Philequity Corner (August 8, 2011)
By Valentino Sy

Panic in the Streets

Since peaking at 12,724 points last July 21, the Dow Jones Industrial Average index had fallen 1,340 points or 10.5% in just 2 weeks. The stock market carnage culminated in a 513-point drop last Thursday that had markets around the world reeling. This bloodbath and the ensuing panic, resulting in the largest weekly drop in the S&P 500 since 2008, engulfed the rest of the world, including the Philippines. Further compounding the problems of the US was S&P's decision to downgrade US debt to AA- from AAA over the weekend, the very first time that the US credit rating has been downgraded.

Behind the Bloodbath

There are a multitude of reasons behind the stock market plunge in the US that led to the 9th biggest point drop in the history of the Dow Jones index. Below is a brief discussion of these reasons.

1. **Weakening U.S. economy** – Recent GDP data show that the US expanded by less than 1% in the first half of the year. Industrial activity is likewise slowing, as evidenced by weak PMI and ISM numbers. All these, plus lower consumer spending all pointed to a weakening economy, bringing about talks of a double dip recession.
2. **Dysfunctional politics** – The political gridlock, the grandstanding of the politicians and the disappointing debt ceiling compromise was met with disgust and disappointment. This was elucidated by the words of PIMCO CEO Mohamed El-Erian when he said that "the stunning political dysfunctionality was exposed by the debt ceiling debacle." In the words of the S&P, "the effectiveness, stability and predictability of American policymaking and political institutions have weakened at a time of ongoing fiscal and economic challenges."
3. **Uncertainty** – As a result of the brinksmanship in Washington, the product was a piece of legislation that did not address the long term deficit issues of the US. Instead of coming up with $4 trillion in savings that would have pointed the economy in the proper direction, the package would reduce the deficit by only $2.1 trillion over 10 years. Instead of taking the bull by the horns as the Philippines did (see *Staying the Course of Reforms,* 31 July 2006), the US has delayed the resolution of the problem. In this case, time does not heal wounds. Rather, it makes it deeper. Uncertainty is anathema to the stock market.
4. **Anticipated credit rating downgrade** – The repeated warnings of the ratings agencies caused the markets to be jittery. Obama's speeches and the repeated torpedoing of each proposal to address the budget deficit did little to calm the frazzled nerves of investors. These warnings finally came to fruition when the S&P downgraded US debt. The S&P said that "the downgrade reflects our opinion that the fiscal consolidation plan that Congress and the administration recently agreed to falls short of what, in our view, would be necessary to stabilize the government's medium-term debt dynamics."
5. **Lack of confidence** – The outcome of the debt ceiling debate in Congress has caused investors to lose confidence in their leaders. Seeing that the bullheadedness of policymakers and their uncompromising hardline stance would be of no help to the economy, investors acted accordingly and sold their holdings. Moreover, perception that the Fed is out of bullets meant that not only would QE3 be ineffective, but that now, no one can rescue the economy from its malaise.

6. **European contagion effect** – Further complicating the matter is the debt crisis in Europe that has threatened to engulf Spain and even Italy, the EU's 3rd biggest economy. To put it in perspective, note that the economies of Greece, Ireland and Portugal combined amount to only about 1/3 of that of Italy. Yet, these roiled the markets as each unfolded.
7. **Technical chart breakdown** – Charts of stock market indices in the US, Europe and other major countries show a technical breakdown. Various bearish patterns have been emerging, like the S&P 500 which broke down from a head and shoulders top. This triggered stop losses which caused traders who use technical analysis to sell their positions.
8. **Risk-off trades** – All the macro headwinds and uncertainties have caused portfolio managers to take risks off the market. Many investors sold all perceived risky assets, like equities, bonds and commodities. They sought the safety of cash and gold. This even prompted the Bank of New York Mellon to charge penalty fees for large cash deposits.

A Stark Contrast

The big difference now between Asian economies, including the Philippines, and the US is that while they continue with their profligate ways, we have learned our lesson from the Asian financial crisis. Asian economies now have good fiscal discipline, which has partially insulated them from the financial turmoil in the developed world. For instance, the US reached the ceiling in terms of its borrowing. On the other hand, the Philippines' budget deficit is way below the cap set by the government.

U.S. Political Gridlock versus Enlightened Philippine Government

While the Democrats and Republicans are wrangling on ways to revive their flagging economy, our legislators and leaders have gotten their act together. The Bangko Sentral ng Pilipinas (BSP) is doing its part in controlling inflation by raising interest rates in line with inflation figures while, at the same time, controlling inflows of hot money into the country. The executive branch and the Department of Finance is closely watching the deficit and ensuring that it remains below the targets they have set. As far as legislation is concerned, constitutional amendments covering economic statutes are now on the table. Lifting foreign ownership limits on mining, utilities, media companies and land is a step in the right direction and a bullish signal for the stock market.

U.S. Downgrade, Philippines Upgrade

Whereas the US and Europe are getting swamped by debt downgrades, Philippine debt recently got upgraded and is on the verge of being rated investment grade. Confidence in developed countries continues to wane as ratings agencies re-rate the Philippines as less risky than the larger world economies. As a result, our Western counterparts' problems will be exacerbated by increasing borrowing costs. On the other hand, our interest expense will only continue to drop.

Breakdown there, Breakout here

While the Dow Jones index has broken down from major support levels in its chart formation, the Philippine Stock Exchange index (PSEi) chart has broken out to all-time highs and is just correcting to support levels. The US market may rally if policy uncertainty is removed, but the current breakdown remains to be a bearish pattern. Technical damage to our index, on the other hand, is limited and contained primarily to stocks with high foreign ownership. The PSEi's bullish chart pattern remains intact.

Buy Philippines

As we mentioned in our previous article (see *Role Reversal*, 25 July 2011), there are sizeable stock market outflows from the developed markets while stock market inflows continue into the ASEAN region, including the Philippines. There is now a paradigm shift where local investors seek safety and security of their investments in their own backyard. Given this era of uncertainty, it is prudent to stick to our own country and the investments that you know. While investing in foreign countries and instruments may seem sophisticated, the risks are larger and the returns had been smaller. With all the problems abroad, why should one invest outside the country? Our advice - in times of uncertainty, bring back your Euros and US dollars to your home country. Buy Philippine bonds, buy Philippine pesos and buy Philippine stocks. Buy Philippines.

For further stock market research and to view our previous articles, please visit our online trading platform at www.wealthsec.com or call 634-5038. Our archived articles can also be viewed at www.philequity.net.