Philequity Corner (October 4, 2021)
By Wilson Sy

Worst monthly drop since Covid outbreak

Global stock markets slumped in September, posting the worst monthly decline since the Covid pandemic. Initially, investors had shrugged off the emergence of the Delta variant and the new lockdowns that accompanied it. However, a confluence of negative factors hounded the markets throughout the month, with the spike in US bond yields last week finally breaking the camel's back. After a 1.2% slide on Thursday, the benchmark S&P 500 index ended down 4.8% in September, its worst monthly loss since March 2020. The index also broke below its 100-day moving average for the first time since November 2020.

Reasons for the sharp correction in markets

Below, we enumerate the reasons why the markets corrected sharply last month:

1) **Spike in US bond yields** - The rapid climb in US bond yields was a key in the market's sharp drop last week. While US yields are still low by historical standards, markets were spooked by the 26 basis points move in the US 10-year yield from 1.3% to 1.56% in just five days. In addition, the 2-year yield rose ten basis points or 50% from 0.12% to 0.31%.

2) **Tech-led decline** — With bond yields rising, the faster-growing tech companies are underperforming, leading to a broader market decline. Note that during the start of the pandemic, unprecedented liquidity crushed yields and pushed P/Es up, fueling a massive surge in tech stocks. But as the pandemic fades and yields normalize, these forces are now working in reverse, hurting highly-priced tech stocks and growth companies by eroding valuations.

3) **Concern over the Delta variant –** Countries worldwide reimposed new lockdowns and restrictions in early July in a scramble to contain the highly transmissible and more deadly Delta variant. Data showed that the Delta variant could spread rapidly through the unvaccinated, including children. This raised fears that we may see more mutations, making the virus difficult to contain.

4) **Fed tapering** –The Fed signaled it would reduce its monthly $120 billion bond purchases as early as November. It also projected rate hikes to start by the end of 2022. Meanwhile, the ECB said it would trim its monthly bond purchases to €60 billion from €80 billion under the pandemic-support program.

5) **US debt ceiling and the risk of a US government shutdown** - The political drama over the US debt ceiling is forcing bond investors to demand a higher yield for US government papers. The House passed a bill to suspend the debt ceiling last Wednesday. But the Republicans in Senate have vowed to oppose the bill. As a result, the US government faces the prospect of a shutdown if Congress fails to raise the limit or suspend the debt ceiling by Oct. 18.

6) **Global energy crunch**- In Europe, energy prices have gone parabolic amid a shortage of supplies. European natural gas has more than quadrupled this year, reaching 7-year highs. This has spilled onto the crude oil market, which sent Brent crude rising to a 3-year high of $80 per barrel last week. Ironically, clean energy alternatives like wind power have fallen short this year due to mild weather and weak wind speeds. With rising demand from Asia and winter coming in, energy prices from natural gas to coal remain highly elevated.

7) **Supply chain bottlenecks -**Soaring energy prices, fuel shortages, pandemic border restrictions, global port congestion, rising freight rates, and labor shortages are exacerbating the extremely stressed global supply chain. These will lead to delays and shortages of essential goods from food to electronics ahead of Christmas. The cost of everything will rise as well, squeezing the profit margins of many producers.

8) **China's power crisis** - A nationwide power crisis in China is affecting its manufacturing and export sector. As many as 20 provinces are affected by power blackouts and electricity rationing. It has disrupted the supply chain of Apple, Tesla, and the broader semiconductor and electronics sector. China's power crisis will likely lead to export price hikes, worsening inflation in the US and other countries.

9) **China's rising regulatory risks** - China's radical reforms and sweeping regulatory crackdown targeting different sectors and numerous companies, including its ban on cryptocurrencies, have sent jitters to the global financial markets.

10) **Evergrande contagion** - The potential default of China's second-biggest property developer, Evergrande, has raised fears of contagion. Initially, there were fears that this would be China's "Lehman moment." However, Evergrande's exposure is mainly China-centric, and China has the available tools to control a spillover.

11) **Elevated inflation** - Inflation in the Eurozone hit 3.4% in September, its highest in 13 years driven by the surging energy prices, supply chain disruption, and full reopening of economies. Inflation in the US is at a 30-year high. The core PCE price index, the Fed's preferred inflation measure, climbed 4.3% in August, the highest level since 1991. Meanwhile, the Philippine inflation rate hit 4.9% in August, the highest level since January 2019.

12) **Stagflation risk** – Economist Stephen Roach warns that the risk of "stagflation" is rising. This environment refers to periods of persistently high inflation and slow economic growth (or stagnation). He said that the supply chain issues had affected many commodities, including inputs like semiconductors. In addition, the energy and power-related shortages, the high price of oil, and labor shortages are reminiscent of the 1970s-style of stagflation.

Markets wake from September slumber

Reports of a new oral treatment for Covid-19 helped markets wake from the September slumber. The Dow Jones led the rally last Friday with a 1.4% gain after Dow-member Merck surged 8.4%. Merck's new Covid-pill, molnupiravir, has been shown to reduce the risk of hospitalization and death by half, according to a phase 3 study. Travel stocks, hotels, casinos, and the so-called "reopening" plays led the markets higher.

Philippine stocks posts positive return in September

Despite the surge of Covid cases in early September and the political noise, the Philippine stock market is one of the few in Asia with a positive return for the month. The PSEi gained 1.4% for the month, outperforming the MSCI Emerging Market Index (EEM), which lost 3.9%. As vaccination rates picked up, daily Covid cases in the NCR and many provinces declined markedly in the latter part of the month. In addition, the slight uptick in net foreign buying in August and September, plus the warm reception to the recent IPO and REIT listings, contributed to lifting the PSE index.

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) 8250-8700 or email ask@philequity.net.