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The Daily Dispatch

Weekly Special Feature

May 14, 2021

What Happens to Stocks and Cryptocurrencies When the Fed Stops Raining Money?

By: Greg Ip— The Wall Street Journal *(Published on May 8, 2021)*

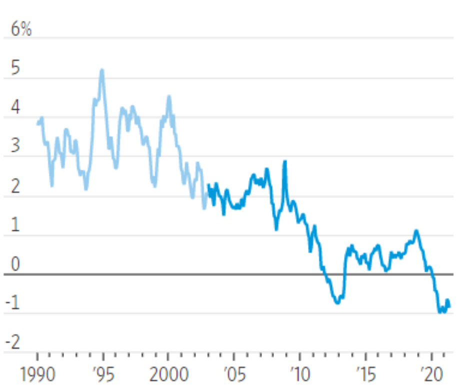
To veterans of financial bubbles, there is plenty familiar about the present. Stock valuations are their richest since the dot-com bubble in 2000. Home prices are back to their pre-financial crisis peak. Risky companies can borrow at the lowest rates on record. Individual investors are pouring money into green energy and cryptocurrency.

This boom has some legitimate explanations, from the advances in digital commerce to fiscally greased growth that will likely be the strongest since 1983.

But there is one driver above all: the Federal Reserve. Easy monetary policy has regularly fueled financial booms, and it is exceptionally easy now. The Fed has kept interest rates near zero for the past year and signaled rates won't change for at least two more years. It is buying hundreds of billions of dollars of bonds. As a result, the 10-year Treasury bond yield is well below inflation—that is, real yields are deeply negative —for only the second time in 40 years.

Money is Dirt Cheap

Inflation-adjusted 10-year Treasury yield



Note: 10-year Treasury yield minus 12-month change in consumer price index excluding food and energy before 2003, 10 year inflation-indexed Treasury yield thereafter

Source: Federal Reserve Bank of St. Louis

There are good reasons why rates are so low. The Fed acted in response to a pandemic that at its most intense threatened even more damage than the 2007-09 financial crisis. Yet in great part thanks to the Fed and Congress, which has passed some \$5 trillion in fiscal stimulus, this recovery looks much healthier than the last. That could undermine the reasons for such low rates, threatening the underpinnings of market valuations.

"Equity markets at a minimum are priced to perfection on the assumption rates will be low for a long time," said Harvard University economist Jeremy Stein, who served as a Fed governor alongside now-chairman Jerome Powell. "And certainly you get the sense the Fed is trying really hard to say, 'Everything is fine, we're in no rush to raise rates.' But while I don't think we're headed for sustained high inflation it's completely possible we'll have several quarters of hot readings on inflation."

Since stocks' valuations are only justified if interest rates stay extremely low, how do they reprice if the Fed has to tighten monetary policy to combat inflation and bond yields rise one to 1.5 percentage points, he asked. "You could get a serious correction in asset prices."

'A bit frothy'

The Fed has been here before. In the late 1990s its willingness to cut rates in response to the Asian financial crisis and the near collapse of the hedge fund Long-Term Capital Management was seen by some as an implicit market backstop, inflating the ensuing dot-com bubble. Its low-rate policy in the wake of that collapsed bubble was then blamed for driving up housing prices. Both times Fed officials defended their policy, arguing that to raise rates (or not cut them) simply to prevent bubbles would compromise their main goals of low unemployment and inflation, and do more harm than letting the bubble deflate on its own.

As for this year, in a report this week the central bank warned asset "valuations are generally high" and "vulnerable to significant declines should investor risk appetite fall, progress on containing the virus disappoint, or the recovery stall." On April 28 Mr. Powell acknowledged markets look "a bit frothy" and the Fed might be one of the reasons: "I won't say it has nothing to do with monetary policy, but it has a tremendous amount to do with vaccination and reopening of the economy." But he gave no hint the Fed was about to dial back its stimulus: "The economy is a long way from our goals." A Labor Department report Friday showing that far fewer jobs were created in April than Wall

Street expected underlined that.

The Fed's choices are heavily influenced by the financial crisis. While the Fed cut rates to near zero and bought bonds then as well, it was battling powerful headwinds as households, banks, and governments sought to pay down debts. That held back spending and pushed inflation below the Fed's 2% target. Deeper-seated forces such as aging populations also held down growth and interest rates, a combination some dubbed "secular stagnation."

The pandemic shutdown a year ago triggered a hit to economic output that was initially worse than the financial crisis. But after two months, economic activity began to recover as restrictions eased and businesses adapted to social distancing. The Fed initiated new lending programs and Congress passed the $2.2 trillion Cares Act. Vaccines arrived sooner than expected. The U.S. economy is likely to hit its pre-pandemic size in the current quarter, two years faster than after the financial crisis.

And yet even as the outlook has improved, the fiscal and monetary taps remain wide open. Democrats first proposed an additional $3 trillion in stimulus last May when output was expected to fall 6% last year. It actually fell less than half that, but Democrats, after winning both the White House and Congress, pressed ahead with the same size stimulus.

Lofty Heights
Price-to-earnings ratio of the S&P 500 based on trailing 12 month operating earnings

Note: Quarterly data through Dec. 2020, last datapoint May 5, 2021
Source: S&P Global

The Fed began buying bonds in March, 2020 to counter chaotic conditions in markets. In late summer, with markets functioning normally, it extended the program while tilting the rationale toward keeping bond yields low.

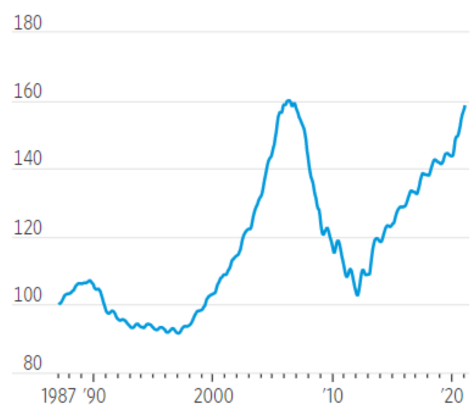
At the same time it unveiled a new framework: After years of inflation running below 2%, it would aim to push inflation not just back to 2% but higher, so that over time average and expected inflation would both stabilize at 2%. To that end, it promised not to raise rates until full employment had been restored and inflation was 2% and headed higher. Officials predicted that would not happen before 2024 and have since stuck to that guidance despite a significantly improving outlook.

Running of the bulls

This injection of unprecedented monetary and fiscal stimulus into an economy already rebounding thanks to vaccinations is why Wall Street strategists are their most bullish on stocks since before the last financial crisis, according to a survey by Bank of America Corp. While profit forecasts have risen briskly, stocks have risen more. The S&P 500 stock index now trades at about 22 times the coming year's profits, according to FactSet, a level only exceeded at the peak of the dot-com boom in 2000.

Other asset markets are similarly stretched. Investors are willing to buy the bonds of junk-rated companies at the lowest yields since at least 1995, and the narrowest spread above safe Treasurys since 2007, according to Bloomberg Barclays data. Residential and commercial property prices, adjusted for inflation, are around the peak reached in 2006.

Building Up
S&P Case-Shiller national home-price index, adjusted for inflation



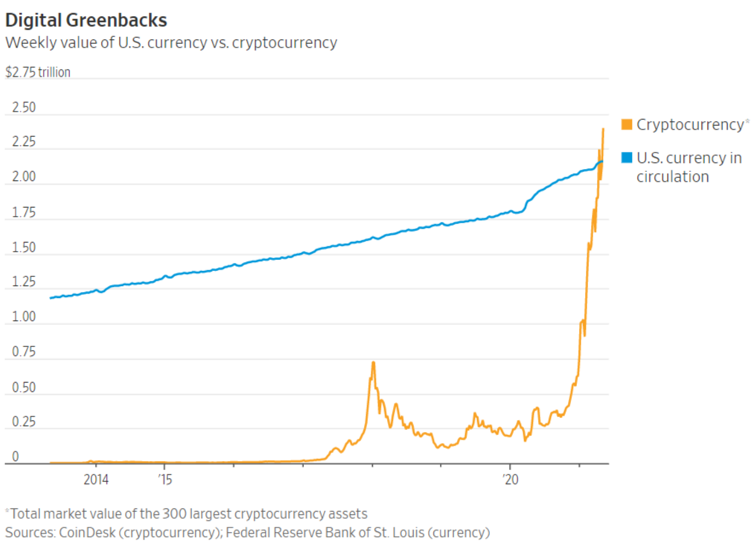
Note: January 1987 = 100
Source: S&P Dow Jones Indices via Federal Reserve Bank of St. Louis

Stock and property valuations are more justifiable today than in 2000 or in 2006 because the returns on riskless Treasury bonds are so much lower. In that sense, the Fed's policies are working precisely as intended: improving both the economic outlook, which is good for profits, housing demand, and corporate creditworthiness; and the appetite for risk.

Nonetheless, low rates are no longer sufficient to justify some asset valuations. Instead, bulls invoke alternative metrics.

Bank of America recently noted companies with relatively low carbon emissions and higher water efficiency earn higher valuations. These valuations aren't the result of superior cash flow or profit prospects, but a tidal wave of funds invested according to environmental, social and governance, or ESG, criteria.

Conventional valuation is also useless for cryptocurrencies which earn no interest, rent or dividends. Instead, advocates claim digital currencies will displace the fiat currencies issued by central banks as a transaction medium and store of value. "Crypto has the potential to be as revolutionary and widely adopted as the internet," claims the prospectus of the initial public offering of crypto exchange Coinbase Global Inc., in language reminiscent of internet-related IPOs more than two decades earlier. Cryptocurrencies as of May 7 were worth $2.4 trillion, according to CoinDesk, an information service, more than all U.S. dollars in circulation.



Financial innovation is also at work, as it has been in past financial booms. Portfolio insurance, a strategy designed to hedge against market losses, amplified selling during the 1987 stock market crash. In the 1990s, internet stockbrokers fueled tech stocks and in the 2000s, subprime mortgage derivatives helped finance housing. The equivalent today are zero commission brokers such as Robinhood Markets Inc., fractional ownership and social media, all of which have empowered individual investors.

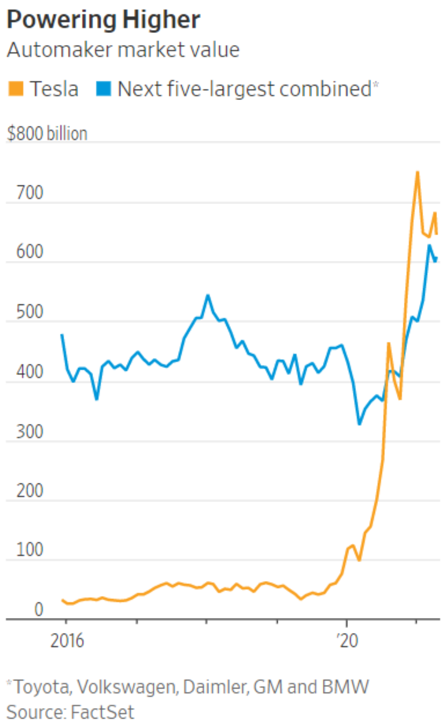
Such investors increasingly influence the overall market's direction, according to a recent report by the Bank for International Settlements, a consortium of the world's central banks. It found, for example, that since 2017 trading volume in exchange-traded funds that track the S&P 500, a favorite of institutional investors, has flattened while the volume in its component stocks, which individual investors prefer, has climbed. Individuals, it noted, are more likely to buy a company's shares for reasons unrelated to its underlying business—because, for example, its name is similar to another stock that is on the rise.

While such speculation is often blamed on the Fed, drawing a direct line is difficult. Not so with fiscal stimulus. Jim Bianco, the head of financial research firm Bianco Research, said flows into exchange-traded funds and mutual funds jumped in March as the Treasury distributed $1,400 stimulus checks. "The first thing you do with your check is deposit it in your account and in 2021 that's your brokerage account," said Mr. Bianco.

Facing the future

It's impossible to predict how, or even whether, this all ends. It doesn't have to: High-priced stocks could eventually earn the profits necessary to justify today's valuations, especially with the economy's current head of steam. In the meantime, more extreme pockets of speculation may collapse under their own weight as profits disappoint or competition emerges.

Bitcoin once threatened to displace the dollar; now numerous competitors purport to do the same. Tesla Inc. was once about the only stock you could buy to bet on electric vehicles; now there is China's NIO Inc., Nikola Corp., and Fisker Inc., not to mention established manufacturers such as Volkswagen AG and General Motors Co. that are rolling out ever more electric models..



But for assets across the board to fall would likely involve some sort of macroeconomic event, such as a recession, financial crisis, or inflation.

The Fed report this past week said the virus remains the biggest threat to the economy and thus the financial system. April's jobs disappointment was a reminder of how unsettled the economic outlook remains. Still, with the virus in retreat, a recession seems unlikely now. A financial crisis linked to some hidden fragility can't be ruled out. Still, banks have so much capital and mortgage underwriting is so tight that something similar to the 2007-09 financial crisis, which began with defaulting mortgages, seems remote. If junk bonds, cryptocoins or tech stocks are bought primarily with borrowed money, a plunge in their values could precipitate a wave of forced selling, bankruptcies and potentially a crisis. But that doesn't seem to have happened. The recent collapse of Archegos Capital Management from reversals on derivatives-based stock investments inflicted losses on its lenders. But it didn't threaten their survival or trigger contagion to similarly situated firms.

"Where's the second Archegos?" said Mr. Bianco. "There hasn't been one yet."

That leaves inflation. Fear of inflation is widespread now with shortages of semiconductors, lumber, and workers all putting upward pressure on prices and costs. Most forecasters, and the Fed, think those pressures will ease once the economy has reopened and normal spending patterns resume. Nonetheless, the difference between yields on regular and inflation-indexed bond yields suggest investors are expecting inflation in coming years to average about 2.5%. That is hardly a repeat of the 1970s, and compatible with the Fed's new goal of average 2% inflation over the long term. Nonetheless, it would be a clear break from the sub-2% range of the last decade.

Slightly higher inflation would result in the Fed setting short-term interest rates also slightly higher, which need not hurt stock valuations. More worrisome: Long-term bond yields, which are critical to stock values, might rise significantly more. Since the late 1990s, bond and stock prices have tended to move in opposite directions. That is because when inflation isn't a concern, economic shocks tend to drive both bond yields (which move in the opposite direction to prices) and stock prices down. Bonds thus act as an insurance policy against losses on stocks, for which investors are willing to accept lower yields. If inflation becomes a problem again, then bonds lose that insurance value and their yields will rise. In recent months that stock-bond correlation, in place for most of the last few decades, began to disappear, said Brian Sack, a former Fed economist who is now with hedge fund D.E. Shaw & Co. LP. He attributes that, in part, to inflation concerns.

The many years since inflation dominated the financial landscape have led investors to price assets as if inflation never will have that sway again. They may be right. But if the unprecedented combination of monetary and fiscal stimulus succeeds in jolting the economy out of the last decade's pattern, that complacency could prove quite costly.

Source: Greg Ip (2021) 'What Happens to Stocks and Cryptocurrencies When the Fed Stops Raining Money?,' *The Wall Street Journal*. Available at https://www.wsj.com/articles/what-happens-to-stocks-and-cryptocurrencies-when-the-fed-stops-raining-money-11620446420 (Accessed 12 May 2021)

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TODAY'S TOP NEWS

P75B needed for expanded vaccination

The government might need to spend P75 billion more until next year to fund its expanded coronavirus vaccination program. Finance Secretary Carlos G. Dominguez III said government agencies might have to realign their budgets again to get funds for the program without widening the budget deficit too much.

Robinsons Land eyes 14 assets in possible REIT

Gokongwei-led Robinsons Land Corp. intends to list a real estate investment trust (REIT) with 14 properties by the second half this year "to create further opportunities for growth" and "to crystalize the value of some of its high-quality office assets."

URC targets healthier product lines

Food manufacturer Universal Robina Corp. (URC) said it is working on introducing healthier products by increasing its wellness criteria on top of its efforts to make its production process safer and more sustainable.

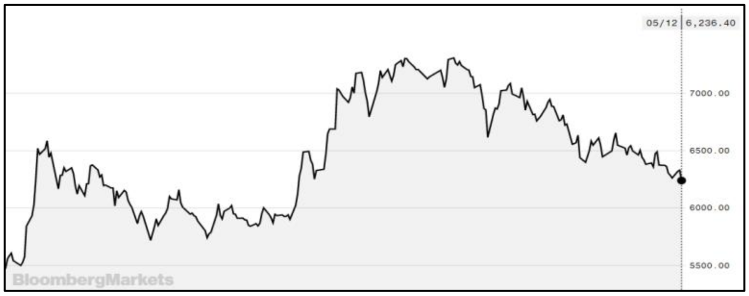
BSP maintains key rate at record low

The Bangko Sentral ng Pilipinas (BSP) held its key interest rate at a record low for a fourth straight meeting on Wednesday, as it continues to support the economy's recovery from the pandemic. The BSP's decision to keep rates steady comes a day after release of disappointing first-quarter gross domestic product (GDP) data.

DoTr's Tugade calls for 30-year transport plan

The Department of Transportation (DoTr) said it will seek legislation establishing a 30-year transportation sector roadmap to minimize the impact of changing priorities set by new administrations.

Philippine Stock Market Update



Previous Close:
6,236.40

1 Yr Return:
9.75%

Open:
6,262.31

YTD Return:
-14.59%

52-Week Range:
5,396.13 - 7,432.40

Source:
Bloomberg

Foreign Exchange

As of May 12, 2021

US Dollar	Philippine Peso
1	47.83

BVAL Reference Rates

As of May 12, 2021

Tenor	Rate
1Y	1.850
3Y	2.598
5Y	3.154
7Y	3.591
10Y	4.110
20Y	4.802

Daily Quote

"Lack of direction, not lack of time, is the problem. We all have 24-hour days."

-- Zig Ziglar

MORE LOCAL NEWS

BSP wants Agri-Agra law revised to support farmers

BSP Governor Benjamin Diokno said in a statement "the Agri-Agra bill will strengthen rural development by providing a holistic approach in addressing the financing needs of the broader agricultural financing ecosystem."
Diokno said the BSP's legislative agenda would help usher the Philippines' next stage of economic development.

Globe upgrading GCash application

Globe Fintech Innovations Inc. (Mynt) is transforming GCash into a financial and lifestyle app from a mobile wallet app to make Filipino lives better. "We want to make a real difference in the lives of every Filipino and break the existing boundaries to enable financial freedom," said GCash president and CEO Martha Sazon.

LandBank launches mobile account opening service

Land Bank of the Philippines (LandBank) clients can now successfully open a savings account with the state-owned lender using their mobile phone at their own safety and convenience without the need to go to a branch.

New 2GO vessel sets sail on May 2

The maiden voyage of 2GO Group Inc.'s new passenger vessel from Japan is slated for May 23, according to the company's executive. "Our target is to sail it by May 23," said 2GO Chief Operating Officer Waldo Basilla in a virtual briefing, adding it will sail to Cebu and Cagayan de Oro.

Maynilad building Ps29-B STP projects

West Zone concessionaire Maynilad Water Services, Inc. (Maynilad) is building several sewage treatment plants (STP) at the same time in Caloocan, Las Piñas, Central Manila, Valenzuela, and Muntinlupa with a total cost of over P29 billion.

Philippines, UK discuss possible RE investments

During a recent virtual meeting of Finance officials with British Ambassador Daniel Pruce, it was agreed that efforts would be continually made to engage with renewable energy investors to "determine possible policy gaps that need to be addressed to encourage the entry of investments to the country."

Gokongweis get slice of Shakey's pizza chain

The Gokongwei Group is grabbing a bite of Shakey's Pizza Asia Ventures Inc. JE Holdings, a private investment company of the Gokongweis, is set to join the Po family's private holding company Century Pacific Group and the sovereign wealth fund of Singapore in Shakey's, with a P1.25 billion infusion.

Recession seen to extend to Q2

The Philippines may suffer its sixth consecutive economic decline in the second quarter as the prolonged lockdown coupled with rising prices force families to reduce their consumption, an international think tank said.

Ecozone investments climb 54% to P25.4 b

Investment pledges approved by the Philippine Economic Zone Authority (PEZA) rose by 54 percent in the first quarter from a year ago despite the ongoing coronavirus pandemic. The PEZA said it approved P25.38 billion worth of investments from January to March, higher than the previous year's P16.5 billion.

Jollibee swings to P153 million profit in Q1

Jollibee Foods Corp., the listed Asian food conglomerate, reported a net income of P153 million in the first quarter, a reversal of the P1.7 billion net loss a year ago. Operating income reached P1.5 billion, 227.2 percent higher than the P1.2 billion recorded a year ago.

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TODAY'S TOP ASIAN NEWS

S.Korea unveils $450b push for chipmaking crown

SOUTH Korea unveiled ambitious plans to spend roughly US$450 billion to build the world's biggest chipmaking base over the next decade, joining China and the US in a global race to dominate the key technology.

DBS Private Bank launches trust solution for crypto

DBS Private Bank has launched a trust solution for cryptocurrencies via the bank's wholly-owned trust company DBS Trustee to allow its private banking clients to invest, custodise and manage digital assets.

HK to expand cross-border tests of digital yuan

HONG Kong is in talks with China to expand cross-border testing of the digital yuan after the first phase proceeded smoothly, another step toward wider adoption of the currency.

Coupang vows to accelerate expansion

Coupang, South Korea's leading e-commerce company, said it would accelerate its expansion after raising capital in a March initial public offering, despite a surge in losses in its first quarter as a public company.

Sea to replace Suntec Reit on MSCI Singapore Index

Following MSCI's semi-annual index review this month, Singapore-based Sea Ltd is to be included in the MSCI Singapore Index while Suntec Real Estate Investment Trust (Suntec Reit) will be dropped, as of the close of May 27.

TODAY'S TOP GLOBAL NEWS

Airbnb bookings jump 52% as vaccines spur demand

[BENGALURU] Airbnb Inc beat Wall Street expectations for first-quarter gross bookings and revenue on Thursday, as speedy Covid-19 vaccinations and easing restrictions encouraged more people to check into its vacation rentals.

Crown to start gambling at Sydney casino

[SYDNEY] Crown Resorts is on course to start gaming operations at its US$1.7 billion Sydney resort within months after the company's current overhaul won support from the regulator.

BlackRock's venture with CCB, Temasek to start biz

BlackRock has received a licence in China for a majority-owned wealth management venture, expanding its footprint in the country's fast-growing asset management market. The US fund giant said on Wednesday that its wealth management venture with a unit of China Construction Bank Corp (CCB) and Temasek Holdings can now start

TikTok begins testing in-app shopping

[HONG KONG] ByteDance's TikTok is working with brands including streetwear label Hype to test in-app sales in Europe, a move that will intensify its competition with Facebook and further blur the line between social media and online shopping.

L Brands to spin off Victoria's Secret

L Brands has decided to spin off Victoria's Secret rather than sell it. The company said last year that it was considering separating Victoria's Secret from the rest of its business, and it tested the interest of private equity.