



Weekly Market Commentary

24 January 2011

Economic Update:

Good news & bad news. There is now a growing consensus that global recovery is firmly gaining traction to be led by emerging market economies and the US. This is what JPMorgan has to say: *Our positive baseline outlook for the year ahead revolves around an interpretation of the reacceleration now taking hold in the US.* The stronger-than-anticipated US recovery, when coupled with solid performance in EM (emerging markets), should confirm that the global expansion has found firm footing (Global Data Watch, 14 Jan. 2011).

This is definitely good news as the US, despite its structural problems (e.g., fiscal & trade deficits that will continuously weigh down on the US dollar), remains the world's largest economy. A healthy US economy is undeniably positive for the rest of the world.

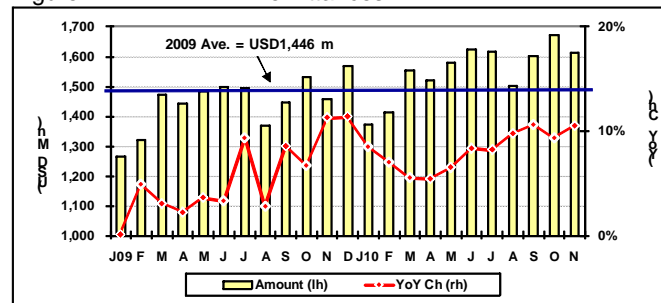
The downside though is that a faster growth momentum carries with it inflationary pressures. For example, crude oil is currently USD89.00/barrel but should US growth picks up, additional demand could pull prices even higher.

Demand for crude oil. In Nov. last year when the pace of US growth was still uncertain, the International Energy Agency (IEA) estimated that global demand for crude oil in 2011 should increase to 88.5 mn barrels/day (mbpd) from 87.3 mbpd in 2010. This projection may have to be revised upwards given current conditions.

The country's **Balance of Payment** surplus reached USD14.4 bn for the entire 2010, more than double the USD6.4 bn recorded in 2009. The surplus was due to higher remittances, exports, IT/BPO operations and portfolio inflows.

Remittances rose by 10.5% in Nov. last year to USD1,613 mn bringing year-to-Nov10 total to USD17.1 bn or 8.2% higher compare to the same period in 2009 (Figure 1). Remittances, which now accounts for 11% of the economy, continue to play a vital role in the country's development.

Figure 1. Remittances



Stocks retreated last week as inflationary concerns are making investors defensive. The PSEi ended the week at 3,951, 4.4% lower compared to the previous week. Losers overwhelmed gainers with only **PLDT** (+0.1% to P2,514) amongst the top names bucking the trend as the company is seen as a defensive play in a retreating market .

Aboitiz Power eased by 4.4% to P28.30 on news that the municipal government of Pagblao has threatened to seized and auctioned off the plant for failure of paying local taxes. The timely intervention of Pres. Aquino III averted what could have been a messy situation. Not only would it put local and national government units at odd with each other but it would also place a black mark on the administration's attempt to attract private capital via the Public Private Partnership (PPP) arrangement.

Still on AP, the Davao City is in the process of evaluating the company's proposal to build a 200 MW coal-fired power plant.

Meanwhile, **Meralco** (-1.7% to P263.00) plans to build a 120 – 150 MW combined cycle peaking plant in Calamba, Laguna at a cost of USD1.0 mn/MW. The plant, to be wholly-owned and operated by MER, will be operational by 1Q2011.

Ayala Land (-8.1% to P14.34) successfully issued a total of P10.0 bn worth of corporate notes in tenors of 5, 10 and 15 years. The coupon rates were at 5.625%, 6.875% and 7.50%, respectively. ALI also conducted a liability management wherein ALI offered to prepay bonds maturing in 2013 and 2016. Investors

representing ₱875 mn worth of bonds accepted the offer.

Perhaps as a sign that the economy is indeed picking-up, **Holcim** (-3.0% to P13.20) plans to reopen its terminal in Calaca, Batangas in anticipation of higher demand in Luzon. According to Holcim, aggregate cement demand is expected to grow by 5% - 10% this year from the 16.0 mn tons consumed in 2010.

Banks. The BSP recently approved an additional single borrower's limit (SBL) of 15% for exposures of banks to oil companies. This additional 15% -- which is on top of the 25% regular SBL -- is only available to finance oil importation.

Market direction. The market remains weak and has tentatively touched our initial support of 3,950. If this support is broken our next hard target is 3,850, the level reached during the previous bull run of 2007.

Figure 2. PSEi



Fixed income. Local bond yields jumped higher compared to last week on continued inflation concerns. Treasury Bill rates in particular corrected by almost 3 percentage points as investors temporarily parked funds in short term deposit to avoid further mark-to-market losses (see Table 1). For peso fixed income investors, perhaps the best place to be now is in Special Deposit Account (SDA) of the BSP.

Meanwhile ROP prices remained weak as investors continue to adjust to US interest rate expectation. The possible end of the Fed's quantitative easing (QE2) in June as originally planned and inflation pressures are what keeping investors on the sidelines.

Table 1. PDSTF Rates

PDST-F	YIELD		Change (bps)
	14-Jan	21-Jan	
1 Month	1.16	4.12	296.31
3 Months	1.15	4.13	297.73
6 Months	1.67	4.38	270.69
1 Year	2.67	4.62	194.67
2 Years	3.93	5.39	146.00
3 Years	4.23	5.70	146.12
4 Years	4.74	6.08	133.67
5 Years	5.21	6.37	115.93
7 Years	5.79	7.30	150.73
10 Years	6.26	7.79	152.40
20 Years	8.18	9.35	117.73
25 Years	8.19	9.52	132.25
HSBC ALBI*	305.77	298.57	-2.4%

*The HSBC Asia Local Bond Index (Phil.) tracks the price movement of Phil. sovereign bonds. A positive change means that bond prices moved higher & yields lower or vice versa.

Table 2. Indicative ROP Prices

Series	Coupon	PRICE		Change (bps)
		14-Jan	21-Jan	
ROP 11	8.375	100.00	100.19	19.30
ROP 13	9.000	114.13	113.75	(38.00)
ROP 14	8.250	117.00	116.75	(25.00)
ROP 15	8.875	124.38	124.00	(38.00)
ROP 16 n	8.000	124.75	124.00	(75.00)
ROP 16	8.750	131.75	130.50	(125.00)
ROP 17	9.375	130.75	129.75	(100.00)
ROP 19	9.875	137.75	135.75	(200.00)
ROP 19 n	8.375	128.50	126.50	(200.00)
ROP 20	6.500	115.63	113.25	(238.00)
ROP 21	4.950	96.38	97.50	112.00
ROP 24 n	7.500	124.25	121.50	(275.00)
ROP 24	9.500	144.00	141.50	(250.00)
ROP 25	10.625	155.13	153.00	(213.00)
ROP 30	9.500	145.38	142.00	(338.00)
ROP 31	7.750	124.75	121.50	(325.00)
ROP 32	6.375	107.50	104.25	(325.00)
ROP 34	6.375	107.13	104.25	(288.00)
JACI Phil*		178.7	176.1	-1.5%

*JACI Phil. tracks the price movement of Phil. USD sovereign bonds with maturity of at least 1 year.

Peso. The peso depreciated by 0.5% to ₱44.45 on speculation that overseas funds are moving money back to the US in anticipation of a stronger growth. Inflationary concerns may also have compelled foreign fund managers to reduce their peso exposure.

We believe though that this trend is merely temporary. After portfolio realignment is achieved, the peso should regain its strength as economic fundamentals remain intact. Besides, if the BSP hikes rates in 2H 2011 (as we forecast) it should somehow contribute to the attractiveness of peso assets.

UITF Performance

Bright prospects. Following the release of our 03 Jan. 2011 Weekly Market Commentary, a colleague of ours told me that my forecasts are *too optimistic*. While I believe that my optimism is based on fundamentals, I fully understand the unease of our colleague as the current economic environment (e.g., benign inflation, low interest rates, relatively stable yet competitive peso, favorable current account & balance of payment positions) is indeed unique. And foreign investors are taking notice: *A rock solid, structural current account surplus, improving fiscal position, and better political environment underpin the Philippines improved fundamentals* (JPMorgan, Asia 2011 Outlook, 19 Jan. 2011).

A broker friend of mine likens our situation to an alignment of heavenly stars. He is apprehensive, however, since something might happen that could bring us back to where we came from.

My view though is that we have not really taken off. We are still at the early stage of economic expansion – a situation that was made possible because of remittances, expansion of IT/BPO operations and prudent fiscal and monetary policies. Immensely important as these are, they are not enough. For the country to sustain its above trend growth and expand even faster, investments need to kick-in. This is where the Public Private Partnership arrangement the current administration is pursuing. This is also where the greatest risks lie, i.e., implementation risks (e.g., conflict between the national and local governments, legal protection for investors).

Thus while the stars are indeed align, we still need to work even harder so that the gods will shower us with more blessings.

Table 3. UITF Performance

UITF (PhP)	31-Dec-10	14-Jan-11	21-Jan-11	Change	
				Wk-on-Wk	Yr-to-Date
UCF	1.4839	1.4853	1.4859	0.05%	0.13%
U\$MMF	1.2462	1.2470	1.2471	0.01%	0.07%
UCMF	1.1451	1.1462	1.1467	0.05%	0.14%
UBF	1.7428	1.7645	1.7159	-2.75%	-1.54%
UEF	2.2666	2.3113	2.2144	-4.19%	-2.30%
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 4. Market Indicators

Indicator		Level			Change			
		2010 Yr. End	14-Jan-11	21-Jan-11	Wk-on-Wk	% Ch	YTD	% YTD
Peso	1	43.80	44.22	44.46	0.23	0.53%	0.66	1.50%
Stocks	2	4,201	4,132	3,951	-181.00	-4.38%	-250.10	-5.95%
3-month PDSTF (%)	3	1.2917	1.1519	4.1292	2.98	297.73	2.84	283.75
Peso Bonds	4	307	306	299	-7.20	-2.36%	-8.87	-2.88%
3-month USD LIBOR (%)	5	0.3028	0.3031	0.3031	0.00	-	0.00	0.03
USD Bonds (ROPs)	6	178	176	176	0.41	0.24%	-1.54	-0.87%
Crude Oil (USD/bbl)	7	91.38	91.54	89.11	-2.43	-2.65%	-2.27	-2.48%
Gold (USD/troy oz)	8	1,420.78	1,361.72	1,342.68	-19.04	-1.40%	-78.10	-5.50%
DXY	9	79.03	79.16	78.21	-0.95	-1.20%	-0.82	-1.03%
ADX	10	116.46	116.17	116.20	0.03	0.03%	-0.26	-0.22%
VIX	11	17.75	15.46	18.47	3.01	19.47%	0.72	4.06%
V2X	12	23.92	20.44	19.80	-0.64	-3.14%	-4.11	-17.20%

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