Philequity Corner (September 10, 2012)
By Valentino Sy

A Battle of Will

Two weeks ago, we wrote about European Central Bank president Mario Draghi's pledge to do whatever it takes to preserve the euro (*Whatever It Takes*, 27 August 2012). It was a turning point for stock markets even if Draghi did not specify how he plans to save the euro. Similarly, US Federal Reserve chairman Ben Bernanke declared in a speech at Jackson Hole that the Fed is open to implementing more quantitative easing measures if the situation arises, signifying that central banks are ready to act if the economy falters.

Bad News is Good News

On US shores, recent data indicates that they have a tepid economy with very slow jobs growth. In fact, last Friday jobs growth was just 96,000, lower than expectations, fuelling speculation that the Fed may do something substantial this week. This creates an odd scenario where bad news is actually good news since investors are looking forward to the Fed implementing the ace up its sleeve.

Bulls vs. Bears

Taken together, these twin declarations, while lacking in definitiveness, were indicative of the urgency of tackling the crisis head on. While interest rates are at historic lows, against the backdrop of a fundamentally problematic Europe, these statements led to a strong division between investors who were believers in the central banks and non-believers. Many economists and research analysts have been cautious and unconvinced that the economy has turned the corner. They believed that the stock market will fall substantially because deep structural and fiscal reforms are needed to lift the global economy.

Enter the Draghi

"*And believe me, it will be enough."* – ECB President Mario Draghi, 26 July 2012

And enough it was. In a press conference last week, Draghi pulled out all the stops. He declared that the euro is irreversible and that a program will be launched that will allow the ECB, with the assistance of the IMF, to purchase bonds of troubled countries. Moreover, in order to effectively *"address severe distortions in government bond markets"*, the ECB said that there will be no limit on the amount of bonds it can buy. Although there were conditions tied to these purchases, stock markets around the world rallied strongly. In the US, the S&P 500 is already at 4-year highs while the NASDAQ index is at levels not seen in the past 12 years. European stock markets have found their bottoms and rallied strongly.

Since the statement of Draghi where he declared that he will do whatever it takes to the unveiling of the OMT, markets have shown that central bankers have the upperhand in this battle of wills between them and the naysayers.

Unconventional Monetary Tools

This new program, called Outright Monetary Transactions, or OMT, called for unlimited purchases of bonds with maturities of up to three years, provided that countries apply for help to the European Financial Stability Facility (EFSF) and European Stability Mechanism (ESM). Thus, when Spain applies for aid, it will have to comply with conditions on economic reform and fiscal improvement if it wants the ECB to continually purchase its bonds. Unlike QE, this program does not call for the expansion of monetary supply, with bond purchases instead being sterilized.

Over the past few years, central banks have used new and unconventional weapons to tackle the financial crises facing them. New ways of measuring financial risk have also emerged, which led to the development to a whole slew of acronyms. From QE 1 & 2 (and maybe even QE 3) as well as Operation Twist in the US, to the LTRO and now the OMT in Europe, central banks are now unveiling an economic arsenal never before seen in history or even in college textbooks.

Light at the End of the Tunnel

While the OMT will not be the ultimate solution to Europe’s woes, it not only eliminated tail risks such as the dissolution of the euro, but it has also bought time for Eurozone countries to pursue the reforms necessary to maintain their membership. Now that the euro has stabilized and gained strength, each country’s government must now focus on ensuring the proper implementation of reforms that will serve as long term solutions. It is too early to say that we are out of the woods, but we can see that there is light at the end of the tunnel. Both Draghi and Bernanke have been very proactive in stemming the crisis and they have shown that they are prepared to do whatever it takes to save their respective domains.

China Plays Its Role

In this globally coordinated stimulus program, world central banks continue to pump prime their economies with low interest rates and other stimulus packages. Last Friday, the Chinese government played its role by announcing its own stimulus program in the form of $126 billion of infrastructure spending for subway and rail projects, as well as plans to build 2,018 kilometers of roads.

Philippines Ahead of the Curve

On the domestic end, Department of Finance Secretary Cesar Purisima and Bangko Sentral ng Pilipinas Governor Amado Tetangco, Jr. are continuing to navigate the Philippines through choppy economic waters. With these two men at the helm, the Philippines remains relatively insulated from the crises unfolding in the more developed parts of the world.

Catching Up

In the meantime, stock markets in countries that were battered and sectors that were pummelled to exceedingly low levels continue to rally. Cyclical sectors have also performed better than defensive sectors. Meanwhile, the Philippine equities market, which has been a stellar performer for the year, continues to consolidate while other countries that underperformed catch up. A consolidation after rising more than 20% year-to-date is, in fact, healthy. We also believe that the Philippine stock market will resume its upward trajectory after this consolidation.

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