Philequity Corner (April 3, 2017)
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Connect the Dots

In our past articles, we have written extensively about the policies of central banks and their impact on the movements of various asset classes. This led us to devote an entire chapter in our book (Opportunity of a Lifetime) to discuss the importance of understanding the Fed's statements and actions. More recently, we have written about the dot plot forecasts. We explained how investors can use this as one of the tools to decipher the Fed's policy trajectory and its effects on the direction of different asset classes. As part of our advocacy in promoting investor education, we would like to explain the dot plot to our readers who may not yet be familiar with it.

The dot plot

The dot plot is a chart which the Fed releases along with its statement after each meeting of the Federal Open Market Committee (FOMC). The dots which are plotted in the chart correspond to projections for the Fed funds rate made by each of the seventeen FOMC participants (composed of twelve voting members and five non-voting members). Hence, the dot plot shows the consensus among Fed officials as to where they think interest rates will go in the medium term.

Don't fight the Fed

In Chapter 4 of our book, we underscored the importance of considering central bank policies when investing and assessing the global macro situation. We highlighted the weight that the Fed's policies carry since the Fed is both a market participant and a regulator. Thus, when they so deem, the Fed and other powerful central banks can change the rules of the game and affect the direction of various asset classes in order to achieve their objectives.

Following the Fed

Following the Fed has allowed us to make better investment calls, such as identifying the bottom of the bear market (*666 on 3-6-9*, April 13, 2009) and staying the course throughout this bull market (*Staying the Course*, February 6, 2012). We use the Fed's statements in conjunction with the study of investor expectations, market sentiment and economic conditions to formulate our investment strategy (*Power of Words*, June 29, 2015).

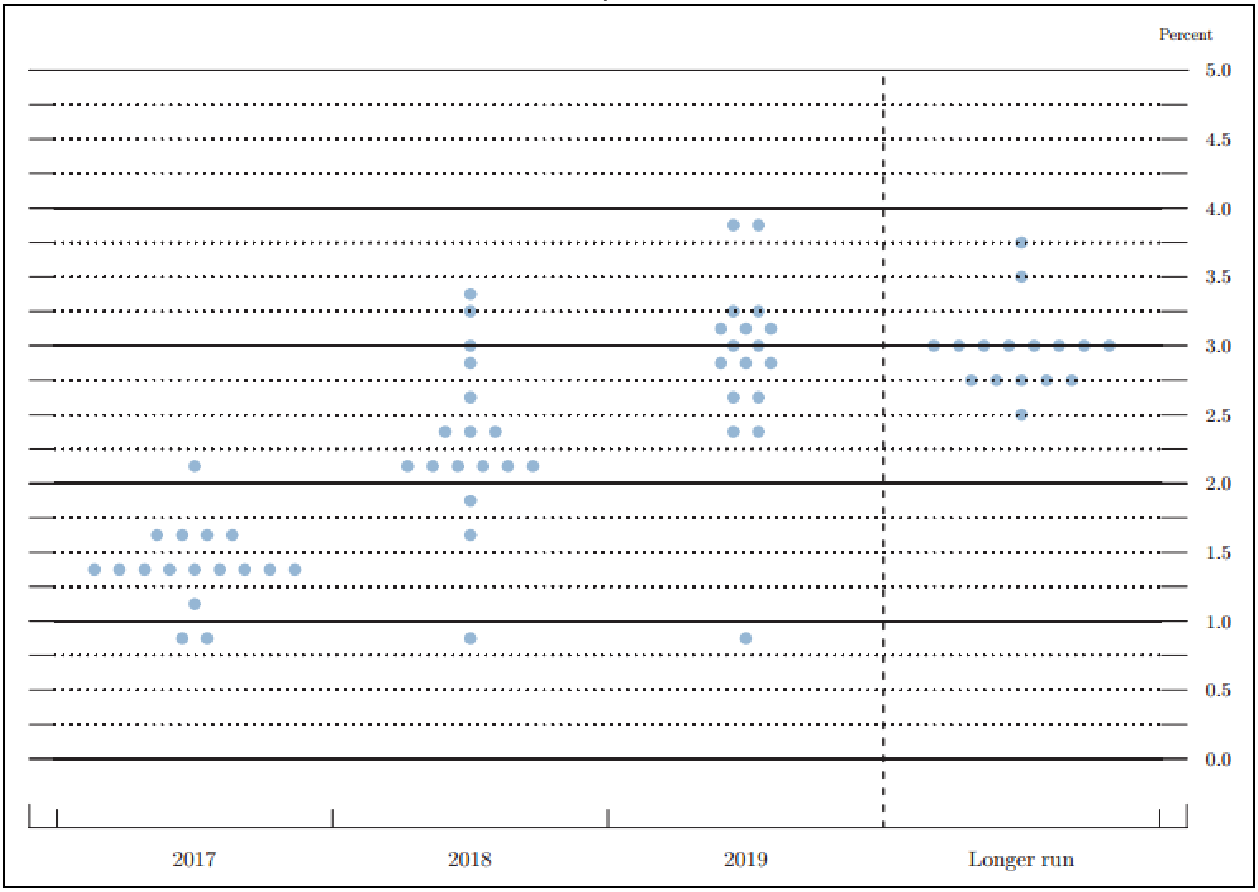
Following the leader

Since the Fed sets the monetary policy for the US, it has a very strong influence on where the US dollar and US interest rates will go. Given that the US is the biggest economy in the world, it comes as no surprise that the US dollar and the Treasuries are the largest and most liquid currency and fixed income markets. With this backdrop, the Fed's statements and actions will inevitably affect how other asset classes will behave. This is why investors, fund managers, economists and even other central banks closely follow every word that each of the Fed members say (*Every Move You Make*, November 29, 2015; *I'll Be Watching You*, June 13, 2016).

Following the dots

The Fed's dot plot shows that the median projections for interest rates are at 1.375% for 2017, 2.125% for 2018 and 2.875% for 2019. These correspond to three rate hikes per year from 2017 to 2019. Moreover, the dot plot shows that beyond 2019, the FOMC expects long-term interest rates to stabilize at 3%. For the benefit of our readers, we share below the dot plot which the Fed presented after its policy meeting last month.

The Fed's dot plot – March 2017



Source: Federal Reserve

What the dots say

By using the dot plot in conjunction with statements by the FOMC and speeches by Fed officials, we can decipher the Fed's assessment of the US economy. Based on what it is communicating through different policy tools, the Fed is essentially telling us that the US economy is now strong enough to withstand a gradual rate hiking cycle. Moreover, the Fed is in the process of normalizing interest rates after years of ultra accommodative monetary policy and quantitative easing. Moving forward, the stock market should continue to move higher if interest rate hikes are supported by stronger economic growth.

The Fed's delicate balancing act

In last week's article, we discussed the debate between doves and hawks (*When doves cry*, March 27, 2017). We explained that the Fed now has to balance its policies and statements with respect to market expectations and actual economic developments. On one hand, if the Fed ends up too hawkish relative to market expectations and the economy's performance, its policies may spook investors and choke the budding economic recovery. On the other hand, if the Fed ends up too dovish, it may signal that the global economy is not stable enough to withstand gradual rate hikes. A Fed that is too dovish may also stoke inflation and pose further delays in policy normalization.

Aside from these, the Fed has to consider developments in other major economies, such as Europe, Japan and China. If the Fed's policies are too far ahead compared to the ECB and the BOJ, the divergent monetary policies may result in too strong a US dollar, which is detrimental to US economic growth.

Thus, it is critical for investors to understand the drivers of monetary policy and how the Fed considers all these developments when it drafts its policy trajectory.

Investing is not an exact science

I was recently invited as a speaker for the National Student-Investors' Convention which was sponsored by the Ateneo Management Economics Organization. In the talk, I explained to the students that investing in the stock market is an art and not an exact science. Having a good grasp of disciplines such as mathematics, finance, accounting and economics is still very important. However, there are also other subjects that one must understand in order to be successful in investments. These include political science, history, sociology and psychology. This is also the reason why we often incorporate insights or quotes from musical pieces, literature and history in our articles and presentations. Apart from crunching the numbers, having a healthy appreciation of the liberal arts can help investors synthesize seemingly disconnected events in order to come up with more informed investment decisions.

Connecting the dots

Aside from studying the Fed's policy statements and analyzing the dot plot, we also look at global developments in politics and economics. We try to understand how these will affect the economy and the stock market. Recently, investors have carefully parsed through political statements made by the Trump administration to see if it can successfully implement its agenda on fiscal stimulus, infrastructure spending and tax reform. We are also keeping a close watch on Brexit developments and the upcoming French election and how these will impact the global political and economic landscape. In light of monumental upsets last year, such as Trump's election win and the outcome of the Brexit vote, it is incumbent upon investors to connect the dots in order to decipher how the global macro picture will evolve. Actions by the Fed, developments in the global economy and the performance of various asset classes such as stocks and currencies will ultimately provide the direction for Philippine assets.

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