Philequity Corner (June 29, 2015)
By Valentino Sy

The Power of Words

"The pen is mightier than the sword." In a short sentence and in just a few words, this popular adage has eloquently captured how powerful words can be. We have seen many examples of famous speeches made by prominent people and how these altered the course of history. This is also something that we have witnessed in the financial world. While numbers, figures and charts are important in finance, it is imperative for us to always remember that words can be just as important. As we have seen many times, words – especially those coming from powerful central bankers – can move markets in big ways.

Yellen's words

Recently, Fed Chair Janet Yellen reaffirmed that the Fed will be careful in determining the timing and pace of monetary policy normalization. While there is an ongoing guessing game as to when the first rate hike in a very long time will occur, Yellen stressed that the decision will continue to depend on economic data. Further, Yellen said that it will be appropriate to raise interest rates when the Fed has seen "further improvement in the labor market and is reasonably confident that inflation will move back to its 2% objective over the medium term." The Fed's latest statement caused markets to move higher, with the Russell 2000 and the Nasdaq reaching new all-time highs. This is one of the many examples that show how powerful central bankers are and how their words can move markets.

Bernanke's precedent

When the global financial system was on the verge of collapse in 2008, Bernanke came to the rescue and prevented a prolonged economic depression. Under his lead, the Fed engaged in unprecedented monetary easing which gave rise to the bull market that we are experiencing now. Aside from this, Bernanke also used words – through the Fed's statements and his various speeches – to clarify monetary policy actions and provide guidance on growth and inflation expectations.

Words move markets

Bernanke's actions and words gave rise to the global bull market that we are witnessing now. The S&P 500 is up 142% since the Fed launched its quantitative easing (QE) program, lifting other global indices with it. During Bernanke's term, central bank guidance became increasingly important, as it clarified the Fed's outlook on growth and inflation even as the global economy grappled with various challenges and headwinds. This practice was judiciously followed by Bernanke's successor, Janet Yellen, as well as other powerful central bankers such as European Central Bank (ECB) President Mario Draghi and Bank of Japan (BOJ) Governor Haruhiko Kuroda. Doing this served to magnify the effects of their policy actions. In fact, there have been many cases when markets moved sharply higher or lower after central bank statements, even before the policy actions were actually implemented.

Words from the Fed

Yellen clearly followed Bernanke's footsteps. Under her lead, the Fed deftly explained that though the US economy is clearly stronger than where it was in 2008, the recovery is still fragile as various headwinds have continued to threaten growth. In light of these risks, the Fed stressed that it will be extremely careful and thorough in normalizing monetary policy so as not to upset the US economy's fragile recovery. In the succeeding paragraphs, we show some of the key words and excerpts from the Fed's previous statements. These words have played a significant role in the ongoing 7-year bull market.

Considerable

September 13, 2012: *To support continued progress toward maximum employment and price stability, the Committee expects that a highly accommodative stance of monetary policy will remain appropriate for a **considerable** time after the economic recovery strengthens.*

Patient

After the Fed was ready to remove the word "considerable" in its statement, it had to find a word that will signal that interest rates will not rise abruptly. To substitute, they used the word "patience."

December 17, 2014: *Based on its current assessment, the Committee judges that it can be **patient** in beginning to normalize the stance of monetary policy.*

March 19, 2015: *Just because we removed the word 'patient' from the statement does not mean we are going to be impatient.*

Data dependent

March 27, 2015: *To conclude, let me emphasize that in determining when to initially increase its target range for the federal funds rate and how to adjust it thereafter, the Committee's decisions will be **data dependent**, reflecting evolving judgments concerning the implications of incoming information for the economic outlook.*

Balanced approach

April 29, 2015: *When the Committee decides to begin to remove policy accommodation, it will take a **balanced approach** consistent with its longer-run goals of maximum employment and inflation of 2 percent.*

Gradual

May 22, 2015: *For this reason, if the economy continues to improve as I expect, I think it will be appropriate at some point this year to take the initial step to raise the federal funds rate target and begin the* process of normalizing monetary policy… *After we begin raising the federal funds rate, I anticipate that the pace of normalization is likely to be **gradual**.*

Whatever it takes

Aside from Bernanke and Yellen, ECB President Mario Draghi is another central banker who has used powerful words to bolster his objectives. Confronted with a sovereign debt crisis in Europe, Draghi dug deep into his bag of tricks and pledged massive buying of European sovereign debt. In a speech he made in July 26, 2012, Draghi boldly said, "*Within our mandate, the ECB is ready to do* ***whatever it takes*** *to preserve the euro. And believe me, it will be enough."* Though the ECB did not initiate its bond buying program then, Draghi's words proved to be a crucial turning point in stemming the crisis and instilling confidence in the European economy. Markets moved higher with Draghi's words, even as the commensurate actions came only years after. In fact, the Euro Stoxx 50 is up 68% since Draghi's "whatever it takes" speech in 2012.

Quantity and quality

When Haruhiko Kuroda assumed the position of BOJ Governor, he knew that he had to come up with an extraordinary and determined effort to pull Japan out of its 23-year sandtrap. Following the examples of his American and European counterparts, Kuroda went all-in and pledged a massive monetary stimulus which involved buying of Japanese bonds, exchange traded funds (ETFs) and real estate investment trusts (REITs). Below is an excerpt from Kuroda's speech in 2013.

April 12, 2013: *Consequently, it becomes important to determine not only how much liquidity to supply but also how to supply that quantity… Thus, it is important to work on two aspects of monetary easing, both in terms of* ***quantity*** *and* ***quality****.*

We note that the Nikkei 225 has gone up 53% since Kuroda's speech in 2013.

Appropriately calibrated

Even our country's central bank head, Bangko Sentral ng Pilipinas (BSP) Governor Amando Tetangco, Jr., has used a careful choice of words to explain the BSP's policy actions with regard to the country's growth and inflation outlook. Below is an excerpt from the BSP's latest policy statement.

June 25, 2015: *The Monetary Board noted that domestic demand conditions remain firm despite the lower-than-expected first-quarter output growth, supported by solid private household and capital spending as well as buoyant business confidence. At the same time, ample domestic liquidity and planned higher public spending are expected to further support domestic economic activity and sustain the economy's momentum in the months ahead. Given these considerations, the Monetary Board believes that prevailing monetary policy settings remain* ***appropriately calibrated*** *to the outlook for inflation and domestic economic activity.*

Words can move mountains

There is a biblical quote that says faith can move mountains. Some people say that words can move mountains. In the financial world, even a single word can cause global markets to move in big ways. As seen in the examples above, significant and timely words such as "considerable", "patient" and "gradual" have caused major market movements. This also highlights one of the most basic investment tenets of Philequity, which is to "follow the Fed" and follow central bank actions. Since regulators have become more transparent about their goals, intentions and actions, it is incumbent upon investors to follow the words of global central banks in order to better understand where monetary policy, the global economy and financial markets are going. We believe that doing this should ultimately allow investors to make better and more informed investment decisions.

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