Philequity Corner (April 4, 2016)
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She Gets It!

In last week's article, we wrote about the confusion created by the statements of 3 Fed members and its repercussions on the different asset classes (see *De Do Do Do, De Da Da Da*, 28 March 2016). Their statements threatened to undermine the efforts of central banks, especially the Federal Reserve, to calm markets and stabilize the global economy.

Waiting for Yellen

With too many voices saying different things about the direction of US interest rates, investors got all the more nervous. With interest rate forecasts now in disarray, investors looked to one person who could bring stability and clarity back to the market - Fed Chairman Janet Yellen. Fortunately, she was scheduled to speak last Tuesday, March 29. Everyone waited with bated breath to see whether she would stick to her previous policy statement or side with the 3 Fed governors who had just spoken.

Every Word You Say

Last year, we explained how every word that the Fed says can move markets (see *Every Move You Make*, 9 November 2015). This is true until now, with many Fed watchers continuing to analyse every Fed statement word per word. They know that even one word that the Fed says can have serious ramifications for equities, currencies and commodities.

Gradual

When Yellen finally spoke, it was exactly what we hoped for. Within the first minute of her speech, she said that she "will explain why the Committee anticipates that **only gradual increases in the federal funds rate are likely to be warranted in coming years**." This is essentially a slap in the face for the Fed governors who were saying that a rate hike could come as soon as April.

Forecast, not plan

Yellen also said that the Fed's guidance "should be understood as a **forecast** for the trajectory of policy rates". "It is not a **plan** set in stone that will be carried out regardless of economic developments". She echoed what she had been saying in previous statements - that the Fed's actions are not preset and will be data dependent.

Counting words

In a previous article (see *The Power of Words*, 29 June 2015), we carefully studied the words used by the Fed since Ben Bernanke's time as Fed Chairman. Self-confessed Fed watchers ourselves, we examine every statement very carefully, be it a change in nuance, the absence of a sentence and even the number of times a particular word is used. For instance, see below a table showing the number of times Yellen used the words "dollar", "global" and "uncertainty" in her speech last March 29.

Word	# of times mentioned
US Dollar	7 times
Global	11 times
Uncertainty	6 times

This is a marked increase from her previous statements. In her speech last December 2015, Yellen mentioned “US dollar” 5 times, “uncertainty” 4 times and “global” just once. This goes to show that she is very much concerned about global risks to the US economy, aside from the strengthening US dollar.

Conditions for a rate hike

Yellen was very precise with her words and her speech last March 29 proved to be her most detailed policy statement yet. She outlined the conditions required for a rate hike, namely:

1. Foreign economies and their financial markets need to stabilize

2. Commodity prices need to stabilize to help commodity-exporting countries grow

3. Inflation is a two-sided risk – rising but not yet robust enough

4. Too strong a dollar is not beneficial to the US economy

With these 4 conditions, it is now clear to investors what to expect before the Fed resumes policy tightening. This shows that Yellen got the message loud and clear.

The dollar cannot strengthen further

In last week’s article, we outlined how dollar weakness is a boon to emerging market (EM) currencies and equities. Likewise, dollar strength usually leads to declines in EM currencies and equities. Even in the US, too strong a dollar would be bad for exporters and manufacturing companies. It may even derail the Fed’s objective of reaching 2% inflation. It bears repeating that a pause in dollar strength is crucial for equities to recover. Thus, **when Yellen said that the dollar cannot appreciate further, it removed a key uncertainty and boosted sentiment in EM, including the Philippines**.

Yellen gets it

Clearly, Yellen gets it and understands that the US economy is not an island. Even if it is growing, she understands that the Fed has to consider other global factors that will have impact on them. She also gets that US inflation will continue to be stubbornly low if commodity prices remain depressed as a result of a global slowdown and strong dollar. She gets that dollar strength is detrimental not just to emerging market economies, but to the US economy as well. **Yellen understands that stability in global equities, currencies and commodities are of paramount importance before she can resume raising interest rates.**

Yellen's understanding of the complex issues surrounding US interest rate policy is crucial to the stability of capital markets. This changes the outlook altogether, from a near disastrous situation of an immediate rate hike to a much welcomed gradual increase in interest rates.

Peso gets stronger

The clearest beneficiaries of the pause in dollar strength are emerging markets, including the Philippines. Consequentially, the peso appreciated further, even briefly going below 46 last week. With Yellen's continued dovishness, it is likely that we have seen the worst for the Philippine peso this year. As we said in a previous article (see *Peso stabilizes below 47*, 21 March 2016), **we have seen the low for the peso at 48.06 and forecast the peso trading between 45.50 and 47.50 to the dollar in the short to medium term.**

Philippine bonds more attractive

In Philequity's Board meeting last Saturday, GSIS President Bernie Vergara had an astute observation. With the US rate hike path being more gradual and the risk of a weaker peso diminishing, the interest rate differential between US and EM bonds has widened. Thus, **the carry trade on EM bonds, including those in the Philippines, became more attractive.** With a sharp fund manager like Vergara at the helm of GSIS, the country's pension funds are clearly in good hands.

Read, read, read

One does not have to study every Fed speech and count words like we did, but one can certainly read. Given the importance of Yellen's speech, we encourage investors to read through it. **This is one her best speeches so far as it shows a clear understanding of the impact of global events and the consequences of Fed actions. Moreover, it specifically states the conditions required for further rate hikes.** In her speech, she covered a range of topics from current events to economic outlook to inflation expectations and its implications on monetary policy It may be a bit long at about 3,600 words, but one will learn a lot about how the Fed thinks and how it can impact asset classes the world over.

In our investor briefings, we encourage our clients to keep reading in order to learn how capital markets work. We urge people, especially children and students, to keep reading to widen their knowledge. In fact, this is the main objective of the book "Opportunity of a Lifetime" – to educate investors. With the Fed publishing Yellen's speech, we should take the opportunity to learn from her as well.

Philequity Management is the fund manager of the leading mutual funds in the Philippines. Visit www.philequity.net to learn more about Philequity's managed funds or to view previous articles. For inquiries or to send feedback, please call (02) 689-8080 or email ask@philequity.net.