Philequity Corner (August 5, 2019)
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First Cut

Last week, we had the most anticipated financial event of 2019 - the US Federal Reserve's July policy meeting. This was a widely watched meeting because investors expected a rate cut from the Fed. This rate cut is very significant because it would offset the effects of slowing global economic growth, counter the uncertainties brought about by the US-China trade war, and sustain what is now the longest economic expansion in US history.

First rate cut in more than 10 years

On July 31, the Fed delivered exactly what investors were asking for by lowering benchmark rates by 25 basis points to 2-2.25%. This is a momentous event because this is the first rate cut in more than 10 years, signaling a reversal of the Fed's monetary policy and interest rate trajectory. The last rate cut was implemented in 2008 during the US Financial Crisis and Great Recession when then-Fed Chairman Ben Bernanke brought interest rates to practically zero.

Rookie mistake

It is important to note that prior to this rate cut, the Fed has raised interest rates a total of 9 times since 2015. Economists and analysts deemed that most of these were warranted given the robust recovery of the US economy. Unfortunately, markets were alarmed by Fed Chairman Jerome Powell's forecasts last year. In 2018, Powell made a rookie mistake by declaring that the Fed will continue to raise interest rates in 2019 despite the potential effects of the trade war and slowing growth in other major economies. Investors widely considered this to be a potentially fatal Fed policy mistake that may plunge the world into a recession (see *You better watch out, you better not cry*, 24 December 2018). Thus, markets sold off, with the US experiencing its worst December drop since the Great Depression.

Fed pivot sparks the 2019 rally in stocks

Fortunately, Powell made a u-turn at the start of 2019, saying that "the case for raising interest rates has weakened somewhat." This was the start of the Fed pivot that sparked the rally in stocks this year. From its Christmas low of 2346, the S&P 500 has risen as much as 29%, hitting a new all-time high of 3027 (see *Christmas rout turns into best one-day gain ever*, 31 December 2018). This carried all the stock markets higher, including the Philippines. From its 2018 low of 6790, the PSEi gained nearly 24% before pulling back to the 8000 level. Eventually, the Dow Jones index would log its best June gain since 1938 while the S&P 500 recorded its best 1st half in 20 years. It is precisely the Fed's pivot that turned the tide for stock markets around the world.

Peso strengthens sharply

Not to be left behind by stocks, the Philippine peso appreciated as well. From a low of 54.49/$ last year, the peso strengthened to as much as 50.79 last week. This lent bullishness to all Philippine assets.

First cut is the deepest

The heading above is not referring to the 1967 song written by Cat Stevens, popularized by Rod Stewart in 1977 and which has new version performed by Sheryl Crow in 2003. Neither are we referring to one's first love or first heartbreak, as the song suggests. Instead, we are referring to the first rate cut of the Fed being the most important and most crucial. Last week's rate cut was the culmination of the Fed pivot. Borrowing Powell's words, this sent a clear signal to markets that the Fed will "act as appropriate to sustain the expansion". After 10 years of keeping rates at ultra-low levels then raising them, this first rate cut marks the end of the Fed's hiking cycle. More than any subsequent rate cut, this first cut will have the deepest impact on stocks, bonds, currencies and the economy.

Trump spoils the party and reignites the trade war

Given that this rate cut was, in Powell's words, "the most telegraphed rate cut", markets corrected after his press conference. This is a classic "buy on rumor, sell on news" stock market move. However, with Powell not ruling out further rate cuts after this "midcycle adjustment", equities staged a recovery the day after.

Unfortunately, Trump just had to spoil the party. Trump made no secret of his long-running frustration with Powell, saying that "as usual, Powell has let us down." But things got worse. Less than 24 hours after the Fed's decision, Trump tweeted that **"the US will start on September 1st putting a small additional tariff of 10% on the remaining 300 billion dollars of goods and products coming from China into our Country. This does not include the 250 billion dollars already Tariffed at 25%..."** With this tweet, Trump threw a monkey wrench not only into trade negotiations, but he may potentially murder both the economic expansion and this 10-year old bull market.

Tug of war – Trump vs. Fed

In a previous article, we said that bull markets don't die of all age, but get murdered instead and that Trump may actually be the murderer (see *Will Trump Murder the 10-year Bull Market?*, 10 June 2019). With Trump re-escalating the trade war despite the Fed's best efforts, last week's first cut may be all for naught. Markets are now stuck in a tug-of-war between Trump and the Fed. Will the Fed save this aging bull market and longest US economic expansion? Or will Trump unwittingly bring these to a bitter end? Only time will tell.