Philequity Corner (November 7, 2022)

Powell ends rally

In the past month, financial markets staged a strong rally, fueled by hopes that the Federal Reserve (Fed) will dial down its ultra-hawkish policy stance. The S&P gained 8% in October while the PSEi increased by 7.2%. Ahead of the Fed meeting, bond yields pulled back while most currencies strengthened. Markets even moved higher intraday during the prepared speech of Fed Chair Jerome Powell. However, Powell's hawkish comments during the Q&A portion completely changed the tone of his message and drastically altered market direction. After the Q&A, the S&P 500 fell 3.5% and the Dow shed 870 points from their intraday highs. Bond yields spiked and currencies fell anew.

Hawkish comments spook markets

In his press conference, Powell signaled a higher terminal rate and said that the Fed has much ground to cover in tightening its policy. Powell telegraphed that interest rates will stay higher for longer in order to bring down inflation. Importantly, Powell clarified that it is too early for the Fed to pause with its rate hikes and warned against prematurely loosening policy. Below, we list notable quotes from Powell's statement and his hawkish remarks during the Q&A segment.

1. "We anticipate that ongoing increases in the target range for the federal funds rate will be appropriate in order to attain a stance of monetary policy that is **sufficiently restrictive to return inflation to 2 percent** over time."
2. "There is significant uncertainty around that level of interest rates. Even so, **we still have some ways to go**, and incoming data since our last meeting suggest that **the ultimate level of interest rates will be higher than previously expected**."
3. "Restoring price stability is essential to set the stage for achieving maximum employment and stable prices in the longer run. The historical record cautions **strongly against prematurely loosening policy**."
4. "From a risk management standpoint, we want to be sure that we **don't make the mistake of either failing to tighten enough, or loosening policy too soon**."
5. "It's very **premature in my view to think about or be talking about pausing** our rate hike."
6. "I think no one knows whether there's going to be a recession or not, and if so, how bad that recession would be. And our job is to restore price stability so that we can have a strong labor market that benefits all over time"
7. "That means that we have to **have policy be more restrictive and that narrows the path to a soft landing** I would say."

Matching the Fed

Last week, Bangko Sentral ng Pilipinas (BSP) Governor Felipe Medalla said that the Fed's 75bps rate hike supports the BSP's stance to likewise hike its policy rate by 75bps in its next policy meeting on November 17. Though the practice is quite unusual, the BSP Governor announced a definitive rate hike move weeks before the scheduled policy meeting in mid-November. Medalla emphasized the need to maintain the interest rate differential that was prevailing before the most recent Fed rate hike. He explained that the BSP's telegraphed rate hike would support price stability and the need to temper sharp peso depreciation.

Considering Medalla's comments, it appears that the BSP would seek to maintain a 100bps spread between its policy rate and the fed funds rate. Market expectations for the Fed terminal rate rose to 5% after Powell's press conference. This means that the BSP may have to bring its policy rate to 6% in order keep an interest rate differential of 100bps and temper further depreciation of the peso.

Game-changer

Powell ended the rally in risk assets with his market-altering comments. The latest market move shows us that the all-powerful Fed can be a game-changer for financial markets and the global economy. Market sentiment quickly turned negative when investors heard Powell's hawkish comments during the Q&A segment. Powell dashed hopes for less aggressive policies when he used the following phrases in his statement: "sufficiently restrictive", "some ways to go", "ultimate level of interest rates will be higher than previously expected", and "premature in my view to think about or be talking about pausing." Powell's hawkish words not only changed market direction altogether but also altered the economic outlook. Higher interest rates maintained for an extended duration may exacerbate the ongoing weakness in major economies and precipitate a deep global recession. On the other hand, the Fed may fail in its goal of taming inflation if it prematurely pauses or slows its tightening. The market action last week illustrates how powerful the Fed is and how it can dramatically change market sentiment and the economic outlook with its words and policies.

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