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Metrobank Group

15 December 2014

Philippine Stock Market 2015: *A Fiscal Upside*

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Missing Locomotive

For the entire 2014, Philippine economic growth may have missed a previously strong locomotive -- fiscal spending -- yet many bet GDP growth is likely still at 6%. Up to 2Q14, government spending was stagnant and even contracted by -2.6% in 3Q. Disbursement bottlenecks were just too huge to battle; the DAP and the PDAF scandals. That GDP would have been off this year's target range of 6.5% - 7.0% is causing little hassle to an elevated stock market, with PE of 19x, the world's 2nd highest next to India. Thanks to record low global crude prices fortifying subdued inflation that boosts low interest rates expectations. With Japan and the ECB about to step on the stimulus pedal to ward off deflation plus low gas prices, an early US rate hike seems like a fading risk. Lately, Moody's Investors Service made good on its positive outlook view given early in the year by upgrading last week (Dec. 10, 2014) the Philippine sovereign rating to Baa2, meaning "highly" capable to pay debt from Ba3's "acceptable" ability to pay debt. Corporate earnings were also robust, up 16% year-on-year (yoy) in 9mo14 for 81 companies we monitored.

Shift to Capital Markets

The BSP's rate hike, initial salvo of 25 bps hike, is now widely expected to be pushed back to 3Q2015 while the 10 yr UST will crawl to 2.7% by end 2015 and reach 3% only by end-2016. The latter is Prof. Roubini's forecast. While low domestic inflation and interest rates will tend to charge up the batteries of the stockmarket for a further run next year, financial regulations are not necessarily supportive of the growth picture. The BSP's bias for harsh and constrictive lending policies in banking will shrink loan portfolios even with the bigger capital bases under Basel 3, ushering what many bankers fear as the dawn of structurally lower operating returns on equity (ROE) for the sector. Recall the reduction in the collateral cover for loans to 60% from 80%. Immediate punitive sanctions hitting incomes and raising the capital burdens are in place for the disobedient banks. Wanting to be much ahead of the curve in Asian monetary policy, BSP is willing to trade off economic growth targets for greater stability of the financial sector. Thus the burden of financing corporate requirements will shift in a greater way to the capital markets.

Pivotal Role for Government

Government cannot afford to be absent again in the growth picture next year because banks won't play the financing part in a big way as they did this year, which pushed construction growth to a six-quarter high of 15.7% in the private sector last 3Q14. It was private construction that spurred overall construction sector growth to 12.3% in 3Q14 which made up half of the fixed capital formation, the latter is a fifth of GDP. Government and the PPP pace will have pivotal roles in the stockmarket's fortune next year. We believe underspending will be the biggest downside risk.

Benefit of History

The good news is there is much confidence in the recovery of gov't spending next year, made more compelling by the Presidential elections in 2016. This assumption is being built around the forecast about PSEi breaching 8000 next year and corporate earnings delivering a projected 12% growth based on Bloomberg consensus. History affirms a cycle of a 12-month stockmarket run prior to the actual month of the past four Philippine elections: PSEi was up +42.26% in 2004 (Senatorial elections) ; up +50.84% in 2007 (Presidential elections); +36.13% in 2010 (Presidential elections); and 38.56% in 2013 (Senatorial elections).

Low Vulnerability for Philippines from Oil and Dollar Shock

Externally, unprecedented drops in global oil prices appear to be a key risk. See Fig 2. Markets fear a contagion of deflation from hard-hit oil exporting countries swallowing the global economy as highly oil reliant economies account for 60% of world GDP based on the World Bank data. The weakness of oil has started to spread in other commodities such as coal and iron ore, weakening resource-based economies. Iron ore prices rallied briefly last month after China cut interest rates for the first time since 2012, but have since failed to stem the rout. Analysts are tipping further downward pressure on iron ore prices. The commodity will average $65 a ton in 2015 from a high of $82/ton this year, with weaker prices in the first half before a recovery as some higher-cost capacity is closed.

Commodity-Linked Currency Depreciation Contagion

With reduced oil and other commodity export receipts, the budget deficits and currencies of resource-based economies could be in for a shock, creating a commodity-linked currency depreciation contagion. It will be a fresh drag on the global economy and reinforce USD strength. US oil giants Chevron and Exxon Mobil lowered revenue and earnings guidance by -13% and -16% for the former and -8% and -19% for the latter, respectively, in 2015. Energy companies that comprise 5% of the global $34 trillion junk bond market are likely to see higher cost of borrowing with their deepening price discounts.

Deflation Fears

Deflationary pressures begin with disinflation, (decelerating inflation) which is evident in the latest 0.3% Eurozone inflation the ECB wants to pump up to 2%. It then leads to deflation, which is an actual fall in the rate prices rise (negative inflation) and makes it hard for indebted countries to get rid of debt as falling prices reduce the incentive for business to hire and produce more, leading to unemployment, falling wages and sluggish, no economic growth and recession. It is a downside risk global stockmarkets are increasingly sensitive to as reflected in last week's 268 point drop of the Dow Jones to 17533 following record lows for global crude prices.

Low External Debt

The Philippines count among the net oil importers which will benefit from cheap oil while the weak peso expands exports receipts of both goods and labor (OFW and BPO income). These two will spur consumption which is three fourths of the economy. The Philippines is also not highly indebted. Gross external debt which is total foreign currency obligations of the public and private sectors that must be repaid out of foreign exchange earnings are only a fifth, 21% or $58bn of the country's $270bn economy. This ratio is the 2nd lowest among the ASEAN 5 and two others; Malaysia's 71.2%; Indonesia's 34.3%; Thailand's 38.7%; Singapore's 445%, South Korea's 32% and India's 23%. And only 14% of the Philippine external debt or $8bn are short-term or maturing in one year. See Bloomberg screenshots 1 & 2 below. The mitigant for all emerging markets is that their collective external debt has gone down to 26% of GDP from 36% four years ago. See Bloomberg screenshot 3.

Understatement

With these favorable macro backdrop and lesser foreign currency debt exposure, Philippine corporate earnings growth next year has ample leeway to deliver. Bloomberg predicts it to be 12%. That earnings pace is going to take the PE of the market lower to 19x from the current 20x, suggesting a target PSEi of 8200 or a 12% upside assuming the market closes the year at 7300. But 2015 is not like any other year. It is the year when rallies start in the last semester, peaking on the election year which is 2016. PSEi at 8200 by next year would be a forecast understated. ▲

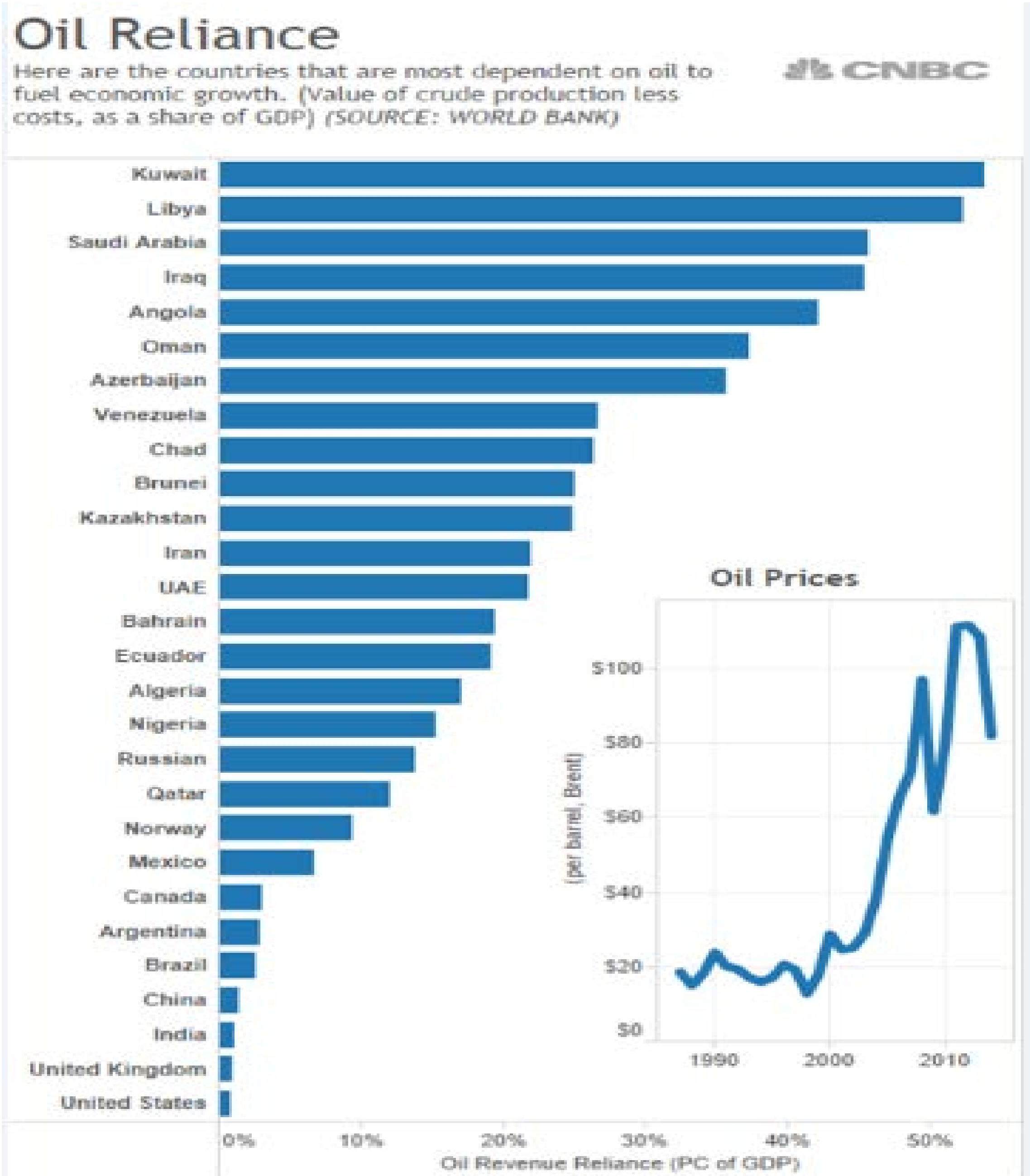
Table 1. Phils. National Income Accounts (NSCB)

Real GDP Growth TYPE OF EXPENDITURE	3Q YOY Growth	2Q YOY Growth	1Q YOY Growth	9MYOY	% of GDP
Household Final Consumption Expenditure	5.2	5.3	5.8	5.4	67.60
Government Final Consumption Expenditure	(2.6)	0.0	2.0	(0.2)	11.07
Capital Formation	3.6	(2.4)	7.7	3.0	20.16
a. Fixed Capital	10.1	4.0	11.2	8.4	21.72
1. Construction	12.3	5.1	(0.9)	5.5	8.63
i. Public	(6.2)	(12.9)	22.3	1.1	1.33
ii. Private	15.7	12.7	(6.0)	7.5	4.35
2. Durable Equipment	8.1	2.3	21.6	10.7	11.17
3. Breeding Stock & Orchard Dev't	(1.2)	(2.0)	(4.1)	(2.4)	1.28
4. Intellectual Property Products	35.1	35.9	22.9	31.3	0.63
Exports	9.8	10.3	12.6	10.9	50.19
Less : Imports	5.8	1.4	8.0	5.1	48.09
GROSS DOMESTIC PRODUCT	5.3	6.4	5.7	5.8	100.00
GROSS NATIONAL INCOME	4.8	7.3	7.6	6.6	120.21

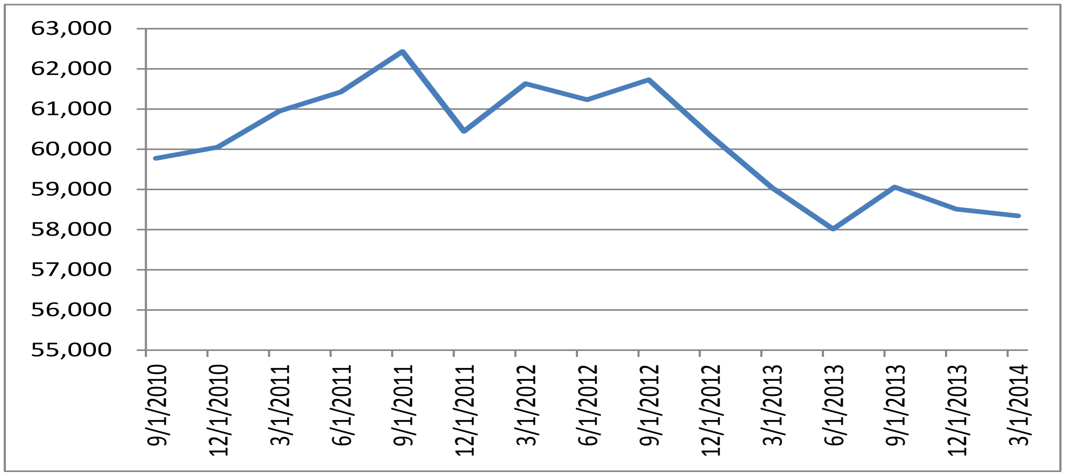
Fig. 1 Global GDP growth vs. Oil Price Growth/Inflation

Source: Bloomberg

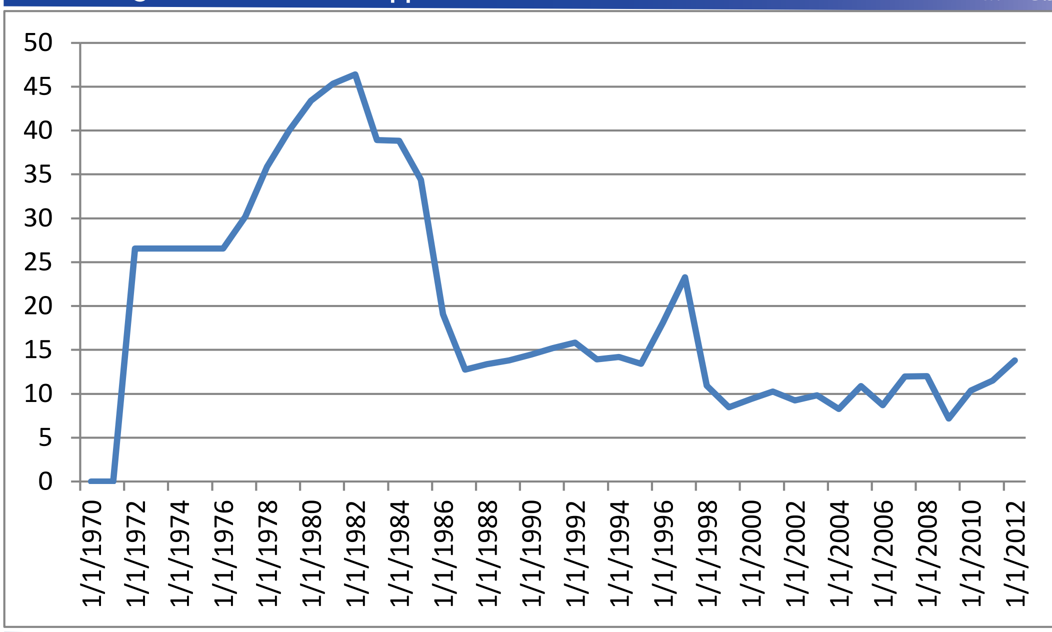
Fig. 2 Crude Production Value as % of GDP



Bloomberg Screenshot 1. Philippines Gross External Debt in mn USD



Bloomberg Screenshot 2. Philippines Short Term External Debt as % of External Debt



Bloomberg Screenshot 3. IMF Emerging and Developing Economies
External Debt as % of GDP