Philequity Corner (June 13, 2016)
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I'll Be Watching You

Every breath you take
Every move you make
Every bond you break
Every step you take
I'll be watching you

If you want to know where stocks and currencies are going next, you have to be a Fed watcher. Thus, at the start of the article, we printed the first stanza of the song "Every Breath You Take" by Sting and The Police. Every move of the Fed is important for stocks, currencies and global economies, including our own peso and stock market. Until now, we are watching every move they make, every word they say and every step they take.

Every Breath You Take

We have been certified Fed watchers since 2008, the time of Ben Bernanke and the US Financial Crisis. We have written many articles about this time and we also devoted one entire chapter for this in the book *Opportunity of a Lifetime* (see *Chapter 4: Don't Fight the Fed*, pages 82-109). However, we are not the only certified Fed watchers. In fact, other central banks, such as the Bank of Japan (BoJ) and European Central Bank (ECB) are closely watching every breath that Yellen makes.

Breather from the Fed

Our very own BSP governor, Amando Tetangco, Jr., is a Fed watcher as well. In a Bloomberg article published last week, Tetangco was quoted as saying that "while our view is that our current stance of monetary policy remains appropriate, we should nevertheless use this breather from the Fed to further consolidate our own domestic sources of resilience so we can take advantage of external developments."

The big miss

This breather that Tetangco speaks off actually got longer after one crucial piece of US economic data. Economists estimated that 162,000 jobs were added in the US last month. Instead, it came in at 38,000, the smallest monthly addition since 2010. From 21%, the chance of a June rate hike immediately dropped to 4% after the data was released. While most analysts were looking at a rate hike in July, the chances of that fell from 58% to 35%. This big miss caused the dollar to weaken, giving emerging market equities and currencies room to rally.

Waiting for Yellen

With this unexpected miss in US jobs data, Yellen's last speech before the Fed meeting was a very much awaited one. Investors were ready to dissect each and every word she said in order to find clues about the direction of interest rates. As Fed watchers, we were also waiting for Yellen to speak. As we have seen before, her words can move markets (see *Every Move You Make*, 9 November 2015).

Uncertainty remains

In her speech at the World Affairs Council of Philadelphia, Yellen addressed the big data miss, saying that it was "concerning." However, she emphasized that one "should not attach too much significance to a single monthly report" and that the Fed will continue to monitor future data reports. However, she highlighted that the Fed is still facing 4 key uncertainties, namely:

1. Thrust and resilience of US domestic demand
2. Economic situation abroad
3. Outlook for productivity growth
4. Inflation moving back to the 2% target

Below neutral, modestly accommodative and stimulative

Given these, Yellen said that a "modestly accommodative policy stance is still appropriate." She also said that despite raising interest rates in December, current monetary policy remains "stimulative". She goes on to explain that one way to determine whether policy stimulates growth or not is by looking at how far the Fed funds rate is from the "neutral value" – the interest rate which would neither be expansionary or contractionary if the economy was operating near full potential. She says that while this value changes over time, she estimates that in current economic conditions, this neutral rate is close to zero when adjusted for inflation. Thus, with the Fed funds rate close to -1% when adjusted for inflation, the current policy stance should be viewed as "modestly accommodative."

Later rather than sooner

Yellen said many more things in that speech, but in summary, she mentioned that it is "appropriate to gradually reduce the degree of monetary policy accommodation, provided that labor market conditions strengthen further and inflation continues to make progress toward our 2% objective." However, she cautioned that it would be easier to raise interest rates later rather than sooner. If the economy were to show signs of overheating, the Fed could just easily raise rates. However, if they raised rates too soon and the economic expansion falters, the Fed would have limited tools to stimulate growth.

Watching other central banks too

It is not enough to just watch the Fed. We have to keep our eyes on the other major central banks as well. With China tackling its economic slowdown, interest rates in Europe still close to zero and Japan already in negative territory, this signals that the global economy is still growing very slowly. In fact, the World Bank recently downgraded 2016 global growth from 2.9% to 2.4%, calling it "insipid".

Zero rates are starting to hurt

Unfortunately, ultra low to negative interest rates in these countries are not stimulating their economies as much as expected. Moreover, they are also hurting the banks and savers. Sadly, savers have nowhere to go as bonds in Europe and Japan have practically zero yields. The ineffective response from central banks has made people quite nervous about their investments, bringing down the equity markets in these countries as well.

Foreign flows bring Philippine stocks higher

Fortunately for us, foreign inflows have poured into the Philippines in the aftermath of our elections and the possible postponement of US rate hikes. All told, we have seen PhP 20 billion worth of foreign inflows going into Philippine stocks since elections. In fact, we had 12 straight days of net foreign buying. As a result, the PSEi is now up 8% YTD, even reaching as high as 7,792 last week. This is the highest level we have reached in more than a year.

Peso breaks 46

The peso reversed its bearish trend as well. Teetering at 47.09 to the dollar right before elections, some analysts were forecasting it to head back to 48. Fortunately, it has since strengthened by 2%, even hitting a high of 45.86/$. As we said in a previous article (see *Groundswell in the stock market*, 30 May 2016), the peso has been a clear outperformer vs. major currencies and other Asian currencies.

Keep watching

It is important to note that since the bottom of 6,084 this year, the PSEi has gone up as much as 28% when it hit 7,792. Thus, a correction and consolidation may be in order. Moreover, things are still very fluid as we have the crucial Brexit referendum on June 23 and the Fed meeting on June 14-15, both of which have significant global repercussions. In the meantime, we will keep watching the moves of Yellen and the other major central bank governors.

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