Metrobank

The Economic Weather Report

3Q 2011 Outlook & Forecasts

Metrobank Research Department

Metrobank

The Economic Weather Report

Economic Outlook and Forecast

3Q 2011 outlook

EXECUTIVE SUMMARY

Present Conditions

- The Philippine economy posted a slower first quarter growth of 4.9% from 8.4%. GDP computation was revised to reflect 2000 prices from the previous 1985 prices. The growth was underpinned by increased investment spending, solid consumer spending, rebound in the agri sector, and solid performance of the industry sectors.
- The National Statistics Office has rebased the consumer price index series to 2006 prices from 2000 prices. Based on the old series, headline inflation came at 4.6% in June from May's 4.5%. Inflation based on 2006 prices likewise rose to 5.2% from 5%. The uptick in consumer prices was attributed to a hike in tuition fees and higher food, electricity, and gas prices.
- The Monetary Board kept policy rates steady after two consecutive hikes. The BSP however increased the reserve requirement by one percentage point.
- The NG achieved a fiscal deficit of ₱9.54 billion in the first five months of the year, 94% lower than the deficit recorded in the same period last year. The government aims to pull back the fiscal deficit to 3.2% of GDP in 2011 from the 2010 ceiling of 3.9%.
- The global economy will still be supported primarily by emerging economies. However, the threat coming from high commodity prices increases the uncertainty and introduces a risk to growth and inflation in most regions. Financial stress in Europe is likely to continue, especially for Greece, Portugal, and Ireland, given the lack of decisive action to deal with solvency concerns. The US will still be hounded by fiscal consolidation and jobless growth woes. The political noise around proposals to finally start the process of fiscal consolidation in the US will only add to uncertainty in the markets.

Outlook

Real economy

- The boost in investor confidence amid sustained fiscal consolidation is seen to take up the slack in government spending. Full-year GDP growth is expected to come in at 5.0%, with upside potential if government pump-priming pushes through in the second half.

Inflation

- Inflation is seen to average 5.0% (using the 2000 index) this year amid easing price pressures. The stronger peso will likely temper any inflationary pressure towards yearend.

Interest rates

- The yield curve is seen to continue inching up, with rates for the short- term securities largely reflecting the current monetary policy stance.

Foreign exchange

- The peso will further strengthen to ₱42.50 towards yearend on the back of sustained capital flows amid solid macroeconomic fundamentals.

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Report by

Pauline May Ann Revillas
Research Analyst

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Corporate Research Department

Marc Bautista, CFA
Head of Research

Metropolitan Bank & Trust Co.
11/F Metrobank Plaza,
Sen. Gil J. Puyat Ave.
Makati City 1200, Metro Manila

Telephone: (632)857-9657
(632)857-9388
Fax: (632)817-6355

PHILIPPINES: AT A GLANCE

	2010	2011 YTD
Real GDP Growth$_{2000=100}$	7.6	4.9 1Q
Ave Inflation$_{2000=100}$	3.8	4.3 June
Interest Rates (91day Tbill, WAIR)	3.7%	1.1% May
Foreign Exchange (end-of-period)	43.89	43.49 June
Current Accounts	$8.465B	$933M 1Q
Budget Surplus/Deficit	-₱314B	₱9.54B May
as % of GDP$_{1985=100}$	3.7%	
Gross Int'l Reserves	$62.067B	$68.996B June

External Sector

Global recovery hits a soft patch

Global economic growth has slowed in recent months, held back by soaring energy and food prices and weakening consumer confidence. The impact of sharply higher prices hit the global economy, which is struggling to sustain a modest recovery from a previous downturn. Overall global growth was at 4.3% in the first quarter.

Advanced economies were hit hard amid their still fragile recoveries. The US posted a weak first quarter growth of just 1.8%, after climbing by 3.1% in the previous quarter, as higher food and oil prices dampened consumer spending. Adding to the dismal picture are renewed concerns over the eurozone's debt woes as Greece's credit rating was cut three levels by Fitch Ratings while Belgium had its rating outlook lowered to negative.

Meanwhile, in most emerging economies, economic growth remains strong, and activity levels are above pre-crisis levels - implying that the recovery is more or less complete. However, inflation in emerging countries has also been rising as domestic demand pressures rise. Thus, concerns over a possible slowdown in these economies have been rife, with China, a main growth driver throughout the global economic slump, already showing signs of cooling down amid government efforts to contain inflation.

Commodity prices present global risk

Higher commodity prices were supported well until April on the back of supply concerns and depreciation of the dollar. Prices of crude oil, agricultural crops, and metals further rose in April. Food prices, in fact, have increased by around 12% on average due to reduced inventories and a tight supply-demand ratio. Likewise, crude oil prices jumped 7% in April, up for a ninth straight month, hitting a high for the year at $119.6/bbl at month-end.

In early May, however, commodity prices plunged on concerns about demand amid signs of a slowing global economy. Silver, cotton, sugar, and crude oil fell most.

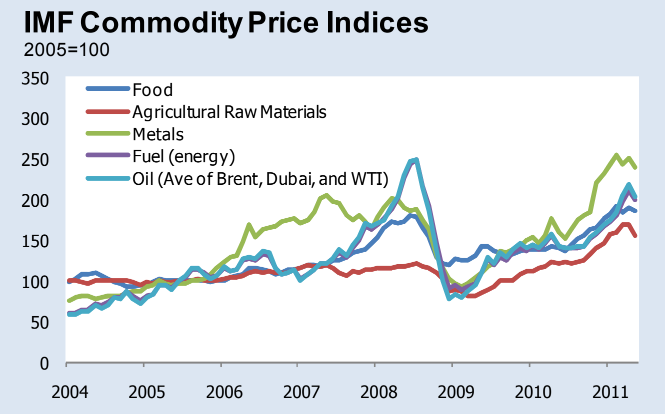
While the unwinding of overbought levels in some commodities is expected to continue, prices are seen to stay elevated amid existing and potential supply risks moving forward.

Risks to the recovery still tilted to the downside

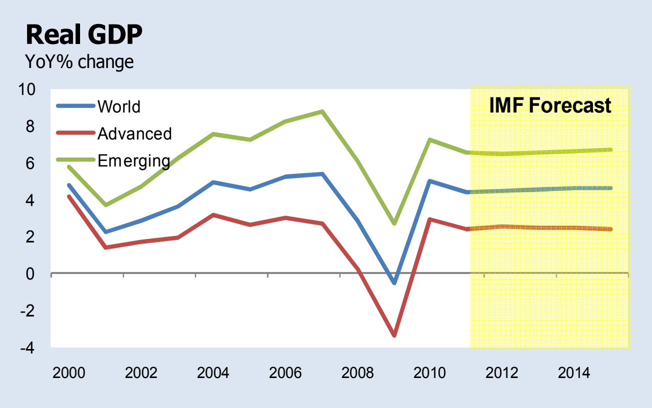
An uneven global recovery will still be the theme moving forward.

The global economy will still be supported primarily by emerging economies. However, the threat coming from high commodity prices increases the uncertainty and introduces a risk to growth and inflation in most regions. Financial stress in Europe is likely to continue, especially for Greece, Portugal, and Ireland, given the lack of decisive action to deal with solvency concerns. The US will still be hounded by fiscal consolidation and jobless growth woes. The political noise around proposals to finally start the process of fiscal consolidation in the US will only add to uncertainty in the markets.

> **"Financial stress in Europe is likely to continue, especially for Greece, Portugal, and Ireland, given the lack of decisive action to deal with solvency concerns"**



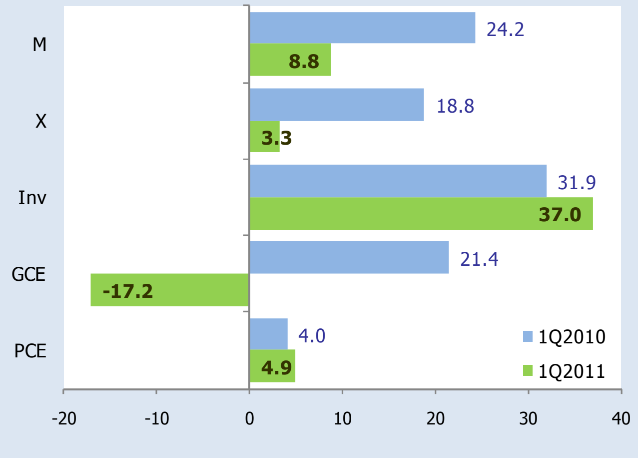
Prices of commodities are seen to remain elevated even amid some potential easing



Risks to the recovery are still tilted to the downside given the still sluggish growth in advanced economies and the cooling down of emerging economies

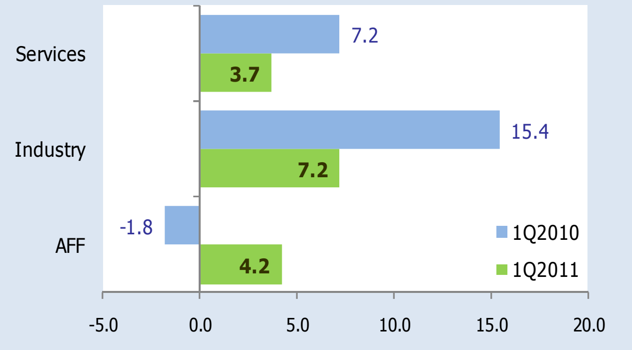
Source: International Monetary Fund

Real GDP by Expenditure Shares (2000=100)
YoY % change



The contraction in government spending contributed to the lower first quarter GDP figure

Real GDP by Industrial Origin (2000=100)
YoY% change



On the production side, the rebound of the Agri sector and the robust performance of the Industry, helped prop economic growth

> **The boost in investor confidence amid sustained fiscal consolidation is seen to take up the slack in government spending**

Source: National Statistical Coordination Board

Slower first quarter growth

The Philippine economy recorded a slower growth in the first quarter at 4.9% amid easing exports and waning government spending. The 2000-rebased GDP figure was lower than the 8.4% growth recorded in the same quarter last year. The drop in the domestic economic performance, although lower than the market consensus of 5.1%, was hardly unexpected as the key driver of the expansion in the first quarter last year was election spending.

On the demand side, growth was mainly attributed to increased investments and personal consumption. Household spending continued to expand in the first quarter by 4.9% from 4% last year. The stable growth in consumer spending is seen to further fuel price pressures. Investments further grew by 37% from 31.9% amid robust capital inflows and positive investor sentiment. Government expenditures, on the other hand, contracted by 17.2% from a positive growth of 21.4% as government pump-priming activities faltered.

On the supply side, the Industry sector was the main economic linchpin. The 7.2% Industry growth was underpinned by the sustained rebounds in the manufacturing, mining and quarrying, and construction sub-sectors. The solid performance especially of the manufacturing sub-sector clearly shows that consumer demand remains solid even amid higher consumer prices. The expansion of the Service sector, on the other hand, eased to 3.7% from 7.2% as a decline in government services growth dragged overall sector growth. The Agriculture Sector recovered from a slump last year to 4.2% amid increased production, expansion in harvest areas, and favorable weather conditions.

The country's Exports and Imports slowed down to 3.3% from 18.8% and 8.8% from 24.2%, respectively, amid a cooling of the economies of major trading partners.

GDP growth to post positive but modest growth

Moving forward, the Philippines is expected to continue posting solid growth, albeit slower than the record growth posted last year. The lower GDP growth is primarily attributed to base effects and cuts in government spending. Nevertheless, the consumption-driven economy is seen to remain afloat amid the still solid remittance inflows. Furthermore, the boost in investor confidence amid sustained fiscal consolidation is seen to take up the slack in government spending.

Research expects the economy to post a full-year average growth of 5%, down from our previous forecast of 5.7%.

Inflation

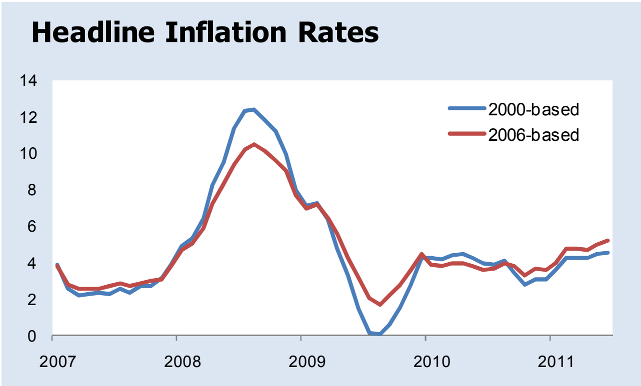
Well-behaved inflation numbers

The government has rebased the consumer price index (CPI) to 2006 prices from 2000 prices. The new CPI series will be issued simultaneously with the 2000-based series until December 2011.

Headline inflation for June, based on the new series, was slightly higher at 5.2% from the May figure of 5%. Year-to-date inflation of 4.7% is now a tad lower than the upper range of the BSP target.

Under the old 2000 base year, inflation likewise inched up to 4.6% from 4.5%.

Upward pressures came mainly from hikes in tuition fees and electricity rates, and higher food and beverage prices. Weather disturbances brought about by 3 typhoons during the month adversely affected supply in the market, thus raising prices.



The new CPI series has new weights for different commodity groups. The adjustments reflect the changes in economic conditions and spending patterns

Consumer sentiment improves

Consumer sentiment remained steady in the second quarter, with the confidence index (CI) declining slightly from -23.1% in the first quarter to -24.1%. Respondents cited anticipation of improved family incomes on the back of good harvest and more employment opportunities as factors to the improved sentiment. Consumers were more bullish in the year ahead, with the CI rising to 4.4% from 1.2%.

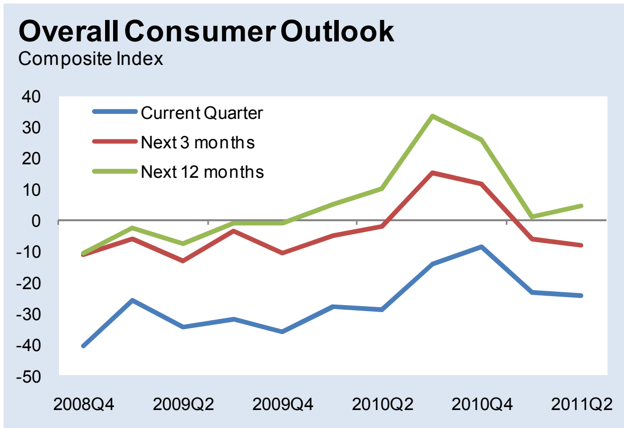
The current quarter outlook mirrored the steady sentiment of consumers in Germany, France, and New Zealand.

"It appears that inflation will be at levels lower than initially expected"

Domestic liquidity growth accelerates

The demand for money continued to grow in April by 7.3% to ₱4.2 trillion. Domestic liquidity levels remain in line with the BSP's price and financial stability objectives.

The sustained growth in net foreign assets of 20.2% fuelled the expansion in domestic liquidity. Net domestic assets, on the other hand, further contracted by 9.3% from a previous drop of 3.5%. This was due largely to the faster expansion of the net other items account (which includes revaluation and capital and reserve accounts as well as the SDA placements of trust entities). Nevertheless, net domestic credits continued to rise by 7.2%, given the accelerated increase in credits extended to the private sector. This trend is consistent with the continued expansion in bank lending to productive sectors of the economy with the further strengthening of domestic demand.



Improved family incomes on the back of good harvest and employment opportunities buoyed consumer sentiment

Inflation to rise but will still come within target

In terms of relative movement, Research still sees inflation on an upward trend for the rest of the year, with some easing around early 4th quarter. After all, even if commodity prices soften, they will still be at elevated levels. It appears that the monetary tightening in China and other emerging economies appear to be working already, plus the speculative activities of funds have been already subdued with the reported exit of major hedge fund players from their profitable commodities trading. This eases up the inflation pressures on the Philippines quite a bit, although, again, it would take some time before some downward movements are seen. Regardless, it appears however that inflation will be at levels lower than expected.

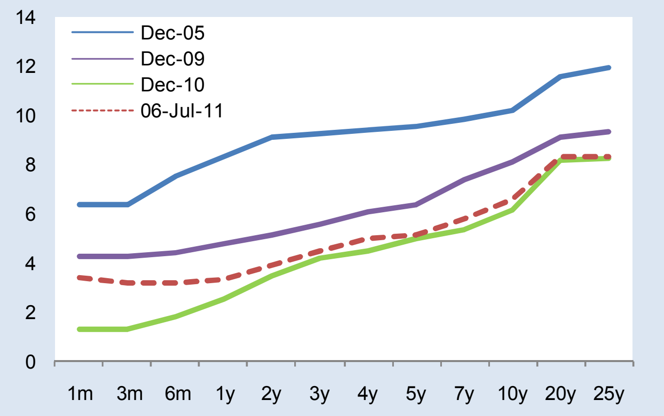
Research sees full-year average inflation to come in at 5%, down from the previous forecast of 5.3%.*

Source: National Statistical Office
Bangko Sentral ng Pilipinas

* using the 2000 index

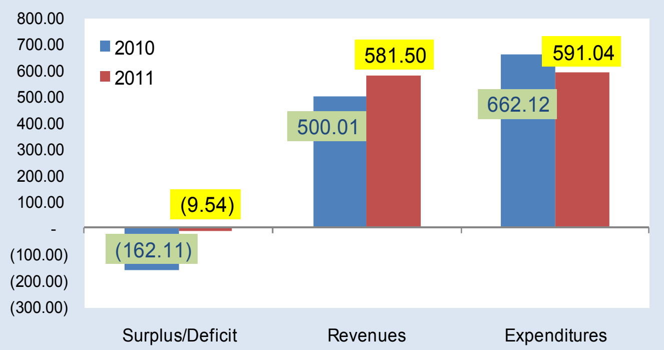
> Interest rates rose to four-month highs… reflecting the current monetary policy stance

PDST-F Rates



Rates will slowly rise up from their year-ago levels as yields realign with the policy stance

Fiscal Performance (Jan-May)
in Bn PHP



The government has set a fiscal deficit goal of ₱82 billion in the third, and ₱65.7 billion in the last three months of the year

Interest rates were at four-month highs, with the short-term rates reflecting the current monetary policy stance.

At the June 28 auction, yield on the 91-day Tbill came in at 2.880% from 2.888%. The government rejected bids for the 182-day debt as offers shot up higher than secondary market levels. The yield of the debt paper would have risen to 3.708% from 2.444% in the previous auction. The rate for the one-year treasury bill climbed 30.8 basis points to 3.219% from 2.911%.

The NG is targeting gross borrowing of ₱117 billion from the local debt market in the third quarter.

The government intends to issue 10- and 20-year Treasury bonds in exchange for shorter-dated bonds at the start of the third quarter. ₱200 billion worth of new 2020 and 2035 peso bonds were issued last December, with coupon rates of 5.875% and 8.125%, respectively. The debt swaps are part of the Aquino administration's efforts to extend bond maturities and cut debt servicing costs.

Fiscal deficit continues to narrow

The January to May fiscal deficit reached ₱9.540 billion, 94% lower than the deficit recorded in the same period last year. The deficit for May alone amounted to ₱9.601 billion. Government spending went down by 10.7% year-on-year to ₱591 billion. Revenues, meanwhile, grew by 16.3% to ₱581.5 billion amid higher collections from the BIR and BTr.

The improved fiscal position is seen to boost the country's chances of getting more credit ratings upgrades this year. Moody's and Fitch have both upgraded the Philippines' sovereign rating in June.

Hawkish monetary policy stance

The Monetary Board (MB), after two rate hikes, decided to keep policy rates steady. However, monetary authorities raised the reserve requirement on deposits and deposit substitutes of all banks and non-banks with quasi-banking functions by one percentage point. The MB has so far raised policy rates by 50 bps, with the RRP and RP facility now at 4.5% and 6.5%, respectively.

With inflation rates remaining well anchored within the BSP's inflation band, Research expects the overnight RRP facility to clock in at 4.75% by yearend. From current rates, another 25 bps rate hike is seen only in the third quarter as inflation numbers are expected to breach the upper range of the BSP inflation target towards quarter-end.

Interest rate direction

The yield curve is seen to move upwards, with the uptrend mostly reflected in the short-end of the curve. The longer-dated securities are expected to remain steady amid positive fiscal data.

Deficit worries are not seen to weigh on interest rates with the deficit likely coming in within the P300-billion target this year.

Source: Bangko Sentral ng Pilipinas
Bureau of Treasury

Foreign Exchange Rate

The peso has again traded in a rough range of ₱43-44 per dollar over the past five months amid the push and pull effects in currency markets.

Excess global liquidity, renewed USD weakness, consolidation in commodity markets, interest rate differentials between advanced and emerging economies, persistent US and Chinese intervention and bullish tone in emerging markets are the key drivers of flows in currency markets.

Continued support for the peso

The peso remained relatively stable in the first five months of the year despite external developments.

Capital flows, in the form of foreign portfolio investments (FPI) in stocks, securities and currency markets, surged in the first five months of the year to $2 billion, 160.3% higher than the figure recorded in the same period last year. Strong macroeconomic fundamentals buoyed the keen interest in portfolio investments to the country.

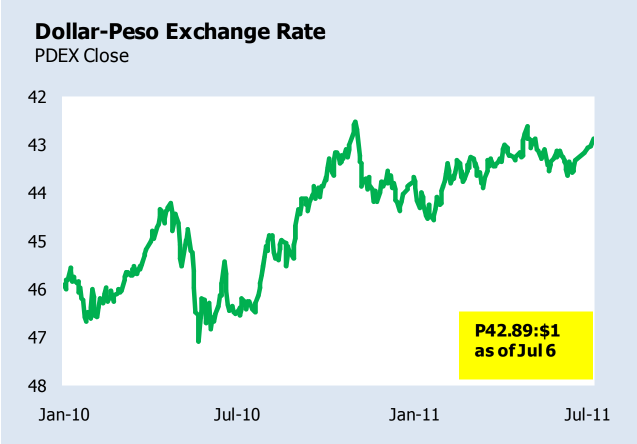
The country's gross international reserves rose to $68.8 billion as of May, higher by $0.3 billion compared to the April level. The sustained rise in the reserves level was mainly due to the foreign exchange operations and income from investments abroad of the BSP. These inflows were partially trimmed down by payments of the NG for its maturing foreign exchange obligations as well as revaluation losses on the BSP's gold holdings on account of the month-on-month slight decline in gold prices in May.

Remittances remained resilient, rising to $6.2 billion in the first four months, posting a year-on-year growth of 6%.The bulk of the inflows came from the US, Canada, Saudi Arabia, Japan, UK, Singapore, UAE, and Italy. The BSP downplayed the impact of Saudi Arabia's decision to stop hiring domestic workers from the Philippines, pointing out that that displacements will only be temporary.

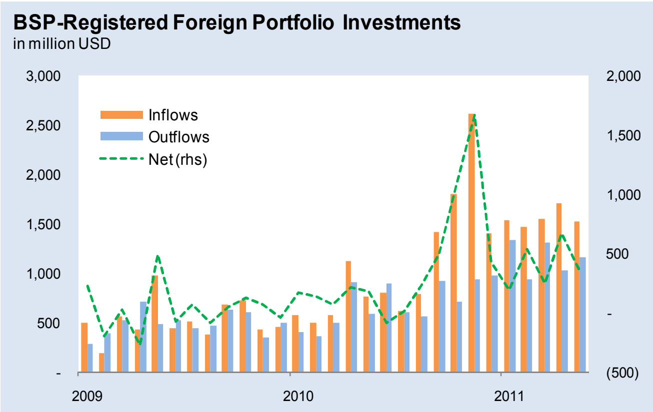
Push and pull factors on the peso

Research expects the appreciating trend of the peso to continue.
The peso is still seen to generally hold the ₱43- 44 levels during the 3rd quarter import season and may come under renewed pressure, especially amid the volatile market sentiment on a still unfolding eurozone crisis.

The subsequent rise in remittances in time for the holiday season is seen support the peso to come in at ₱42.50 to a dollar by yearend.



The peso was relatively stable as it remained at the ₱43-44 level against the dollar even amid external developments



Strong macroeconomic fundamentals buoyed the keen interest in portfolio investments to the country

> **"The peso is still seen to come under pressure amid the volatile market sentiment on a still unfolding eurozone crisis"**

Source: Bangko Sentral ng Pilipinas
National Statistics Office

KEY FACTS & INDICATORS

Fears of a global relapse have suddenly become more real amid dismal economic data especially from advanced economies. The US is still grappling with a jobless recovery amid fiscal consolidation woes. The eurozone likewise is again in the doldrums with solvency concerns yet to be fully addressed. From where we are right now, not much is expected from the rich world countries as clearly these economies have yet to post sustained growths, without the need for further deficit-generating stimulus, to warrant a modest recovery. In the other part of the world, most emerging economies are said to have bounced back to pre-crisis growth levels. A downside to the fast-paced growth however would be an overheating economy. Concerns are now focused on slower expansions moving forward amid the tightening policies these economies are now implementing to contain heightened inflationary pressures.

Here at home, macroeconomic fundamentals remain strong despite the expectation of a lower full-year GDP growth compared to last year. Sustained consumer spending has kept the consumption-led economy afloat, supported by solid remittance flows. Inflation is well-anchored within the central bank's band and is no longer seen to affect consumption spending. The boost in investment spending augurs well for the domestic economy that is now stepping towards a more sustainable growth path.

FORECASTS

	2010	2011 Full-year Forecast
GDP Growth	7.1% (Full-year)	**5.0%**
Average Inflation (2000=100)	3.8% (Full-year)	**5.0%**
Overnight RRP	4.0% (end-December)	**4.75%** (yearend)
Foreign Exchange	43.89 (end-December)	**42.50** (yearend)

estimate

MARKET WATCH

Government Bonds	**Latest Yield (as of 6.11)**		
5Y T-Bond	5.1865		
10Y T-Bond	6.5585		
Currencies	**Latest Rate (as of 5.11)**		
USDPHP	43.494		
JPYPHP	0.5387		
EURPHP	62.7836		
Stock Market	**Latest Value (as of 7.7.11)**		
PSEi	4,391.46		
Policy Rates	**Latest Policy (as of 6.11)**		
BSP Overnight Borrowing	4.50		
BSP Overnight Lending	6.50		
Sovereign Ratings	**Rating**	**Outlook**	**Date**
S&P	BB	stable	11.10
Moody's	Ba2	stable	6.11
Fitch	BB+	stable	6.11
R&I	BBB-	positive	9.08

Source: ADB website

As of July 8, 2011

PHILIPPINES: AT A GLANCE

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011F
Real GDP Growth$_{2000=100}$	3.7	5.0	6.7	4.8	5.2	6.6	4.2	1.2	7.6	**5.0%**
Average Inflation$_{2000=100}$	3.0	3.5	6.0	7.6	6.2	2.8	9.3	3.2	3.8	**5.0%**
Foreign Exchange (end-of period)	53.10	55.57	56.27	53.07	49.13	41.40	47.49	46.36	43.89	**42.50**
Current Accounts	$279M	$288M	$1,628M	$1,984M	$5,347M	$7,119M	$3,897M	$9,358M	$8,465M	**$9,000M**
Budget Deficit	-P210.7B	-P199.9B	-P187.1B	-P146.8B	-P64.8B	-P12.4B	-P68.1B	-P298.5B	-P314B	**-P300B**
as % of GDP$_{1985=100}$	5.3%	4.6%	3.8%	2.7%	1.1%	0.2%	0.9%	3.9%	3.7%	**3.2%**
Gross Int'l Reserves	$16,365M	$17,063M	$16,228M	$18,494M	$22,967M	$33,751M	$37,551M	$44,242M	$62,067M	**$78,000M**

Metrobank