Philequity Corner (October 22, 2012)
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The Great Global Monetary Easing

In recent articles, we talked about the bold moves of Fed Chairman Ben Bernanke and European Central Bank (ECB) President Mario Draghi (*A Battle of Will*, 10 September 2012). Using every weapon at their disposal from rate cuts to outright bond purchases, they were the ones who started the "Great Global Monetary Easing". Central banks all over the world have also followed suit, using conventional and unconventional tools to stimulate their respective economies. The Philippines also rode the wave of global easing, with the Bangko Sentral ng Pilipinas (BSP) reducing benchmark interest rates 3 times, for a total reduction of 0.75% in 2012, bringing rates to a record low of 3.75%. All in all, global central banks have risen to the challenge of fending off the threats of a global recession. Some stock market pundits have even coined terms such as "QE Infinity", referring to Bernanke's intention to ease all the way till 2015.

With all these newfangled words flying around in the news, our readers have been asking us to explain (in layman's terms) what exactly has been happening around the world. Below are some of the most frequently asked questions.

What is QE infinity?

Prior to Bernanke's press conferences, this was referred to as QE 3, or the 3rd round of QE. QE stands for quantitative easing, an unconventional monetary policy that involves buying financial assets, usually bonds, from banks in order to increase bank reserves and stimulate loan growth and consequently, economic growth. In this case, QE 3 will focus on the purchase of mortgage bonds in the amount of $85B for the rest of 2012, or about $40B per month. Bernanke stated that the Fed will continue buying bonds until the outlook for the labor market improves substantially. This is in addition to the pledge to keep benchmark interest rates low until at least mid-2015**.** This open-ended aspect is an unprecedented move on the part of the Fed since, instead of specifying a duration for their program, they tied its completion to a specific outcome. With this pledge to ease until the economy recovers, it was dubbed QE Infinity.

What is OMT?

Like Bernanke, ECB President Mario Draghi made a similar promise, saying that he will do "whatever it takes" to preserve the euro (*Whatever It Takes*, 27 August 2012). OMT stands for Outright Monetary Transactions, a program which calls for unlimited purchases of government bonds, with maturities under 3 years, of troubled European countries. Under the program, additional funds will also be lent to countries that are already having difficulty accessing bond markets. These funds will be coursed via the European Financial Stability Facility (EFSF) and European Stability Mechanism (ESM). However, in order for the ECB to continue purchasing bonds of these countries and keep their borrowing costs low, these countries will have to comply with certain goals and conditions on economic reform and fiscal improvement.

Why is the Fed engaging in QE?

Unlike the BSP which has the singular mandate of maintaining price stability, the Fed has a dual mandate of maintaining price stability and fostering economic growth. Thus, QE 3 has the explicit goal of stimulating economic growth that will raise employment levels. Through the purchase of mortgage bonds, the Fed expects the assets, such as equities and the housing market, to recover. They seem to have succeeded, with US indices reaching multi-year highs and housing prices bottoming out. Eventually, when stocks and housing prices rise, the Fed believes that there will be a “wealth effect” that leads to increased consumer confidence and consumption. The resulting rise in economic activity will then lead to lower unemployment rates, accomplishing the Fed’s mandate.

What are the risks to investing?

There are a number of risks to buying stocks in this environment, such as the global economic slowdown, the European sovereign debt crisis, the US fiscal cliff, a slowdown in earnings and a possible hard landing in China. These have prompted many fund managers, economists, strategists and retail investors to be cautious of the market.

Will QE work?

The coordinated action of global central banks to lift asset prices and encourage confidence seems to be working, at least for now. There are concerns that this unprecedented pumping of liquidity will lead to higher inflation and maybe even asset bubbles later on. It will take years to see if this wave of central bank action will work. However, history shows us that central bank intervention has worked numerous times before. For instance, central bank action triggered the recovery of Asian countries in the 1997 financial crisis. The same was also necessary in stimulating the recovery and growth of Brazil. A more recent example would be how the Fed avoided a bigger crisis when it intervened in the 2008 financial crisis.

Why should we buy stocks even as we are dealing with various macroeconomic headwinds?

The earnings reports that came out last week and the problems in Europe caused the market to gyrate, leading to substantial corrections. In fact, last Friday the Dow Jones dropped 205 points because earnings reports showed anemic growth.

Though we do not know yet whether the global monetary easing will work this time, one thing is clear - central bankers want asset prices to go up. This can be seen when, even after deep stock market corrections, markets still continue to move higher. Prior to last Friday’s drop, both the Dow Jones and S&P 500 were at 3-year highs while the Nasdaq was at its highest level since 2000. In Europe, Spanish 10-year bond yields are down from the danger zone of 7% and are currently at 5.4%. With developed markets growing at 2% or less, this anemic growth is expected, and this is precisely what the “Great Global Monetary Easing” is for. While the verdict is still out on whether these global problems will be solved, with central bankers worldwide behind us, we would bet on asset prices going up in spite of all the fear and skepticism. As the popular stock market adage goes – don’t fight the Fed.

What does all this mean for the Philippine stock market?

Corrections in global markets will also cause a correction here. However, since we are buoyed by strong domestic consumption which accounts for 75% of our GDP, the Philippine economy has been relatively insulated from the problems that plague the global economy. Earnings visibility for Philippine companies

is also higher versus those in more developed countries. The PSE Index has also mirrored this resilience and has continued to perform strongly this year. In fact, it has made a new all-time high last October 5 and is up 24% YTD.

We believe that a correction is healthy for the stock market. We should take advantage of the nervousness and the jitters in the world stock market by buying stocks that benefit from the ever-growing domestic consumer demand. We recommend that investors treat these dips as opportunities to buy. We are confident that the PSEi's recent high will eventually be surpassed.

Best Finance Minister of 2012

History and recent events clearly show that the actions of policymakers greatly influence the economic position of countries. In the case of the Philippines, we at Philequity believe that the country's exceptional economic managers have played a major role in steering our economy through these tough times. It is in this light that we would like to congratulate Department of Finance Secretary Cesar Purisima for being named as the Euromoney Finance Minister of the Year for 2012.

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