

## Weekly Market Commentary

06 February 2012

**Turbo boosting the economy & the financial markets.** Local stocks have been exceedingly buoyant since the start of the year. Buying has been across the board but with emphasis on big cap issues (i.e., issues with large capitalization). What makes the current rally interesting is that price appreciation is accompanied by strong volume. Apparently, this is not your flash in the pan rally but something more real. By the end of January, the PSEi was already ahead by 7.1%, a far cry from its 4.7% performance for the entire 2011.

**The big question.** As market strength continues investors are starting to worry about the sustainability of the rally. How long will it last? Can it continue further or is this merely a fluke?

In general, there are two factors that exert influence on share prices -- fundamentals (e.g., earnings, management, economy) and technicals (e.g., sentiment, funds flows). Key developments indicate that both fundamental and technical factors are working together for the benefit of the economy and financial markets. These converging developments are as follows:

1. **Monetary easing.** We expect the BSP to cut rates by at least 50 basis points (0.5%) this year on the back of a benign inflation outlook and concern over growth. And indeed, the BSP did not disappoint. Last week the central bank cut by 25 basis points its key policy rates. Overnight borrowing dropped to 4.25% from 4.5% while overnight lending declined to 6.25% from 6.5%. This was the reason for the recent rally in govt. securities.

In addition, the BSP has instituted changes to the reserve requirements (RR) of banks. These changes include:

- Eliminating the difference between statutory and liquidity reserves. Currently banks are required to maintain 10% statutory reserves and 11% liquidity reserves. The former are kept in the vault of the BSP while the latter are kept in the vault of banks. The BSP wants to remove the distinction by creating one unified RR category.

- Non-remuneration of the unified reserve requirement. Banks currently earn 4% on 40% of their statutory reserves. The new unified RR will not earn any interest.
- Exclusion of vault cash and demand deposits as eligible forms of RR. All funds set aside as RR will now be kept in the vaults of the BSP. This will tighten compliance and simplify - monitoring by the BSP.

To off-set the loss of income by the banks, the BSP has cut the unified RR to 18% from 21% at present. It is estimated the 300 basis point cut will free around P100 billion. Banks will be able to generate income from the freed amount via additional loans and from treasury operations. These changes in the RR will take effect on April 06.

2. **Fiscal expansion.** As we have noted in our previous newsletter the govt. is very much committed to accelerate spending after restraining itself last year (see *Why 2012 will be a better year* dated 24 January 2012). Unlike before, the govt. has money to spend as revenue collection continues to improve. Higher govt. spending will not only boost personal consumption but also enhances investment prospects especially in the infrastructure space. Moreover, in spite of greater govt. spending the administration is confident that fiscal deficit will be brought down to 2% of GDP by 2013 from the projected 2.6% this year. Enhanced spending will not be due to more debt but from higher revenues.
3. **Privatization.** Since the govt. does not have the resources to address all infra needs of the country, it has invited the private sector to undertake key projects under the Public Private Partnership (PPP). This program has met some delays as the govt. was not yet ready for its implementation when the President announced it nearly two years ago. Moreover, it appears that the govt. is now ready to its implementation. In Dec. last year, Ayala Corp. won the bidding for the 4 km. Daang Hari project, the first privatization under the PPP initiative. We estimate 16 PPP projects will be auctioned off this year valued at P152 billion.

4. **High Liquidity.** Three sources will continue to enhance market liquidity, two indirect and one direct. The two indirect sources are (a) remittances; and (b) revenues from IT/BPO sector. These are indirect sources since the first stop of these funds is not the stock market or fixed income securities but rather to address more immediate needs like food, education, shelter and mobility. Later as these funds are recycled in the economy some of it will eventually be invested in stocks and bonds.

The more direct source is foreign portfolio investments. Aside from the usual long-only funds (e.g., mutual funds) and hedge funds, a third type is now making itself felt in the market. This is passive money coming from exchange traded funds (ETF). For instance, there is a dedicated Phil. ETF that is slowly gaining followers in the U.S. As this ETF gets larger (and it is growing), more funds will automatically flow into local stocks since an ETF is mandated to track as close as possible the underlying index. In the case of the Phil. ETF, it is the MSCI Phil. index.

I have listed the potential impact of these four events on the economy and financial markets in Table 1 below. The matrix shows that aside from the overall economy, the main beneficiaries out of these converging events are the fixed income and equity markets.

**Virtuous cycle.** We may look at these converging events as an auspicious alignment of stars in the heavens. Interest rates are falling, the govt. is spending more yet the fiscal deficit will continue to fall to a sustainable level and the private sector is excited as it is participating in a big way in govt. projects. Meanwhile, foreign investors are getting more attracted to the Phil. either from a portfolio or from a direct investment perspective.

If these events continue in their current trajectories, we should find ourselves under a virtuous cycle of increasing govt. spending, sustainable fiscal deficit, greater investments, vibrant capital market and a generally robust economy.

These are the reasons why I believe that the economy and financial markets will receive a significant dose of stimulus this year.

Table 1. Impact on Economy & Markets

Event	Fixed Income Market	Stock Market
<b>Monetary Easing</b>	<ul style="list-style-type: none"> <li>Generally stimulates economic activities</li> <li>Good for bondholders but upside is already limited as rates are at all-time lows</li> </ul>	<ul style="list-style-type: none"> <li>Compelling argument to go into stocks as returns from fixed income are now very limited</li> </ul>
	<ul style="list-style-type: none"> <li>Positive for loans growth</li> </ul>	<ul style="list-style-type: none"> <li>To benefit listed banks with large loans portfolio but bad for banks that rely on trading income</li> <li>To benefit the property sector</li> </ul>
<b>Fiscal Expansion</b>	<ul style="list-style-type: none"> <li>Generally stimulates economic activities</li> <li>As govt. spending works its way within the economy, some of the money will eventually find its way into stocks &amp; bonds</li> </ul>	<ul style="list-style-type: none"> <li>Some listed companies may directly benefit from govt. projects</li> </ul>
	<ul style="list-style-type: none"> <li>Preserves limited govt. resources by utilizing private capital for public good</li> </ul>	<ul style="list-style-type: none"> <li>Private sector may raise capital via bond/note offering</li> <li>Privatization to directly benefit some listed firms</li> </ul>
<b>Privatization (PPP)</b>	<ul style="list-style-type: none"> <li>Portfolio inflows to directly benefit stocks &amp; bonds</li> </ul>	<ul style="list-style-type: none"> <li>Some of the inflows from remittances &amp; IT/BPO revenues should eventually find their way into stocks &amp; bonds</li> </ul>
	<ul style="list-style-type: none"> <li>Will help to keep bond yields low</li> </ul>	<ul style="list-style-type: none"> <li>As trading volume increases, more funds will be attracted to local stocks</li> </ul>
<b>High Liquidity</b>	<ul style="list-style-type: none"> <li>Some companies will find it more attractive to raise capital directly from investors rather than borrow from banks</li> </ul>	

## UITF Performance

Table 2. UITF Performance

UITF (PhP)	31-Dec-11	27-Jan-12	03-Feb-12	Change	
				Wk-on-Wk	Yr-to-Date
UCF	1.6013	1.6213	1.6447	1.45%	2.71%
U\$MMF	1.2649	1.2651	1.2652	0.00%	0.02%
UCMF	1.1769	1.1796	1.1802	0.05%	0.28%
UBF	1.9234	1.9991	2.0127	0.68%	4.64%
UEF	2.5150	2.6519	2.6568	0.19%	5.64%
UCF	United Conservative Fund				
U\$MMF	United USD Money Market Fund				
UCMF	United Cash Management Fund				
UBF	United Balanced Fund				
UEF	United Equity Fund				

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