Philequity Corner (March 23, 2015)
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No More Patience

We are amazed with how one word can capture the attention of the global investment community. Last Wednesday, all eyes of investors were glued to their screens, waiting for the next FOMC statement. Here in Manila, we were awake at Thursday 2am, waiting for the Fed statement and the subsequent interview with Fed Chair Janet Yellen.

There was investor anxiety regarding the removal of the word "patience" from the Fed's forward guidance. The concern was that this might trigger an increase in interest rates, cause the US dollar to strengthen and consequently drive stock prices lower. Punters were ready to pounce on a possible drop. However, to their chagrin, short-sellers were taken aback by the clarity of the Fed's explanation.

While the word "patience" was indeed removed from the FOMC statement, the Fed deftly clarified the milestones that have to be achieved before it starts raising rates. The Dow was down 152 points before the announcement, but it moved 379 points higher to close 1.3% up (227 points up) for the day. Consequently, the PSE Index also moved 0.7% higher the next day.

No patience, but not impatient

As expected, the Fed removed the word "patience" from its forward guidance for interest rates and monetary policy. The Fed did this in light of the recent gains in unemployment reduction. US unemployment rate went down to 5.5%, the lowest in almost seven years. Moreover, payroll gains have averaged 200,000 workers for 12 straight months, the longest streak since March 1995.

With the change of guidance, the Fed has opened the door for rate hikes later in the year, though it practically ruled-out a rate increase in April. As Fed Chair Yellen said, just because the Fed is not using the word 'patient' does not mean that it will be impatient. More importantly, however, the Fed clearly communicated that the change in forward guidance does not indicate that it has decided on the timing of the initial rate hike. The Fed has also explicitly stated the milestones that it wants the economy to achieve before it considers raising interest rates.

Lower and slower

In this statement, the Fed came up with an astute reading of the US economic environment and voiced specific sources of concern. It downgraded its US GDP growth forecast range for 2015 to 2016, from 2.6%-3.0% to 2.3%-2.7%. The FOMC statement also cited export weakness and the slow pick-up of inflation, which we deduce were caused by the surging dollar (*Surging dollar, slumping euro*, March 16, 2015). It appears that the Fed is mindful of the detrimental effects of a strong dollar, which is also what everyone else is concerned about. Consequently, the "dot plot" estimates, or the average estimates for the yearend Fed funds rate by the Fed officials themselves, were lowered for 2015 (from 1.125% in the

previous meeting to 0.625% in the latest meeting) and 2016 (from 2.5% in the previous meeting to 1.875% in the latest meeting).

US dollar too strong?

Given these, it seems that the Fed is cognizant of the underlying fragility behind the apparent strength of the US economy. It is also aware of the weakness in the global economy and the strengthening of its currency, and how these affect growth and inflation. This is why it lowered its interest rate estimates for end-2015 and end-2016 while also implying that the pace of rate increases will be slower than what was previously expected.

2% inflation objective

In its latest statement, the Fed specified what it wants to see for policy normalization and interest rate hikes to commence. It said that it wants to see "further improvement of the labor market." The Fed also said that it will only raise interest rates if it is "reasonably confident that inflation will move back to its 2% objective over the medium term." Note that this is similar to the inflation target that Japanese Prime Minister Shinzo Abe and Bank of Japan Governor Haruhiko Kuroda are aiming for (*Out of the Sandtrap*, April 15, 2013 and *The Big Driver*, November 17, 2014). The Fed is well-aware that the strong growth figures and low unemployment rate have so far not translated into inflation and wage growth, which are what the Fed ultimately wants.

Global monetary easing, except for the US

Following the Fed's lead, Europe and Japan are doing their own brand of monetary easing. Moreover, so far this year, 24 other countries have cut their benchmark interest rates. This shows that central banks elsewhere in the world have understood the success of the Fed's policies and are replicating these in their respective countries. They are providing the appropriate monetary policies to stimulate their economies in light of prevalent global weakness and low commodity prices.

BSP doing the right things

For its part, the BSP has been mindful of the developments abroad and what the other global central banks are doing. More importantly, the BSP has kept a watchful eye on how these will affect the country's growth and inflation outlook. Aside from its oversight of the local banking sector, the BSP has always come up with timely and appropriate policy measures to support our country's growth while keeping inflation and the Philippine peso at stable and acceptable levels.

Bernanke is our hero

Prior to the Fed statement, there was a lot of second-guessing as to what the Fed would do. There were also some who kept criticizing the Fed's actions, saying that these will not work or that these will lead to negative long-term consequences. In our opinion, these doubters and critics fail to understand what the Fed has done for the global economy and global equities.

The Fed, particularly former Fed Chair Ben Bernanke, is the architect of the 6-year bull market that we are experiencing. The Fed's policies and actions practically saved the world from a financial Armageddon and have stimulated the global economic recovery that we are currently witnessing. The fact that other global central banks are following the Fed's lead is a clear testament to the success of its policies.

Don't Fight the Fed

One of the significant investment strategies that we at Philequity closely adhere to and share with our investors is the basic tenet that one should not fight the Fed and the central banks. This is actually a very simple strategy which, unfortunately, many fail to follow. Central banks are very powerful institutions because they are regulators. This means that they can change the rules of the game if needed. Time and again, we have seen that central banks will do whatever is necessary to achieve their purpose, whether it is to stimulate growth, rein in inflation or stabilize their currencies. As such, their policies can have a dramatic impact on the direction of stocks, bonds and currencies. We thus believe that "don't fight the Fed" is an investment strategy that is of paramount importance. We have therefore written numerous articles about understanding and following central bank action (see list below).

1. *The Rescue*, September 22, 2008
2. *Here Comes Feddy Claus*, December 22, 2008
3. *Stimulus Package*, February 16, 2009
4. *666 on 3-6-9*, April 13, 2009
5. *The Twist*, September 26, 2011
6. *Central Banks to the Rescue*, December 5, 2011
7. *Whatever It Takes*, August 27, 2012
8. *Central Banks Winning*, September 17, 2012
9. *The Great Global Monetary Easing*, October 22, 2012
10. *Out of the Sandtrap*, April 15, 2013
11. *No Taper!*, September 23, 2013
12. *Don't Fight the Bangko Sentral*, February 10, 2014
13. *BSP firmly in control*, May 19, 2014
14. *Bangko Sentral's Pre-Emptive Strike*, June 23, 2014
15. *The Big Driver*, November 17, 2014

Follow the Fed

After what the Fed and other global central banks have so far achieved, they will be very careful with their subsequent actions to ensure that this fragile global recovery is nurtured and sustained. Moreover, the Fed's well-crafted statement shows that it is mindful of how global markets and asset classes will react to its policies. The Fed has made it clear that it wants growth to firm up and inflation to show a clearer and stronger trajectory before it starts increasing rates. What is implied is that it also wants the stock market to go up, as this brings about investor and consumer confidence that should precipitate stronger economic growth. For us at Philequity, we really do not have to overcomplicate things. For now, what we have to do is follow the Fed, follow the central banks and stay the course.

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