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Central Banks Strike Back

Last Saturday, we held our investor briefing at the Meralco Theater. The venue was filled as many of our investors attended to see what our market outlook is in a turbulent time such as this. We provided a recap of the events that have so far transpired this year. These included the worst two-week start in history for most global indices, recent central bank stimulus actions, their effects on stocks and currencies, and different scenarios for the markets.

Vicious Bear Attacks

Global markets started the year battling a perfect storm of headwinds. The global backdrop seemed like a recipe for disaster and dealt a huge blow to investor confidence. We witnessed several unprecedented moves in various asset classes which are typically symptoms of a vicious bear market. We enumerate these below.

1. Worst two-week start for most global indices
2. Historic drop of oil prices
3. Most commodity prices at historic lows
4. Most EM currencies dropping to historic lows
5. Extreme volatility in the Chinese stock market

A Global Slowdown

In the past few months, many risks to global growth have surfaced and there have been increasing concerns of a possible global slowdown. Many are wondering if Europe and Japan can sustain their fragile recovery. There are also questions about China's ability to avoid a hard-landing. Moreover, a pronounced economic slowdown has been seen in many EM countries. Though the US economy is in better shape, there are concerns that the budding US recovery may be derailed by slowing growth overseas. Along with supply-demand imbalances, these concerns precipitated the historic lows that were witnessed in oil, commodities and EM currencies. Many have opined that the oversupply in oil and commodities, excess capacity in different countries and weakening global demand may be signalling impending deflation and a possible recession.

Coordinated central bank stimulus actions?

In the last eight trading days, the world's major central banks responded strongly to the threats of global slowdown and financial market turmoil. Seemingly coordinated and on cue, the statements of global central bank heads came one after the other, all pledging to maintain monetary policies that would be supportive of the fragile recovery. Fed Chair Janet Yellen and European Central Bank (ECB) President Mario Draghi relied on verbal intervention to convey their policy intentions and guide market expectations. Bank of Japan (BOJ) Governor Haruhiko Kuroda, on the other hand, used the element of surprise to shock the markets and forward his objectives.

Draghi – 'we have plenty of instruments'

In his press conference, ECB President Mario Draghi said, "**We have plenty of instruments. We have the determination, and the willingness and the capacity of the Governing Council, to act and deploy these instruments.**" Draghi's mere mention of the phrases 'plenty of instruments' and 'willingness and capacity… to deploy these instruments' caused markets to rally. Based on Draghi's pronouncements, it is likely that the ECB will come up with something big or shocking in its meeting on March.

Yellen – a slower pace of tightening

After the FOMC meeting last Wednesday, Fed Chair Janet Yellen said, "The Committee is **closely monitoring global economic and financial developments** and is **assessing their impact on labor markets and inflation**." Though Yellen was non-committal in her statement, she reassured markets that the Fed is closely watching various headwinds to growth and the financial market turmoil around the globe. She also reiterated that future policy decisions will be data dependent. This means that a March rate hike is probably not being considered and that the Fed will undertake a slower pace of tightening than what was previously stated.

China lashes at bears

Last week, the Chinese government responded strongly to bearish comments made about its currency and economy. Specifically, the government addressed comments by billionaire investor George Soros, that a hard-landing in China is practically unavoidable. China responded with commentary articles in its state media, asserting that the country had "ample reasons to stay confident in the face of speculators." Moreover, China said that speculators against its currency will end up losing badly in the end.

Kuroda – surprise attack

Two weeks ago, BOJ Governor Haruhiko Kuroda stated, "If necessary to achieve the 2% inflation target, particularly if the underlying inflation trend is seriously affected, then we can expand or further strengthen QQE in many ways." Last Friday, Kuroda shocked the markets by pushing BOJ's benchmark interest rates below zero. Following his announcement, Kuroda said, "What's important is to show people that the BOJ is strongly committed to achieving 2 percent inflation and that it will do whatever it takes to achieve it." Kuroda's surprise attack and the BOJ's determination in achieving its inflation target caused markets to go up substantially last Friday.

Strong rebound of EM stocks and currencies

As we noted in our investor briefing, it was Draghi's statement that caused the markets to start rallying from their recent lows. This was followed by Yellen's statement, which served to calm nervous investors. Then last Friday, Kuroda shocked the markets by pushing interest rates into negative territory, causing a sharp rally in global stocks. The recent actions of the major central banks are clearly directed at stimulating growth in their respective countries. However, what is noteworthy is that battered EM stocks and currencies, including Philippine stocks and the peso, have been the biggest beneficiaries of this latest market rebound.

Don’t Fight the Fed

In our book “Opportunity of a Lifetime”, a chapter is devoted in highlighting the wisdom of following central bank action. Chapter 4 of our book is titled “Don’t Fight the Fed.” Time and again, we have stressed the power that central banks wield in their hands. Central banks have various policy tools that they can use to achieve their objectives. In recent years, we have seen global central banks become more creative and daring in coming up with policies and programs to stimulate growth. Moreover, it is important to note that central banks are not normal market participants; they are regulators and they can change the rules of the game, if needed. This quote can be found in page 105 of our book: *“The US Federal Reserve has provided a roadmap on how to use Quantitative Easing (QE) to achieve economic stability and growth. Following the Fed’s footsteps, the Bank of Japan, the European Central Bank and the People’s Bank of China launched their own stimulus programs in order to address deflation. Moreover, central banks are coordinating their moves with one another. Rather than making isolated decisions, heads of central banks consult one another in order to arrive at the best plan of action for the fragile global financial system.”* In page 107, we said this: *“Because central banks are so afraid of a double-dip recession, they will be very determined and all-out in their reflationary measures.”*

Who will prevail?

In the face of various risks to global growth, central banks retaliated with powerful statements and showed their dogged determination to achieve their policy objectives. Doing this has restored a lot of the confidence in the markets, especially in battered EM indices and currencies. Moreover, it buys some time and respite for the markets to recover and digest the various issues in play.

It is shaping up to be a great battle with central banks on one side and hedge fund bears on the other side. It remains to be seen whether this wave of central bank statements and actions will translate to an actual improvement in economic figures, so this is something that we will all have to monitor very carefully.

Though central bank heads did not give any indication of deliberate coordination with one another, it seems that they are acting in consonance and are fighting the same risks and threats to growth. If the macro picture continues to turn for the worse and global markets continue to be volatile, it is not far-fetched that global central banks will resort to deliberately coordinated action, as they have done this in the past. If we have to pick a side, **our bet is ultimately with the central banks.**

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