

Weekly Market Commentary

16 January 2012

How was 2011 for investors? 2011 proved to be a very challenging year for financial markets. As most economies continue to reel from the effects of the sub-prime fallout, a number of crises emerged that threatened to push the world economy over the edge and into another recession.

The first of these crises was the tragedy that hit Japan in early March. Aside from the loss of lives and the destruction of property, the massive earthquake which triggered a devastating tsunami also caused a nuclear meltdown. Consequently, international commerce and trade suffered due to the interruption of the global supply chain.

Meanwhile the Arab Spring, the pro-democracy movement sweeping the Middle East & North Africa (MENA), was gaining momentum. While most observers view the movement as long-term positive, investors were clearly concerned over the spreading instability in the oil-rich region.

As if the above events were not enough, around the middle of the year a mini-crisis erupted in the U.S. over its debt ceiling. Congressional leaders were at odds on how to tackle the issue. An impasse ensued. Investors were on the edge since a failure to increase the debt ceiling would trigger a technical default by the world's largest debtor. An 11th-hour compromise was reached thus averting chaos to financial markets worldwide.

However, the biggest threat to global growth last year was the worsening debt crisis in the Eurozone. As European leaders argued and debated, the crisis slowly spread from Europe's periphery to its core. The latest measures agreed upon have somehow calmed markets but the threat of contagion remains given the enormity of the problem.

We were, undoubtedly, affected by developments overseas. However, the adverse impact of these events were somehow cushioned by our much improved fundamentals. Consider the following:

- During periods when portfolio funds moved out of the Phil., the peso remained relatively stable as the outflow of funds was more than offset by the inflows from remittances and IT/BPO revenues.

- Remittances have been increasing in a significant way that it enabled the country to post a Current Account surplus for the last 8 years. This is also the reason why the country enjoys a favorable Balance of Payment position.
- It is also because of remittances, and to a lesser extent IT/BPO revenues, that the country has been able to boost its international reserves.
- The national govt. debt has steadily declined over the years on improved revenue collection and a more efficient management of expenditures. This will enable the govt. to bring down the fiscal deficit to a sustainable 2% of GDP.
- Interest rates have been at historic lows on benign inflation, ample liquidity and less aggressive borrowing by the govt.
- Our efforts have not gone unnoticed. International ratings agencies have upgraded our credit rating as well as our credit rating outlook. The goal to achieve investment rating is now within reach.

Despite events overseas, our local financial markets still managed to end the year on a positive note. Stocks had a wild ride last year but closed 4% higher compared to 2010. Govt. bonds performed strongly on the back of a favorable macro environment. The yield of a 10-year govt. bond dropped by almost 69 basis points to 5.4% versus 6.1% at the end of 2010. Prices of US dollar denominated Philippine bonds (i.e., ROPs) also closed higher versus their levels in 2010. As mentioned earlier, the peso remained relatively stable ending the year at almost the same level as at the start of the year.

[The above is part of the letter we sent to clients of the Trust Banking Group.]

How did our Unit Investment Trust Funds perform in 2011? The Unit Investment Trust Funds (UITF) that we managed fared pretty well if (a) compared to the performance of a benchmark (i.e., a similarly-situated instrument) and (b) compared to the performance of similar funds in the industry.

Trust Banking Group manages five unit investment trust funds, two money market funds (United Money Market Fund & United US\$ Money Market Fund), a peso conservative fund (United Conservative Fund), a moderately aggressive fund (United Balanced Fund)

and an aggressive or growth fund (United Equity Fund).

Fund Performance vs. Benchmark

Table 1. UITF Multi-Year Performance

| | Cash Mgt. & Money Market | | Conservative | | Moderate | | Aggressive / Growth | |
|--|--------------------------|-----------|--------------|------------------------|-----------|------------------------|---------------------|------------------------|
| | UCMF | USMMF | UCF | Benchmark ¹ | UBF | Benchmark ² | UEF | Benchmark ³ |
| Inception | 17-Nov-06 | 15-Sep-05 | 27-May-05 | | 05-Mar-07 | | 15-Jan-07 | |
| Last 5 yrs. | 3.2 | 2.2 | 4.7 | 4.0 | | | | |
| Last 3 yrs. | 2.7 | 1.1 | 5.0 | 3.7 | 27.2 | 19.0 | 46.0 | 31.5 |
| Last year | 2.8 | 1.5 | 7.9 | 2.3 | 10.4 | 3.7 | 11.0 | 4.7 |
| 6-yr. CAGR ⁴ | | 4.0 | 7.5 | 4.0 | | | | |
| 5-yr. CAGR | 3.2 | | | | | | | |
| 4-yr. CAGR | | | | | 14.0 | 6.5 | 20.3 | 8.1 |
| Notes: | | | | | | | | |
| 1/ Based on the HSBC Money Market Index | | | | | | | | |
| 2/ Blended benchmark based on 60% PSEi & 40% HSBC Money Market Index | | | | | | | | |
| 3/ Based on the PSEi | | | | | | | | |
| 4/ Compounded Annual Growth Rate | | | | | | | | |

United Cash Management Fund. The fund seeks to preserve capital & generate income by investing in government securities, Special Deposit Account of the BSP and time deposit. It is suitable for a conservative type of investor with a short-term investment horizon.

The 2.8% return of UCMF last year (all UITF returns are net of taxes & fees) is slightly better than most time deposit rates of 1 year or below which averaged 2.8% gross or 2.3% on a net basis (BSP data).

While the UCMF is primarily for cash management (i.e., its main purpose is to serve as a facility for investors to park their funds) its compounded annual growth rate (CAGR) for the past 5 years is 3.2%. This is way above the return of similar outlets like a savings or time deposit facility.

United US\$ Money Market Fund. This fund aims to preserve capital and generate income through investments in fixed income instruments such as government securities (e.g., ROPs), corporate bonds and in time deposit. This fund is suitable for a conservative type of investor with a short-term investment horizon.

Last year, the fund returned 1.5% net which is still better compared to the 1.5% gross rate (1.3875% net) of a typical US dollar time deposit.

United Conservative Fund. This fund seeks to achieve long-term capital growth through investments in high grade instruments such as government securities, Special Deposit Account of the BSP & time

deposit. The fund is suitable for a conservative type of investor with a long-term investment horizon.

Except for 2006 when the industry changed its valuation from accrual to mark-to-market, 2011 was by far the best year for the UCF as it gave clients an annual net return of 7.0%. It is definitely higher than its benchmark return of 4.0% or even to the Special Deposit Account rate of 4.6875% (3.75% on a net basis).

The above par performance of the UCF can be attributed to the ability of the fund to take advantage of falling bond yields as the country's macro environment continues to improve.

United Balanced Fund. The UBF seeks to achieve long-term capital appreciation & income by investing in a mix of domestic, listed equities & fixed income securities. This fund is suitable for a moderately aggressive type of investor with a long-term investment horizon.

Despite market volatility (discussed above), the fund managed to provide its investors a return of 10.4% net versus a return of 3.7% of its blended benchmark (60% PSEi & 40% HSBC Money Market Index).

The strong performance of the UBF was actually made possible by the return generated by its fixed income component which was mostly invested in govt. securities. UBF was able to take advantage of declining bond yields.

United Equity Fund. The UEF seeks to achieve long-term capital growth through investments in domestic, listed equities. This fund is suitable for an aggressive type of investor with a long-term investment horizon.

Last year was a very difficult year for equities given the external shocks that unnerved investors and brought uncertainty to financial markets.

Despite these challenges, the UEF gave its investors a return of 11.0% which compares well versus the 4.7% return of the PSEi.

How should CAGR be interpreted in Table 1?

CAGR means compounded annual growth rate. It simply means that if you were invested, for example in the United Conservative fund since its inception in 2005, you would have earned an average of 7.5% net every year for the past 6 years.

In the same manner, if you have invested in the United Balanced Fund since its inception in 2007, your average annual return would have been 14% in the last 4 years up to end December 2011.

Fund Performance vs. Peers

Compared to our peers, our funds generally landed within the top three in the industry (data based on figures provided by the Trust Officers Association of the Phil.).

UITF Performance

Table 2. UITF Performance

| UITF (PhP) | 31-Dec-11 | 06-Jan-12 | 13-Jan-12 | Change | |
|---------------|------------------------------|-----------|-----------|----------|------------|
| | | | | Wk-on-Wk | Yr-to-Date |
| UCF | 1.6013 | 1.6103 | 1.6212 | 0.67% | 1.24% |
| U\$MMF | 1.2649 | 1.2650 | 1.2650 | 0.00% | 0.01% |
| UCMF | 1.1769 | 1.1776 | 1.1783 | 0.06% | 0.12% |
| UBF | 1.9234 | 1.9570 | 1.9797 | 1.16% | 2.93% |
| UEF | 2.5150 | 2.5735 | 2.6103 | 1.43% | 3.79% |
| UCF | United Conservative Fund | | | | |
| U\$MMF | United USD Money Market Fund | | | | |
| UCMF | United Cash Management Fund | | | | |
| UBF | United Balanced Fund | | | | |
| UEF | United Equity Fund | | | | |

Table 3. Market Indicators

| Indicator | Level | | | Change | | | |
|-------------------------------|--------------|-----------|-----------|--------------------|--------|-------------------|--------|
| | 2010 Yr. End | 06-Jan-12 | 13-Jan-12 | Wk-on-Wk | % Ch | YTD | % YTD |
| Peso | 43.80 | 44.09 | 43.77 | -0.33 | -0.74% | -0.03 | -0.08% |
| Stocks | 4,201 | 4,483 | 4,614 | 130.47 | 2.91% | 412.69 | 9.82% |
| 3-mo. PDSTF (ch in bps) | 1.2917 | 1.4799 | 1.7165 | 0.24 ¹ | 23.66 | 0.42 ¹ | 42.48 |
| Peso Bonds | 307 | 347 | 348 | 1.04 | 0.30% | 40.37 | 13.13% |
| 3-mo. USDLIBOR (ch in bps) | 0.3028 | 0.5815 | 0.5670 | -0.01 ⁵ | (1.45) | 0.26 ⁵ | 26.42 |
| Rep. of the Phil. bonds (ROP) | 178 | 196 | 196 | -0.08 | -0.04% | 18.61 | 10.47% |
| Crude Oil (USD/bbl) | 91 | 102 | 99 | -2.86 | -2.82% | 7.32 | 8.01% |
| Gold (USD/troy oz) | 1,421 | 1,609 | 1,626 | 17.04 | 1.06% | 204.76 | 14.41% |
| DXY (USD Index) | 79 | 81 | 82 | 0.26 | 0.32% | 2.49 | 3.15% |
| ADXY (Asian Currencies) | 116 | 115 | 116 | 0.32 | 0.28% | -0.93 | -0.80% |
| VIX | 18 | 21 | 21 | 0.28 | 1.36% | 3.16 | 17.80% |
| V2X | 24 | 31 | 29 | -1.64 | -5.38% | 5.00 | 20.90% |

Sources:

| | | |
|--|--------------------------------------|---|
| 1/ Phil. Dealing System | 5/ Bloomberg; change in basis points | 9/ DXY = USD spot index |
| 2/ Phil Stock Exchange Index | 6/ JP Morgan Asia Credit Index | 10/ ADXY = Asian currencies vs. USD index |
| 3/ Phil. Deal. & Exch. Corp.; change in basis points | 7/ West Texas Intermediate | 11/ CBOE volatility index |
| 4/ HSBC Local Bond Index | 8/ Bloomberg | 12/ Eurozone volatility index |

Annex A Explanatory notes on our Market Indicators.

In general, market indicators are used to assess the pulse and health of our economy. It is very similar to how doctors check our heartbeat, the color of our eyes, our cholesterol level or the sugar content of our blood to initially assess how healthy (or unhealthy) we are.

Since we are generally concerned with investments, the appropriate measures to look at are economic and market indicators. As investors, we want to know where these indicators are headed so we can make the appropriate decisions. These indicators are as follows:

Peso. *This is our currency and its current level and direction normally indicate the general health of the economy.*

Stocks. *A strong or robust stock market reflects a strong and growing economy or vice versa. Our stock market cannot be strong if our economy is weak. And the opposite is equally true. After all, corporate earnings and prospects reflect the overall outlook of the economy. The index we are using is the Phil. Stock Exchange Index (PSEi).*

3-month PDSTF Rate. *This is the indicator we use for domestic interest rates. It used to be the 90-day Treasury Bill rate but this instrument has lost its appeal since it is not very liquid and may not truly reflect market levels. PDSTF rates are better indicators of where interest rates are since these are based on actual rates of highly liquid instruments.*

Peso Bonds. *The HSBC Local Bond Index (Phil.) tracks the average price movements of local bonds and is a good indicator of how expensive (or cheap) bonds are. The index should also provide an indication of where bond yields are headed since bond prices and bond yields move in the opposite direction.*

3-month USD LIBOR. *This is the US dollar counterpart of the 3-month PDSTF rate. LIBOR means London Interbank Offer Rate, the rate at which banks lend to each other and used as a benchmark for commercial lending.*

USD Bonds (ROPs). *This index tracks the price movements of Phil. bonds denominated in US dollars. The index we are using is the JPMorgan Asia Credit Index (Phil.).*

Since the indices we use for stocks, peso bonds and USD bonds (ROPs) are based on price movements, the higher the level of the index, the better it is for investors.

Crude Oil. *At least in our lifetime, oil will always be one of the most important economic indicators since it is a basic feedstock of economies worldwide. The benchmark that we are using is the West Texas Intermediate (WTI) as it is the most common and widely used crude oil index.*

Gold. *This is our proxy for uncertainty. The price of gold normally goes up during uncertain or difficult times. This is because gold is the ultimate store of value. Paper currencies could lose their value but gold will always retain its value whether as an ornament or as a unit of exchange.*

DXY. *It is a spot index of the USD based on a basket of five currencies, Euro (57.6%), Japanese Yen (13.6%), British Pound Sterling (11.9%), Canadian Dollar (9.1%), Swedish Krona (4.2%) and Swiss Franc (3.6%). The DXY does not reflect the trade position of the US in the global economy. It is being used for convenience as its value is updated on a daily basis.*

ADXY. *It is a spot index of emerging Asian currencies versus the USD. It is composed of ten currencies, Renminbi (33.9%), South Korean Won (14.2%), Hong Kong Dollar (11.4%), Singapore Dollar (10.3%), Taiwan Dollar (8.2%), Indian Rupee (6.3%), Malaysian Ringgit (5.2%), Thai Baht (4.9%), Indonesian Rupiah (3.3%) and Phil. Peso (2.3%). The index is constructed based on two considerations, trade performance (75%) and liquidity (25%).*

Finally, note that there will always be a speculative element in the movement of these indicators. But speculation is not their main driver. The most important driver that normally sustains the movement of an indicator over the long-run is its fundamentals. For example, the movement of the peso is dictated by the following fundamental factors: (a) the health of our economy; (b) the amount of US dollars remitted by Filipinos working and living abroad; (c) the level of our exports; and (d) the amount of foreign direct investments we receive.

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