Philequity Corner (December 19, 2016)
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Three, not Two

Last Wednesday, December 14, the US Federal Reserve finally pushed through with the much anticipated interest rate hike. For about a year, markets have discussed, debated and anticipated the impending rate hike. In the two months prior, Fed fund futures have practically seen this as a certainty. In fact, Fed Chairman Janet Yellen herself said that it would be “dangerous not to raise rates.”

Second rate hike after 10 years

This is only the second US rate hike after 10 years. The first one happened in December 2015. Prior to that, the last rate hike occurred at the end of the 3-year hiking cycle in 2006. In that last rate hike, interest rates were raised from 5% to 5.25%. Note that interest rates now are still a far cry from those levels as they are just a paltry 0.5 to 0.75%.

Not a sell on news?

Citing historical trends, many analysts and market participants were expecting a “sell a news” for the dollar after the Fed announcement. The dollar index, DXY, had strengthened by as much as 4% in the past month, with some saying it was now ripe for a correction. Instead, the DXY strengthened by as much as 2% after the Fed decision was announced, catching many currency traders by surprise.

Not two, but three

The reason behind this is that the Fed indicated that rates would rise more than expected next year. Not only was the Fed decision unanimous, but voting indicates that the members see an average of not two, but three rate hikes in 2017.

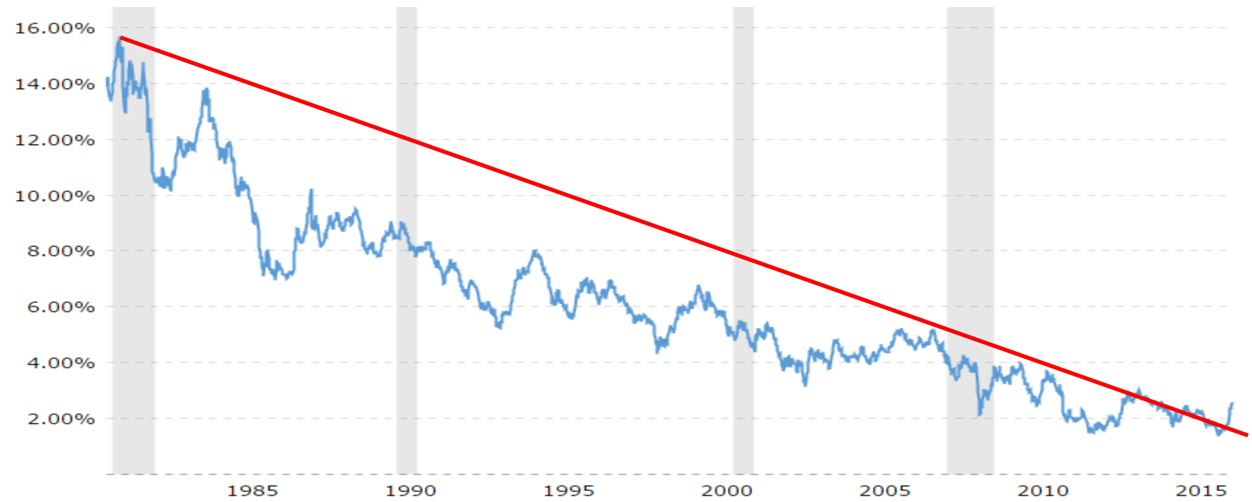
Dot plot indicates three hikes per year for the next three years

If one looks at the so called “dot plot” in the Fed’s economic projections, one will note that the long run interest expectations of the Fed governors did move higher. In fact, based on their projections, not only are we going to see 3 rate hikes next year, but another 3 each in 2018 and 2019. These means that we may see a total of 9 rate hikes in the next three years, bringing long run US interest rates to 3%.

End of the 36-year US Treasury bond bull market?

With the Fed’s interest rate trajectory steeper than the market expected, asset prices the world over experienced sharp reactions. However, one of the biggest casualties are bonds. After reaching a historic low this year, US 10-year bond yields have since doubled to 2.6%. Though this is still relatively low in historical terms, it may well signal the end of the bond bull market globally. See below a chart of US 10-year bond yields going back to 1980. You will see that the 30-year down trendline has been decisively broken. For those who follow technical analysis, this may signal the end of the 36-year bull market in bonds. With higher interest rates expected in the future, bond prices are poised to fall and yields to rise.

10-year US Treausry bond yield (1980-2016)



Source: Wealth Securities research

Will BSP follow the Fed's lead?

With the US raising interest rates for a second time and indicating that there is more to come, we may start seeing higher interest rates in other countries. Europe has started to slowly taper its bond purchases. Other countries have yet to announce any changes in their monetary policy. In our case, the Bangko Sentral has stood pat for quite some time now. With 10-year Philippine bond yields now at 4.5%, we may already be witnessing the start of an adjustment in local interest rates.

Will US dollar strength continue?

On the currency front, the US dollar may finally consolidate after its blistering rally brought it near resistance levels. Dollar strength in the past weeks have sent the Japanese yen lower by 4% to 118 and the Euro closer to parity at 1.04. The Philippine peso is flirting dangerously with the crucial 50 level, making it one of the worst performing currencies in Asia year to date.

Almost 20,000

Normally, at the start of a hiking cycle, equities tend to correct or consolidate. However, US stock prices are anything but weak. Because of Donald Trump's victory and despite all analysts saying that a sharp correction would follow if he wins, US markets have made new highs (see *The Trump Card***,** 12 December 2016). In fact, since we called the low on March 6, 2009 (see Chapter 2 of the book, Opportunity of a Lifetime), the Dow Jones index has more than tripled! Last week, it was just 49 points shy of hitting a milestone level of 20,000. Although we may see a correction or a consolidation in US equities as the market digests the prospects of much higher interest rates, the US bull market is very much alive and kicking.

Is Santa Claus coming to town?

Unfortunately, unlike the Japanese and European stock markets which are also rising, the PSEi did not follow the US' lead. After reaching a high of 8,118 this year, the Philippine stock market has fallen 15.6% from its peak. This dismal performance in the last few months has made us one of the worst performing equity markets in Asia. So with only 8 trading days left for the year, many are hoping for a Santa Claus rally so that 2016 can end on a high note.

In Chapter 10 of the book, Opportunity of a Lifetime, we discussed seasons in the stock market. On page 195, the reader will see that data going back to 1987 shows that December is the month with the highest probability of showing a positive return. There is also a 70% chance of December ending in the green with an average return of 3.9%. Moreover, the average return from October to January is 9.2%. On the other hand, the PSEi is currently down 10.2% from the start of October up to last Friday.

So, will statistics and probability be on our side? Or will 2016 be the year that Santa Claus skips the Philippines?

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.