Philequity Corner (February 22, 2016)
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The Bounce

The first six weeks of the year proved to be very bloody for many asset classes. Equity indices experienced historic and record-breaking drops, with many equity indices falling double digit percentages in just a matter of weeks. Many stock markets had their worst 4-day start to the year while some had their worst weeks in history. Images all over the news were comparing this drop to the 1997 Asian Financial Crisis and the 2008 US Financial Crisis. This prompted some naysayers to pronounce that we have entered a bear market and that stocks have nowhere to go but down.

Perfect storm

Many have been wondering why the market fell so much at the start of the year, so we took the opportunity to explain this to our investors in our January 30 briefing. Our 1st three articles after New Year also explained these, so our readers can refer to them (see *China Pummels Global Markets, It's the Strong Dollar, Stupid! – Episode 3* and *When good turns bad*). For those who were not able to attend our briefing, the reasons behind the perfect storm at the start of the year are as follows:

1. Global economic slowdown
    - Fears of a recession as Europe, Japan and the US experience tepid growth
    - Many emerging and commodity-exporting countries are in technical recession
    - China slowing down and dragging down global growth
2. China
    - Economic slowdown with the possibility of a hard landing
    - Sharp and unexpected renminbi depreciation
    - Precipitous drop of China's stock market and the government's mishandling of the sell-off
3. Fed rate hike and divergent interest rate policy
    - As other countries ease, the US Fed is tightening, driving flows out of other countries and into the US
4. Strong dollar
    - As a result of the divergent interest rate policy, the US dollar strengthened significantly, specifically against emerging and commodity-linked currencies
    - Negative impact on emerging bonds and stocks
5. Low oil prices and Middle East conflict
    - Saudi Arabia-Iran conflict at the start of the year was the initial trigger for the correction
    - Low oil prices reflective of deteriorating credit outlook for oil-producing companies and countries, which heightened the risk of default
    - Specifically for the Philippines, possibility of OFWs being sent home from the Middle East

More risks emerge

Unfortunately, more bearish headlines would come our way as European banks came under attack. Analysts questioned their loan exposure to oil-producing companies and whether the banks had a large enough capital buffer to offset potential losses from defaults. With their financial health now in question, European bank stocks were sold off. Foremost of these was Deutsche Bank, which lost more than 40% of its value since the start of the year and is now trading at 0.3x tangible book value.

The selloff in European banks dragged down most equity markets. In fact, US and European indices eventually broke their January lows. Near zero interest rates made matters worse for them. Though low interest rates stimulate growth, net interest margins for banks shrink, especially when interest rates are below zero.

Central banks fight back

Cognizant of the risk of a global economic slowdown, central banks started to fight back. In her latest testimony, Fed Chairman Janet Yellen played down initial expectations of more rate hikes this year, noting that they are concerned about global and financial developments. Both European Central Bank President Mario Draghi and Bank of Japan Governor Haruhiko Kuroda also announced that they will not only deploy more instruments, but they will expand their monetary stimulus as well (see *Central Banks Strike Back*, 1 February 2016). This had a very positive impact on sentiment and markets rallied as a result.

Foreign flows are trickling in

The change in sentiment was reflected in foreign fund flows into the Philippine market. After months of practically unabated foreign selling, foreign funds net bought PhP 3 billion worth of Philippine stocks in just 5 days, from January 26 to February 1. Although we have seen foreign outflows during the selloff in European banks, we note that the PSEi has been relatively resilient. In fact, as of last Friday's close, the PSEi is up 11.6% from its January bottom despite sharp drops in developed markets. This resilience may also be a sign that local funds have been buying as well.

Buybacks

It is not only the central banks fighting back, but the CEOs and major shareholders of companies as well. Two weeks ago, as the US stock market was reeling from the selloff in European banks, JP Morgan CEO Jamie Dimon announced that he bought $27 million worth of JP Morgan shares. This marked a reversal for bank stock prices worldwide. Since the announcement of the purchase, the Dow Jones index has bounced back 4.7%.

Pause in dollar strength

One main reason behind the weakness in emerging market currencies and stocks is the overwhelming strength of the US dollar. After Yellen's testimony pointing towards a more gradual tightening, the dollar fell more than 4% from its end-January levels. The Chinese renminbi weakness which spooked markets also took a backseat as the currency strengthened 1.5% in just one day. With the pause in dollar strength, most emerging market and commodity-linked currencies also rallied strongly, helping the recovery in global equities.

Battle not over

While some of the risks have been mitigated, the battle is not over. Although we are seeing some signs of stabilization, volatility remains elevated as the global economy continues to slow down. Concerns over a hard landing in China continue to linger. With oil prices expected to stay lower for longer, investors may view this as an indicator of weakness in the global economy. There are also concerns over the effectiveness of central banks.

Given this myriad of risks, it is crucial that central banks maintain coordinated action in order to ensure that the global slowdown does not turn into a recession. Thus, it looks like central banks have many more difficult battles ahead of them.

Is it a recovery or dead cat bounce?

With exactly 1 month passing since the January bottom, many are wondering if the Philippine stock market has finally recovered or is just in the midst of dead cat bounce. However, given that this was a very strong, 12% upmove, this recovery in stock prices is not just a dead cat bounce. We believe that it is very likely that the Philippine stock market has reached a bottom at 6,084. Though the stock market may need to consolidate in order to strengthen its base, we note that recoveries tend to start out as short covering or a rally from an oversold position. Though we are not yet out of the woods, this may well be the start of a lasting recovery.