Philequity Corner (April 2, 2018)
By Wilson Sy

The Return of Volatility

2017 was a very good year for global equity markets which saw record streaks made and record highs broken with nary a correction (see *2017 – A Record Year for Stocks*, 3 January 2018 and *Starting the New Year with A Bang!*, 8 January 2018). All 3 major US equity indices made new highs last year with returns in excess of 20%. Our flagship Philequity Fund gained 23.3% last year and went on to hit a new record high NAV/share of 43.01 in January.

Rough 2018

However, after a smooth 2017, it looks like we are in for a rough 2018. Unlike 2017 where investors were always rewarded with new all-time highs, 2018 saw wild swings. Unfortunately, people are not used to these huge drops. Thus, after FOMO (fear of missing out) brought stock markets to their peaks (see *9000*, 29 January 2018), some investors turn tailed and are now afraid of being the last one holding the proverbial empty bag.

From record highs to sharp plunges

In January of this year, both the Dow Jones index and the PSEi hit new milestones. The Dow Jones hit 26,000 for the first time while the PSEi hit the 9,000 level – a new record. However, after hitting record highs, global equities fell sharply. At the start of February, the Dow Jones index experienced two 1000-point drops in the span of a week. Though it recovered some of its gains, it succumbed to yet another correction last week, plunging more than 700 points on March 22. This latest drop brought the Dow Jones index back to its low for the year. Our own stock market followed this sharp plunge as well, with the PSEi falling from a record high of 9,078 to an intraday low of 7,834. This 1200-point correction erased all our stock market's YTD gains and more.

What's causing stock markets to drop?

Many investors were left reeling and dazed by the recent volatility. They have been wondering what is causing the sharp drop in global markets. The corrections in the past 2 months were not caused by a single factor, but a series of events that took place one after the other.

1. **Fears of higher inflation and rising interest rates**
    - At the start of February, the US reported strong employment figures and 2.9% hourly wage growth – the highest in 9 years. This led to fears of higher inflation and faster-than-expected rate hikes, causing a sharp bond selloff, leading to a sharp plunge in equity prices.
2. **Potential Fed policy mistake**

- With the Fed raising rates for the 6th time since the 2008 US Financial Crisis, economists are worried that the new Fed Chairman Jerome Powell may raise interest rates too fast, thereby undoing the US' economic expansion. Another concern is how the Fed will unwind its $4.5 trillion balance sheet without causing instability for the economy and financial markets.

3. **Threats of trade war and protectionist rhetoric**
    - In the past weeks, Trump amplified his protectionist policies. He signed an executive order implementing a 25% tariff on steel imports and 10% tariff on aluminum imports, causing markets to drop. Fortunately, markets heaved a sigh of relief when he allowed exemptions for certain countries. However, he bolstered his protectionist stance by announcing $60 billion worth of China-specific tariffs. China countered saying that it will retaliate with $3 billion worth of tariffs on 128 US products (see *Trade Wars*, 26 March 2018). Though these are not yet final, the psychological impact of these statements, the potential impact on global economic growth and the fear of the unknown continue to instill fear in the markets.
4. **Regulatory risk for tech giants**
    - The past 2 weeks have been quite harrowing for Facebook because of the unauthorized use of data from 50 million of its users by Cambridge Analytica. This led to cries for more regulation, causing Facebook's share price to drop precipitously with the company losing as much as $60 billion of its market capitalization. Recently, Trump has also taken aim at Amazon's tax treatment and how it is destroying thousands of jobs in brick-and-mortar businesses. This caused Amazon's stock price to plunge, erasing about $70 billion of its market cap. These sharp drops in the tech giants then spread to the whole tech sector and broad market as investors scrambled to reduce their exposure to equities.
5. **Political risk in the US**
    - Trump is also embroiled in an investigation into Russian interference in the 2016 US elections, as well as a scandal regarding his previous affairs with a number of women. This has led to Trump tweeting more controversial statements. Political noise from these issues is also dampening market sentiment.

Macroeconomic fundamentals should prevail

With these sharp spikes in volatility and wild swings in the stock market, the bull market has taken a pause. However, it is important to note that recent events have not impaired economic and corporate fundamentals that are underpinning the bull market. The global economy is still growing and the Philippines is expected to grow close to 7% in the coming years. Corporate earnings are still rising both in the US and here, with our research team forecasting 12% earnings growth for 2018. Unless we have a full blown trade war, we believe that macroeconomic fundamentals will prevail over the transitory factors that are causing volatility in the stock market.

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.