Philequity Corner (August 22, 2016)
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The Waiting Game

Ever since the US subprime crisis and the gargantuan efforts of the Fed to save the US economy from the clutches of depression, we have been closely watching the moves of the Fed. In fact, we are among those certified Fed watchers who study every word they say and every move they make (see *I'll Be Watching You*, 13 June 2016). We even allocated one chapter of our book, Opportunity of a Lifetime, to talk about how the Fed pulled out all the stops to put an end to the crisis (see Chapter 4, *Don't Fight the Fed*).

Throwing darts

With the first rate hike since June 2006 finally happening last year, everyone had been waiting for the next rate hike. Economists were all guessing when this will happen. They were also forecasting how fast tightening will be, where interest rates will be at the end of the year, next year, and so on. Though some analysts claim that attempting to forecast the Fed's next move is like guessing where your dart will land before throwing it, this doesn't stop the talking heads on business channels from staking their credibility on it.

Connect the dots

For starters, one can look at the Fed's own forecasts to determine where interest rates will go. This is shown in the so-called "dot plot". Released along with the Fed's summary of economic projections, this shows where each Fed participant thinks the Fed funds rate will be at the end of the year, the end of the next few years, and in the long run. By looking at this, one can see how hawkish or dovish the Fed is as a group. Unfortunately, history has shown that this dot plot tends to change as new events affect the Fed's outlook. Given how volatile market and economic conditions have been recently, connecting the dots may not draw the correct picture.

Divining the future

Some analysts have observed that the Fed's policies seem to be driven by market expectations, instead of the other way around. Thus, it pays to look at Fed fund futures. Essentially, this is the numerical equivalent of market expectations regarding where interest rates will be at a specific point in time. They say that through mathematical calculations, one can divine the future and calculate the probability of a rate hike on any given month. Assuming that market participants correctly price in the impact of current events on Fed policy, analysts say that Fed fund futures are an accurate predictor of what the Fed will do.

He said, she said

Projections and probabilities are indeed useful in providing clues regarding the direction of interest rates. It is also worthwhile to listen to the pronouncements of each Fed governor. However, these are still guesses. Ultimately, it is what they say as a collegial body that is most important. Unfortunately, as we wrote previously, the Fed governors are once again giving us mixed signals (see *De Do Do Do, De Da Da Da*, 28 March 2016).

New York Fed President William Dudley and San Francisco Fed President John Williams both indicated that a September rate hike is possible because economic data supports it. This is not only at odds with the weak inflation figure, but also with the dovish monetary policy statement of the Fed. While some Fed members are in the camp of hiking rates next month, Fed Chairman Janet Yellen believes that it is more prudent to raise interest rates later than to prematurely raise it and risk an economic relapse.

Jackson Hole

Thus, Yellen's statement on August 26 at Jackson Hole is crucial. Nestled in between mountains, Jackson Hole is located in the world renowned Yellowstone National Park. It is here that central bank heads, Fed governors, economists and academics discuss the most relevant and important factors surrounding not only the US economy, but the global economy as well.

A few years ago, I had the good fortune of going to Jackson Hole while then-Fed Chairman Ben Bernanke was speaking. It was a very memorable event for me to be in the presence of my hero and the person I consider to be the main architect of the US bull market we are witnessing now.

Waiting with bated breath

The importance and historical significance of Jackson Hole cannot be understated. It is here that Bernanke publicly announced QE2 and QE3. It is also the place where he discussed policies that were crucial to reviving the flagging US economy.

In the speech Yellen will be giving on August 26, she will be shedding light on the direction of the Fed's monetary policy. Given how crucial policy announcements in Jackson Hole are, Fed watchers like us hang on to every word that is uttered during this event. Yellen's statements though will be the most awaited and most important, so we are waiting for her to speak with bated breath.

She Loves Me, She Loves Me not

Yellen has always said that Fed action is data independent and not on a preset course. Thus, her predisposition towards policy tightening has waxed and waned with the strength of economic data. Thus, the market is kept in a "she loves me, she loves me not" scenario where stocks rise when she says interest rates will stay lower for longer, or fall when she indicates that the next rate hike is on its way.

Dollar falls, EM rises

As a result of Yellen's deferment of rate hikes, the US dollar has weakened against most currencies. Last week, the euro went above 1.13 and the yen strengthened below 100. Her dovishness also sent stock markets higher, especially those in emerging markets and ASEAN (see *It's Hip to be in TIP*, 8 August 2016).

A prudent Fed

Whatever Yellen says on Friday, we have to remember that even if she decides to raise interest rates in September, US interest rates would still be at historic lows. Though we are experiencing a correction because of fears over rising interest rates, we believe that the Fed will be prudent in its actions. We also believe that they will continue raising rates only if economic conditions warrant it. That said, expectations of policy tightening and the imminent rise of interest rates may create more volatility. However, over the long term, this should not detract from the overall upward trajectory of the Philippine stock market.