Philequity Corner (September 26, 2022)
By Wilson Sy

Hawkish Fed pummels markets

The peso reached historic lows amid the continued climb of the US dollar. The PSEi dropped 4.4% while S&P 500 plunged 5.3% last week. Bond prices fell as US bond yields surged to their highest levels in the last decade. More than the Federal Reserve's (Fed) 75bps rate hike, the higher terminal rate guidance and Fed Chair Jerome Powell's hawkish policy speech triggered a sharp plunge in financial markets.

Seismic impact across asset classes

US stocks have fallen 14% from their recent highs in August. A large portion of this move occurred last week when Powell delivered his policy speech. Below, we summarize the seismic impact of a very hawkish Fed on various asset classes.

1. **US dollar surges to 20-year high.** The US dollar index (DXY) is up 18.1% year-to-date. It gained 3.1% last week and is now at 113.
2. **Euro decisively breaks parity.** The euro convincingly broke parity, with the EURUSD dropping to 0.9687.
3. **British pound plunges a staggering 3.6% in one day** The British pound fell by a stunning 3.6% last Friday as it fell to 1.085, a 37-year low. The pound was down 5.1% last week and 20% year-to-date.
4. **Japan intervenes to stave yen drop.** The yen's massive drop (as much as 26% year-to-date) forced Japan to support it for the first time since 1998.
5. **Chinese yuan continues its descent.** After breaching the critical level of 7, the yuan continued its slide and was down 2.1% last week.
6. **Peso hits record lows.** The peso made all-time lows and the USDPHP rate reached 58.50 last Friday.
7. **Bond yields jumped.** The US 10-year government bond yield touched 3.83%, a 12-year high. The US 2-year government bond yield reached a high of 4.27%.
8. **Global stock markets tanked.** The MSCI All-Country World Index (ACWI) ETF fell 5% last week and is down 13.9% from its recent high in August.
9. **Gold not a safe haven.** Gold has not functioned as a haven asset and has fallen 8.8% from its August peak.
10. **Oil falls below $80.** Oil has fallen for four consecutive weeks and was down 5% last Friday. WTI oil is now below $80/bbl, down 34% from its peak in June.
11. **Commodity prices drop.** The Bloomberg Industrial Metals Subindex dropped 3.7% in last Friday and has plunged 55% from its 2022 peak. The FAO Food Price Index declined by 10.8% in the past two months.

Higher and longer

Powell doubled-down on his hawkish Jackson Hole speech which sent a strong and unequivocal message regarding the Fed's commitment to bring down inflation (see *Hawk at Jackson Hole*, August 29, 2022). Powell was even more hawkish in his policy speech last week when he bared the Fed's much higher dot-plot projections. The consensus among Fed officials is a fed funds rate of 4.4% by end-2022 and 4.6% by early 2023, with no anticipated rate cuts until 2024. This shocked investors as this would imply an additional 125bps rate hike for the rest of the year (potentially 75bps in November followed by 50bps in December) after the Fed has already raised rates by 300bps year-to-date.

Powell's recession warning

Investors fear that the Fed will overdo its monetary tightening and cause a recession. Though the word "recession" is seldom used and typically avoided by central bankers, Powell used the word outright last week. Powell said, "No one knows whether this process will lead to a recession or if so, how significant that recession would be… The chances of a soft landing are likely to diminish to the extent that policy needs to be more restrictive, or restrictive for longer." Between taming inflation and preventing a recession, the Fed has clearly decided to prioritize the former.

Fed policies affect BSP choices

After the Fed rate hike, the Bangko Sentral ng Pilipinas (BSP) followed with a 50bps policy rate hike. BSP Governor Felipe Medalla said, "Strong dollar is requiring us to have bigger policy rate increases… Clearly, the Fed's policies have affected our choices. We don't want to match the Fed, at the same time we have to respond." The BSP has raised its policy rate by 225bps year-to-date, still falling below the Fed's cumulative year-to-date rate hikes of 300bps. Despite the BSP's tightening, the interest rate differential continues to narrow as US interest rates and bond yields catch up with ours.

Nowhere to hide

Except for US dollar cash and cash equivalents, there is nowhere to hide. We have seen shocking drops in equities, bonds, currencies, and commodities. Global currencies are plummeting against an almighty US dollar. Bond yields surged amid expectations of higher Fed rate hikes. Oil initially went up because of the Russia-Ukraine war. However, oil prices have dropped precipitously in the last three months along with many other commodities. Gold, which has traditionally been a safe haven and a hedge against inflation, has also fallen.

Don't fight the Fed

Last Thursday, Powell said, "My main message has not changed at all since Jackson Hole." This was reinforced when Powell provided a clear template of the Fed's plans in his policy speech. Financial markets reacted violently, underscoring the influence of the US economy and the power of the Fed. When the Fed was easing, most asset classes were moving higher. Now that the Fed is tightening, all asset classes, except for US dollar cash, are plunging sharply. Either way, it is extremely difficult to fight the Fed. It will therefore be crucial to watch and monitor the Fed as their words and actions will give us a cue on what to do. At this point, market movements are primarily determined by what the Fed says and does.

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