities of financial institutions to prevent another crisis originated from the recommendations of former Fed chairman Paul Volcker. Obama called it the "Volcker Rule."

Volcker heads the Economic Recovery Advisory Board which is tasked to come up with solutions to the economic crisis. He is best known as an inflation fighter during his tenure at the Fed from 1979 to 1987. He forced inflation down to 1 percent from 15 percent by pushing the fed funds rate up to 20 percent.

Back to the Future

Obama's plan is reminiscent of the Glass-Steagall Act of 1933 which separated commercial banking from investment banking. It was repealed in 1999 when Lawrence Summers (now Obama's chief economic adviser) was Treasury Secretary in President Bill Clinton's administration.

Obama's proposal, however, is a lighter version of the Glass-Steagall Act because it would still allow commercial banks to continue investment banking activities like underwriting stock offerings, providing M&A advice and asset management.

Triple Whammy

Indeed, a triple-whammy dealt stocks their biggest weekly decline since March 2009. The Dow Jones Industrial Average lost 5 percent week-on-week because of the following reasons:

1) **Calls to limit the risk-taking of banks**. As discussed above, the first whammy was Obama's proposal to put a leash on banks. The led to a 5.1 percent slide in the S&P 500 Financials index last week. JP Morgan and

Goldman Sachs, who may have to sell some private equity businesses and stop investing in buyouts under Obama's plan, have lost 10.3 percent and 6.7 percent, respectively last week.

2) **Chinese monetary tightening.** Concerns that China will raise interest rates caused Asian stocks to fall last week. China is among those countries leading the world out of the global recession. Its 10.7 percent growth in the 4th quarter of 2009 has ignited fears that it will soon raise borrowing costs and banks' reserve requirements to keep its economy from overheating. China's CSI 300 index fell 3.3 percent for the week. Meanwhile, the MSCI Asia Pacific Index slumped by 4.9 percent over the same period.

3) **Bernanke and Geithner's job in peril.** Bernanke's job as Fed chairman is suddenly in jeopardy after the Republican upset for the Massachusetts Senate seat. Two more Senate Democrats said last week that they would vote against Bernanke's second term. Meanwhile, there is also speculation that Treasury Secretary Timothy Geithner could be replaced. With the US Congress facing mid-term elections in November, many lawmakers are careful not to take a stand that appears to benefit Wall Street and not Main Street.

Not only in the Philippines

We thought it was only in the Philippines where politicians make a lot of noise and use a lot of antics. But politicians will always be politicians. In fact, we see the same thing happening in the US Congress. We see Obama's proposal as a populist move aimed to regain political momentum, especially after an important Senate loss in Massachusetts last week. Similarly, the jobs of Bernanke and Geithner job have become hostage to the populist anger brewing out in the country.

Bernanke needs a Senate resolution to be reappointed as Fed chairman. It is dismaying to see somebody as respected as Bernanke (voted as Time Magazine's 2009 Man of the Year for 2009) to be subjected to this kind of embarrassment.

Beginning of a big correction?

By Friday's 10,173 close the Dow Jones Industrial Average had taken back about 10 weeks of gains in just three days (see chart below).

Similarly, our own PSE Index is little changed in 10 weeks.

Both the Dow and the PSE Index have now registered decisive breaks of their respective uptrend lines and are now below their 50-day moving averages. These indicate the likelihood of substantial corrections in the indices mentioned.

What should investors do?

Given the possibility of a much bigger correction from hereon, we advise investors who are long in the market to sell part of their holdings, especially those who are trading margin accounts.

Meanwhile, those who have are underweight in stocks and those who have no positions at all should look for levels to buy. In the case of the Dow, 9,500 to 10,000 looks like a strong support area for which to enter. Meanwhile, the PSE index has strong support between the 2,800 to 2,900 levels. While it appears that stocks may continue to pullback in the short-term, we continue to be positive on stocks on a long-term perspective.

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