OCTOBER 31, 2023

PHILEQUITY CORNER

By Wilson Sy

PhilEquity MANAGEMENT INC.

Off-cycle rate hike

Last week, the Bangko Sentral ng Pilipinas (BSP) delivered an off-cycle rate hike of 25 basis points. Its policy rate stands at 6.5%, the highest level since 2008. The BSP has hiked its policy rate by 450 basis points from a record low of 2% during the pandemic.

Tighter for longer

The BSP explained that it may have to keep monetary settings tighter for longer in order to quell supply-side pressures and prevent second-round effects from worsening. Below, we share important quotes from the BSP's latest policy statement.

- "The Monetary Board recognized the need for this urgent monetary action to prevent supply-side price pressures from inducing additional second-round effects and further dislodging inflation expectations."
- "Second-round effects have broadened, including transportation fare increases and minimum wage adjustments. Inflation expectations have risen sharply, highlighting the risk of further second-round effects."
- "The balance of risks to the inflation outlook still leans significantly toward the upside, due mainly to the potential impact of higher transport charges, electricity rates, international oil prices, and minimum wage adjustments in areas outside the National Capital Region."
- "The Monetary Board also continues to support fiscal efforts to sustain growth through more rapid programmed spending, as well as non-monetary interventions to address persistent supply-side pressures on prices."
- "Looking ahead, the Monetary Board deems it necessary to keep monetary policy settings tighter for longer until inflationary expectations are better anchored and a sustained downward trend in inflation becomes evident."
- "The BSP is prepared for follow-through monetary policy action as necessary to bring inflation back to a target-consistent path, in keeping with its price stability mandate."

Meaningful tightening in the pipeline

The BSP's hawkish statements have a similar tone with the recent comments of Federal Reserve (Fed) Chair Jerome Powell. These have triggered a jump in the US dollar, a surge in bond yields, and a drop in equity prices. Below are some quotes from a speech that Powell made last October 19 which signaled that there may be more tightening actions to come.

- "The September inflation data continued the downward trend but were somewhat less encouraging."
- "We cannot yet know how long these lower readings will persist, or where inflation will settle over coming quarters."
- "While the path is likely to be bumpy and take some time, my colleagues and I are united in our commitment to bringing inflation down sustainably to 2 percent."

- “Still, the record suggests that a sustainable return to our 2 percent inflation goal is likely to require a period of below-trend growth and some further softening in labor market conditions.”
- “Geopolitical tensions are highly elevated and pose important risks to global economic activity.”
- “Given the fast pace of the tightening, there may still be meaningful tightening in the pipeline.”
- “A range of uncertainties, both old and new, complicate our task of balancing the risk of tightening monetary policy too much against the risk of tightening too little.”

War in Israel escalates

Many fear that the escalation of the war in Israel would lead to a wider conflict in the Middle East. Aside from fighting Hamas in Gaza, Israel also clashed with Hezbollah near the Lebanese border. Israel’s defense system was tested by missile attacks from Houthi rebels in Yemen. Meanwhile, US fighter jets struck Iran-linked sites in Syria. The US sent aircraft carriers and attack ships to the Persian Gulf to aid Israel, deter other countries from participating, and prevent the conflict from evolving into a regional battle. A full-blown war in the Middle East would trigger a spike in oil prices which would result in surging inflation.

Rising tensions within our shores

Closer to home, geopolitical tensions rose after a Chinese coast guard ship collided with a Philippine supply boat in the South China Sea last week. The incident fanned tensions between China and the Philippines due to repeated encounters in the disputed waters. In light of these events, US President Joe Biden stated that “the US defense commitment to the Philippines is ironclad.” Biden said, “Any attack on Filipino aircraft, vessels or armed forces will invoke our mutual defense treaty with the Philippines.”

Proactive and pre-emptive

The BSP’s off-cycle rate hike is a proactive and pre-emptive move that seeks to combat inflationary pressures and stop these from further broadening. The latest rate hike would help the BSP’s defense of the peso and allow the USDPHP rate to stabilize. A stable currency would mitigate imported inflation. As an oil-importer, the country is vulnerable to oil price spikes caused by the wars in Ukraine and Israel. Higher oil prices would translate to transport fare hikes, higher power costs, and higher wages which would result in elevated inflation.

Though higher interest rates would bring down inflation, they would also slow down economic activity by tempering loan growth. This comes at an unfortunate time when economic growth decelerated sharply in 2Q23 due to the contraction in government spending and slower consumption growth. Moreover, higher for longer or tighter for longer is not conducive to strong financial market performance. Nonetheless, we understand the BSP’s rationale and we see higher rates as a bitter pill that must be taken in order to get inflation under control. As the Monetary Board stated, it recognized “the need for this urgent monetary action to prevent supply-side price pressures from inducing additional second-round effects and further dislodging inflation expectations.” The BSP is steadfast in pursuing its mandate because price stability is a crucial component that underpins long-term economic growth.

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) 8250-8700 or email ask@philequity.net.