Philequity Corner (March 27, 2017)
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When doves cry

Last March 15, the Fed raised its benchmark interest rate by 25 bps. Though the rate hike was widely anticipated, the Fed surprised markets when it came out more dovish than expected. This caused the US dollar, Treasury yields and the US stock market to drop.

Doves vs. hawks

In a recent article (*Beware the Ides of March*, March 13, 2017), we discussed that there were expectations that the Fed would come out with a hawkish policy statement, which then caused anxiety in the stock market. There were also concerns that the Fed will talk about hiking interest rates four times this year instead of three.

Instead, the Fed came out a bit too dovish than what the market had expected. The Fed stuck to its guidance of three rate hikes in 2017, as seen in its policy statement and the dot plot. Moreover, Fed Chair Janet Yellen repeatedly stated that interest rates will be hiked in a gradual manner, thus emphasizing the Fed's dovish bias.

The drops in the US dollar and the 10-year Treasury yields were the results of the unwinding of US dollar and Treasury trades which were aligned with expectations of a hawkish Fed. These brought concerns that the drops may have signalled that the US economy may not be as strong as previously thought. Doubts about the continuation of the reflation trade have also started to surface.

Sell on news phenomenon

As we discussed in last week's article, what we witnessed after the Fed rate hike was a typical sell on news phenomenon (*Reversion to the Mean*, March 20, 2017). Below, we discuss the impact of the Fed's dovish statement on different asset classes, many of which have turned around and reversed course.

1. **US dollar falls.** The dovish Fed disappointed dollar bulls and caused an unwinding of long US dollar trades. This resulted in the 2.8% drop of the US dollar from its recent high.
2. **Euro and yen firm up.** The Fed's dovish tone de-emphasized the policy divergence between the US vs. Europe and Japan. Moreover, growth and inflation are picking up in Europe and Japan, which have prompted the ECB and the BOJ to contemplate scaling back their monetary stimulus programs. These resulted in the recent strength of the euro and the yen, which have consequently caused other major currencies to firm up vs. the US dollar.
3. **Treasury yields drop.** The Fed's decision to maintain its rate hike guidance for this year (three rate hikes instead of four) meant that interest rates will still move higher but at a slower pace than initially feared. This caused Treasury yields to fall from a high of 2.62% before the Fed meeting to the current level of 2.4%.
4. **US financials fall.** In consonance with the drop in the US dollar and Treasury yields, financial stocks – which have been the leaders of the post-election rally in US equities, fell sharply. A more gradual rate hiking cycle would mean that interest rates and bank margins will not rise as fast as expected.

These have dimmed the earnings outlook for US bank stocks and caused them to drop. And as an old market adage states, as financials go, so goes the market.

5. **US stocks experience 1% correction.** Last Tuesday, the S&P 500 sank by more than 1%, the first time since October. Likewise, the Dow declined 1.5% last week, its biggest weekly decline since September. The fact that the US stock market has not had a meaningful pullback for the past five months indicates that US stocks are ripe for a correction. In addition, technicals point to overbought conditions while valuations have become stretched. Thus, a correction at this point in time may indeed have been warranted.

Trump and Republicans lose vs. Obamacare

Last Wednesday, there were already indications that Trump and the Republicans would lose the Congressional vote on health care reform. This caused nervousness among investors and ultimately caused the stock market to drop. Indeed, President Trump and Speaker Paul Ryan cancelled the voting last Friday, finally conceding that they would lose the vote to repeal Obamacare. The recent setbacks of Trump and the Republicans have only added to the anxiety and uncertainty in the US stock market.

Is the Trump card losing its luster?

Aside from the sell on news phenomenon, markets were taken aback by the apparent loss of Trump and the Republicans in pushing for health care reform. With the failure of the Republicans to muster enough votes to repeal Obamacare, markets are now questioning if Trump has enough control over the Congress. Thus, there are doubts about the ability of the Republican-dominated Congress to pass key reforms such as tax reform and infrastructure spending, promises which Trump made during his campaign.

Given the setback that Trump and the Republicans experienced last week, many investors are now wondering if Trump's mystique is starting to fade. Without Congressional support, the US President will have an extremely difficult time forwarding his pro-growth agenda. If the Trump administration fails to deliver on its campaign promises, the Trump trade (i.e. trades that will benefit from Trump's prospective policies) will continue to wane and may eventually reverse course.

US dollar bull run – a reversal or a pause?

The strengthening of the euro, yen and other major currencies caused the US dollar index (DXY) to drop below 100, a key technical support level. Given the recent rise of major currencies against the US dollar, many investors and economists are wondering where the US dollar will go. Is this the start of the reversal of US dollar strength? Or is this merely a temporary pause in the dollar bull run? The answer to this will depend on US economic numbers and how the global economy performs.

When doves cry

With all the debate between doves vs. hawks and the intensified focus on the Fed's recent dovish statement, we would like to leave you with an excerpt from the song "When doves cry" which was written and performed by singer, composer, Grammy and Academy award winner, Prince.

How can you just leave me standing?
Alone in a world that's so cold?
Maybe I'm just too demanding…
Why do we scream at each other
This is what it sounds like
When doves cry

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