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PHILEQUITY CORNER

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May, not March

Last Wednesday, equities dropped as Federal Reserve (Fed) Chair Jerome Powell dashed investor hopes for a March rate cut. Last Friday, despite better-than-expected US nonfarm payrolls and robust wage growth which typically usher higher interest rates, the Dow and the S&P 500 were not deterred from making new all-time highs.

May or later

The S&P 500 fell by 1.6% while the Nasdaq dropped by 2.2% last Wednesday. These moves came after the policy statement of Powell where he clarified that a March rate cut is unlikely. Below are some important quotes from Powell's speech.

- "Inflation has eased notably over the past year but remains above our longer-run goal of 2 percent. "
- "The lower inflation readings over the second half of last year are welcome, but we will need to see continuing evidence to build confidence that inflation is moving down sustainably toward our goal."
- "Our restrictive stance of monetary policy is putting downward pressure on economic activity and inflation."
- "We believe that our policy rate is likely at its peak for this tightening cycle and that, if the economy evolves broadly as expected, it will likely be appropriate to begin dialing back policy restraint at some point this year."
- "We are prepared to maintain the current target range for the federal funds rate for longer, if appropriate."
- "We know that reducing policy restraint too soon or too much could result in a reversal of the progress we have seen on inflation and ultimately require even tighter policy to get inflation back to 2 percent. At the same time, reducing policy restraint too late or too little could unduly weaken economic activity and employment. "
- "The Committee does not expect it will be appropriate to reduce the target range until it has gained greater confidence that inflation is moving sustainably toward 2 percent."

Market lifted by Meta and Amazon

Meta (formerly Facebook) soared 20.3% last Friday while Amazon gained 7.9%. In the process, Meta made a record one-day rise in terms of market capitalization. Despite the initial knee-jerk reaction from Powell's statements, the US market closed at all-time highs last Friday. Led by tech stocks, the market continued advancing despite news of strong nonfarm payrolls (353,000 vs. an estimated expansion of 185,000). Average hourly earnings jumped 0.6% vs. 0.3% estimate. On a YoY basis, wages grew 4.5% vs. the 4.1% estimate.

Escalating tensions in the Middle East

We recently wrote about the war between Israel and Hamas, and how it could spiral into a wider regional conflict (see *Impact of War in Israel*, October 16, 2023). In that article, we said that a wider war in the Middle East was one of the main risks to the stock market. Israel fired air strikes against Hamas and launched a ground invasion in Gaza. In response, various sects of Iran-backed Islamic militia perpetrated attacks and counterattacks on Israel and its allies. Houthi rebels from Yemen have carried-out attacks in the Red Sea, thereby forcing ships to take long detours which may result in delays and supply constraints. Meanwhile, Lebanon-based Hesbollah has launched attacks against Israel. The latest attack was a drone strike in a US military base in Jordan which resulted in the death of three American soldiers. In retaliation, the US carried out air strikes against Iran-backed Islamic militia operating in Syria and Iraq. Despite its retaliation, the US carefully made sure that there was no direct attack on Iran as it would result in a bigger escalation.

Other important developments

Aside from central bank statements regarding a pause in rate hikes, there have been other important developments taking place globally. Governments have been stepping-up efforts to bolster their respective stock markets. China's government has prepared a stabilization fund of up to 2.3t yuan to counter the market downturn. However, despite interventions by the national team and the announcement of the stabilization fund, Chinese stocks continued to drop sharply. Korea unveiled a series of financial reforms to bolster its stock market. Meanwhile, Japanese stocks are making multi-decade highs. And still, the government continues to mandate listed companies to improve their efficiency and increase shareholder returns.

Domestically, we saw inflation ease to 3.9% in December and 4.3% in 4Q23. This was followed by 4Q23 GDP growth of 5.6% which came above the consensus estimate of 5.2%. Consumption spending growth of 5.3% and the rebound in capital formation (11.2% from -1.4% in the previous quarter) were the main contributors on the demand side. On the supply side, faster services growth (7.4% from 6.8%) and stronger agricultural output (1.4% from 0.9%) compensated for slower industry growth (3.2% from 5.6%).

Awaiting the first cut

In Powell's recent statement, he downplayed investor expectations of an immediate rate cut in March. Instead, he said that the first cut may occur in May or even later in the year. Though investors were initially disappointed, and the market pulled back, the most important development is that the Fed finally signaled the start of its pivot. Powell indicated that the Fed was transitioning from tightening to pausing, and to now start contemplating rate cuts. In this cycle, it is the first time that Powell talked about cutting rates. For us, it is not really important whether the first policy rate cut occurs in March or May. What is essential is the Fed's pivot and where interest rates are heading. At the same time, market sentiment is transitioning as investors now favor sectors or stocks that are not affected or are less affected by higher for longer rates.