Philequity Corner (July 24, 2017)
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Every Word You Say

In previous articles, we have written extensively about how important words can be. We explained how the words uttered by central bank heads can move stocks, bonds and currencies. Just recently, Fed Governor Janet Yellen and European Central Bank (ECB) President Mario Draghi made statements that caused global equity markets to move higher. Just like in the past, we are borrowing words from the song “Every Breath You Take” by the Police for the title of this article (see *Every Move You Make*, 9 November 2015 and *I’ll Be Watching You*, 13 June 2016).

Fed watching since 2008

Ever since the central banks started intervening to save the global economy from financial armageddon, we have been watching their every move. In Chapter 4 of the book Opportunity of a Lifetime, titled Don’t Fight the Fed, we explained how the Fed helped the US claw its way out of the worst recession since the Great Depression. From TARP to QE to Operation Twist, we have been keeping a close eye on the Fed. In previous articles, we dissected and analyzed their statements word per word in order to determine where the stock market will go (see *The Power of Words*, 29 June 2015 and *More than Words*, 19 September 2016).

Central banks wanted to rekindle growth

Because of the consequences of the 2008 Financial Crisis, the primary concern of central banks since then was the revival of the floundering world economy. Thus, they experimented with unconventional monetary policies in a bid to rekindle growth across the world.

Draghi’s words – “Reflationary forces are at play”

Despite the extraordinary tools used by central banks, there were still concerns about sluggish growth. Recently, Draghi made a statement that **“reflationary forces have displaced deflationary forces.”** In addition, he said that **“growth is above trend and well distributed”** and **“inflation dynamics remain more muted than one would expect.”** Taken together, the remarks made by Draghi assured the market that the global economy has begun to recover, bringing global equities higher.

Coordinated central bank action leads to synchronized global growth

It is important for everyone to remember that the global recovery and bull market we are experiencing now would not have been possible without coordinated central bank action. As we have written before, though the Fed led the way, central banks around the world had to provide their own stimulus and move in the same direction in order for the world to recover from the worst recession since the Great Depression (see *Central Banks to the Rescue*, 7 November 2011 and *Central Banks Strike Back*, 21 February 2016). The product of this coordinated action is the synchronized global growth we are enjoying now (see *Synchronized global growth*, 12 June 2017).

Fear of rising interest rates

After keeping interest rates close to zero for nearly 10 years, the US has finally started growing. However, with the Fed starting to tighten, there are worries that the budding economic growth will be stifled by rising interest rates. We wrote about these concerns in previous articles (see *The Tale of the Taper*, 22 July 2013 and *What happens when the Fed raises rates?*, 14 December 2015).

Yellen's words – rates to rise but not much further

Markets continued to be jittery as the Fed projected that they would be raising interest rates 3 times per year from 2017 to 2019, for a total of 9 hikes which amount to an increase of 2.25% for the Fed funds rate (see *Connect the Dots*, 3 April 2017).

This all changed when Yellen testified before the US Congress. In her prepared remarks, she said that "**because the neutral rate is currently quite low by historical standards, the federal funds rate would not have to rise all that much further to get to a neutral policy stance."** Not only will she be hiking slower than expected, but even if interest rates rise, it will probably not go back to levels we have seen in previous cycles.

What does "neutral" mean?

Note that Yellen used the word "neutral" twice in the aforementioned statement. In fact, if you listened to her testimony, you will notice that she used the word "neutral" 5 times in just one paragraph. As was the case in all the previous Fed statements, this is not a random choice of words or a coincidence. She was stressing that at 1.25%, US interest rates are very close to a neutral level, meaning that it keeps the economy on an even keel and is neither expansionary or contractionary. Again, this reinforces the notion that they will not be tightening monetary policy as quickly as they forecasted.

Interest rates to remain below levels seen in previous decades

Moreover, Yellen went on to say that "the Committee continues to anticipate that **the longer-run neutral level of the federal funds rate is likely to remain below levels that prevailed in previous decades**." Even if interest rates do rise, they will likely be low by historically standards. For instance, instead of settling at 5% level that the US was accustomed to in the past 20 years, long term interest rates may peak at 3% or even lower.

Yellen and Draghi's words bring markets to new highs

The reassuring words from Draghi & the ECB, as well as Yellen & the Fed, have brought markets higher. US equity indices made new all-time highs, with the Nasdaq rising for 10 straight days just recently. Most other markets in Europe and Asia have also followed suit, either moving closer to their previous highs or making new historic highs.

Growth + low interest rates + benign inflation = bull market

As we have said in previous articles and presentations, the first leg of the bull market was due to easy monetary policy. As for the second leg of the bull market, it would be heralded by economic growth. Thus, with synchronized global growth in progress in a low interest environment and benign inflation, we may well be experiencing the next leg of the bull market. Listening to Yellen and Draghi, the words they have said tell us that the global bull market will continue charging on.

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Duterte's 2nd SONA

Today, President Duterte will be presenting his 2nd SONA. We hope that his words will further clarify his program and unite the people behind the government's economic agenda.