Philequity Corner (December 21, 2015)
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The Force Awakens

The long wait is finally over! After 7 years of near-zero interest rates, the US Federal Reserve has finally raised its benchmark rate. This rate hike has been the most talked about, the most telegraphed and the most awaited interest rate increase. This rate rise has left Fed watchers, analysts, bankers and investors hanging on to every word that comes out from the mouth of the Fed (see *Every Move You Make*, 9 November 2015).

The first

As we have written before, the reason why this event is on the mind of many investors is because it is the first rate hike since June 2006. At that time, US interest rates were at 5.25%, a far cry from where we are now. It has also been more than a decade since the start of the last US hiking cycle, which was way back in 2004. Thus, it can be compared to the significant firsts in people's lives, just like a first love or first kiss.

The Force Awakens

We are not talking about the record-breaking movie, "Star Wars: The Force Awakens." We are actually referring to the force of the economic recovery in the US. In her statement justifying the first rate hike in more than 9 years, Yellen said "that the Fed's decision reflects our confidence in the US economy. We see an economy that is on a path of sustainable development." With unemployment at 5%, payrolls data above forecasts and GDP growth holding above the 2% level, the interest rate hike clearly reinforces the notion that the force of the US economy has clearly awakened from its stupor.

Divergent

While the force of the US economy has awakened, the same is not true elsewhere. Europe is still stuck in the doldrums, China continues to slow down and Japan is having difficulty hitting its economic targets. This divergence in growth has led to a similar divergence in monetary policy. As the US is raising interest rates, Europe and Japan are in the midst of their own version of quantitative easing (QE).At the same time, China and many emerging market countries are cutting interest rates to stimulate growth in their respective countries. Unlike other hiking cycles where interest rates in major economies are moving in the same direction, this hiking cycle is characterized by divergent monetary policies across different countries.

Dollar too strong

This divergence has created a strong dollar which is rising against almost all currencies. The anticipation of an increase in interest rates has resulted in a strengthening US dollar for the past few years (see *Opportunity of a Lifetime, Chapter 7, Peso Tops Out* and *It's the Strong Dollar, Stupid*, 24 June 2013). The US dollar is further bolstered by interest rates heading lower in most other countries. Previously, Yellen had already expressed caution regarding the rapid ascent of the US dollar as it is already having a detrimental effect on exporters.

Loonie, Kiwi, Aussie, Rand, Ringgit, Rupiah, Real

Dollar strength has also weighed on commodity prices, especially crude oil. This has brought down equities and currencies in many emerging markets, especially those that are reliant on crude oil and other commodity exports. Among the worst hit are currencies of commodity-exporting countries, such as the loonie (Canadian dollar), kiwi (New Zealand dollar), aussie (Australian dollar), rand (South African rand), ringgit (Malaysian ringgit), rupiah (Indonesian rupiah) and real (Brazilian real).

Philippines a beneficiary of low commodity prices

However, unlike the countries above, the Philippines actually benefits from low commodity prices. We are a net oil importing country, with 20% of our import bill coming from crude oil and other related products. Moreover, with 70% of our GDP coming from domestic consumption, these historically low prices redound to the benefit of the Filipino consumer and the country's economy.

Philippines falls with other emerging markets

Unfortunately, despite the fact that we are beneficiary of low oil prices, we are also classified as an emerging market. In fact, the widely followed MSCI Emerging Markets index includes Philippine stocks, with a total weight of 1.4%. Therefore, when most other emerging markets fall, the Philippines is included in the sell-off by virtue of its membership. The overall strength of the US dollar has also caused emerging market currencies to depreciate, including the Philippine peso. Thus, it will be difficult for the peso not to depreciate when all other currencies are going lower.

Quadruple witching

Another event that exacerbated the drop in equities is the so-called quadruple witching last Friday, December 18. In foreign markets like the US, one can trade stock options and futures. These have specific expiry dates which sometimes overlap. When they do overlap, extreme price volatility ensures as traders renew or exit their positions. Hence, many trades have dubbed this time as the "witching hour." Last Friday, the US stock market was due for quadruple witching, meaning that 4 types of derivatives (index options & futures, stock options & futures) were expiring on exactly the same day. Coupled with volatility and uncertainty after the Fed rate hike, the downward move became all the more violent. On Friday alone, the Dow Jones index fell 367 points on high volume.

Risks abound

Aside from the first rate hike last week, other risks still remain. Too strong a dollar poses a risk not just to emerging markets, but to the US as well. The spectre of slowing global growth continues to haunt markets. A hard landing for China's economy is also a constant worry for many investors. Commodity prices at historic lows are also affecting the health of many emerging market countries. This was highlighted when crude oil prices fell 11% in just one week, a 7-year low. Geopolitical risk, such as terrorism and the EU refugee crisis, is also a cause for apprehension.

The Philippines is more resilient

In spite of our 5% YTD drop, it is important to note that the PSEi is still in better shape than many emerging markets and its ASEAN neighbors, most of which are down double digit percentages for the year. In fact, several prominent foreign investment houses have upgraded the Philippines to an overweight. For instance, Goldman Sachs has a 12-month PSEi target of 7,900 while Macquarie has a yearend 2016 target of 7,800.

In a statement about the Fed's liftoff, Finance Secretary Cesar Purisima said that the Philippines will remain "resilient from increased rates." He further added that "the Philippines has been a current account surplus country for 12 straight years and we expect this record to be maintained further by falling oil prices. We are on track to post a surplus of $14.2 billion this year, equivalent to 4.4% of GDP. Foreign reserves remain ample at $80.6 billion, able to cover 10.3 months of imports as of end-November 2015." As long as we have capable economic managers, we believe that the Philippines will be able to differentiate itself from its less insulated neighbors.