Philequity Corner (March 13, 2017)
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Beware the Ides of March

On March 15, the Fed will hold its policy meeting. Aside from the expected rate hike, investors and economists will carefully peruse the Fed's policy statement and examine the accompanying dot plot forecasts on that day. Literature buffs, especially Shakespeare aficionados, will understand the ominous significance of the Ides of March. Thus, while markets have recently moved higher despite the imminent rate hike, investors should beware of a Fed that may be more hawkish than expected.

Shakespeare's Julius Caesar

The Ides of March gained notoriety when Julius Caesar was murdered on March 15, 44 BC. After being proclaimed 'dictator for life', Caesar received a warning from a soothsayer who said, "Beware the Ides of March!" Being the powerful man that he was, Caesar ignored the warning and proceeded to the Theatre of Pompey, where he was stabbed and murdered by conspiring senators. Caesar's death sparked a civil war in Rome and turned the Ides of March into a notorious and ominous date. William Shakespeare, in his famous play, immortalized the story of Julius Caesar and the phrase "Beware the Ides of March!"

Rate hike, a certainty on the Ides of March

Based on recent Fed statements and the dot plot (which shows the interest rate forecasts of each Fed official anonymously plotted on a chart), a rate hike this week is practically certain. Last week, market odds of a March rate hike increased from 20% initially to almost 100%. The main reason behind the turnaround in rate hike expectations is the improving performance of the US economy. Last Friday, it was reported that the US economy added 235,000 jobs, above market expectations. This brought US unemployment down to 4.7% as wages grew 2.8%. Moreover, the most recent inflation reading came in at 2.5%. It is therefore apparent that the Fed is moving closer towards its dual goals of promoting maximum employment and stable prices.

Happy 8th birthday, bull market!

One indicator of the improving US economy is the strong performance of the US stock market. US stocks have been on a bull run and all four major US indices – the Dow, S&P 500, Nasdaq and Russell – are trading near all-time highs. In addition, the Dow touched 21,000 for the first time on March 1 and closed at 20,903 last Friday.

Incidentally, last week (March 6) was the 8th anniversary of the current bull market. Though many people remember the S&P 500's closing low of 676 on March 9, 2009, the bottom of the bear market took place when the S&P 500 hit an intraday low of 666 on March 6, 2009. We called this bottom in a past article (*666 on 3-6-9*, April 13, 2009) and we discussed this lengthily in our book Opportunity of a Lifetime (see Chapter 2). Since then, the S&P 500 has surged by 251% while the Dow is up 224%. In comparison, the PSEi is up 309% from its March 2009 low.

Recovery in major global markets

The improving performance of the US economy and the recent run-up in US stocks has been accompanied by a recovery in other major global markets. Last week, European Central Bank (ECB) President Mario Draghi hinted at a potential pause in monetary stimulus on the back of a pick-up in growth. This goes with improving economic indicators in Japan and China. These have driven the strong performance of the Euro Stoxx and the Nikkei, which are both trading at or near 52-week highs. The Shanghai Composite has also been on a steady uptrend since recovering from its 2016 lows.

Paradigm shift

Since the start of the bull market, investors got spooked and became anxious whenever the Fed talked about the tapering of monetary stimulus and potential rate hikes. However, the market has experienced a paradigm shift recently. The prospect of a Fed rate hike has been taken positively by the market. And as explained by Fed officials, **interest rate hikes are being done in the context of policy normalization**.

From deflation to reflation

In our book, we discussed that the Fed engaged in unprecedented monetary policy easing because it wanted to prevent a double-dip recession and a repeat of the 1929 Great Depression (see Chapter 4 – Don't Fight the Fed). **Lately, it has become more apparent that the global economy has avoided deflation and is now back on a reflationary path. This has become evident as we start to see green shoots of growth globally.** These are the reasons why the stock market has gone up despite imminent rate hikes.

Beware the hawkish Fed

We believe that the Fed is now leading the market's interest rate expectations. By using explicit forward guidance through its policy statements, the Fed has managed to steer market expectations of 2017 rate hikes from two to three. As the Fed holds its FOMC meeting on the Ides of March, it will be important to watch what the Fed will say in its policy statement and in the dot plot. Investors should beware of a Fed that comes out more hawkish than expected. Investors and economists should therefore watch if the Fed's rate guidance, as seen in the dot plot, shifts from three to four rate hikes this year. The concern is that a faster than expected rate hiking cycle (i.e. four or more rate hikes in 2017) may stifle the fragile global economic recovery.

Delicate balancing act

We believe that the Fed is currently facing a delicate balancing act. On the one hand, if the Fed ends up being too hawkish, its policy statements and actions may spoil the fragile global recovery. On the other hand, if the Fed ends up being too dovish, its policies may stoke inflation and eventually result in asset price bubbles. **The challenge for the Fed is to craft a policy trajectory that will manage inflation and normalize interest rates while also supporting stronger economic growth.** Over the medium to long term, markets should move higher with a gradual interest rate hiking cycle, provided that the rate hikes are accompanied by economic growth. Still, we will be closely watching out for any pertinent changes in the Fed's policy statement and the dot plot. We will also monitor how markets and asset classes will react after the Fed concludes its policy meeting on the Ides of March.

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