Philequity Corner (June 18, 2018)
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4, not 3

After their historic 4-0 sweep against Lebron James and the Cleveland Cavaliers, the Golden State Warriors have now won 3 championship titles in the past 4 years. On the other hand, the US Federal Reserve surprised markets by indicating that it may raise interest rates 4 times this year, not 3. This was announced last week after the Fed decided to increase interest rates for the 2nd time this year. From a record low of 0-0.25% in December 2008, the Fed has now brought interest rates to 1.75-2%. Most market participants were expecting only 3 rate hikes this year, so many traders were caught off guard by the projected 4 rate hikes this year.

Word watching

In previous articles, we borrowed lyrics from the song "Every Breath You Take" by The Police to show how important the Fed's words are. Some of the titles of our columns are **Every Move You Make** (9 November 2015), **I'll Be Watching You** (13 June 2016) and **Every Word You Say** (23 July 2017).

The latest statement that came out from the Fed was unusually short, coming it at only 320 words – less than half the length of a typical Fed monetary policy statement. However, the small number of words used by Powell did not take away from the Fed's change in tone. See below the significant differences between the Fed's May and June policy statements:

1. **Economic growth** – from "moderate" to "rising at a solid rate… with sustained expansion"
2. **Unemployment** – from "stayed low" to "declined"
3. **Household spending** – from "moderated" to "has picked up"
4. **Interest rate hikes** – from "gradual adjustments" to "increases"

Dove to hawk

What these changes in language show is that the Fed is intent in picking up the pace of rate hikes. After standing pat for 7 years, the Fed was slow to raise rates. From 2008 to 2016, the Fed raised rates only 2 times in order to allow the fragile US economy to recover. However, since March 2017, the Fed has raised interest rates 5 times or 1.25%. With another 2 more likely this year, the US would end up raising interest rates 7 times or 1.75% in the past 2 years. This is a clear sign that the Fed has now evolved from dove to hawk.

US hikes rates because of strong growth

The Fed did not raise interest rates just for the sake of becoming hawkish or matching their dot plot. In fact, the Fed turned hawkish because US economic growth has strengthened significantly. After being in recovery mode for 8 years, the US is firmly in expansion mode.

With tax cuts boosting disposable income of US citizens, economists are forecasting that the US economy will grow 3.6% in 2Q18, nearly double the previous quarter's growth rate. This very strong growth figure is one of the main reasons why the Fed is willing to raise interest rates at a faster clip. In contrast, the EU will probably raise interest rates in the 2nd half of 2019 – a sign that Eurozone growth is not yet deemed to be strong enough to absorb tightening monetary policy right now.

Money flows back to US

With the US clearly ahead of the pack in terms of growth, portfolio managers have been trimming their emerging market (EM) exposure, including the Philippines. Outflows from EM and into the US have continued as US growth strengthens, US interest rates rise, and the US dollar appreciates.

Philippine peso breaks 53

With the Fed raising rates and the US dollar strengthening as a result, the Philippine peso broke the psychological support level of 53/$, ending the previous week at 53.33. At this level, the peso has depreciated 7.1% YTD. The sharpness of the depreciation is one of the reasons behind the weakness of the Philippine stock market which is already down 12% YTD.

BSP to decide appropriately

In reaction to the recent Fed rate hike and its hawkish language, our economic managers have issued statements. DOF Secretary Sonny Dominguez said that "the Fed hike is a reality we must adapt to". When asked about the prospects of a potential rate hike, Dominguez said he is "confident that the central bank will decide appropriately" during the Monetary Board meeting next week. BSP Governor Nestor Espenilla Jr. reacted to the Fed rate hike, saying that it is a relevant factor that has to be considered in their monetary policy decision.

Headwinds continue for emerging markets, including Philippines

If more US rate hikes were not enough for emerging markets to contend with, matters have become more complicated as the trade war looks ready to escalate. Last Friday, Trump announced $50 billion worth of tariffs on Chinese products. China responded swiftly, saying "we will immediately introduce taxation measures of the same scale and the same strength. All the economic and trade achievements previously reached by the two parties will no longer be valid at the same time". Over the weekend, China announced retaliatory tariffs of approximately the same amount. Thus, emerging markets like the Philippines have to struggle with foreign portfolio outflows, strengthening US dollar, rising inflation, higher interest rates, and now a looming full scale trade war.

Philequity Management is the fund manager of the leading mutual funds in the Philippines. Visit www.philequity.net to learn more about Philequity's managed funds or to view previous articles. For inquiries or to send feedback, please call (02) 689-8080 or email ask@philequity.net.