September 27, 2011

Gliding through the Turbulence

We are again witnessing tumultuous times. This past week we saw a broad and severe sell-off of Philippine financial markets. Risk appetite waned in the absence of any consensus and concrete resolution to address the sovereign debt crisis and contagion fears plaguing the European region. These fears have fed into heightened concerns of a recession in the US and a significant slowdown in emerging economies. From September 19 – 26, 2011, the Philippine Stock Exchange Index (PSEi) dropped 586.77 points or -13.62%. The Philippine peso depreciated against the greenback by almost 1% to Php43.870. Local bond and US dollar-denominated bond yields rose by 73 bps and 31 bps, respectively.

What is clear at this point is that, fundamentals aside, Philippine markets have been taking their cue from developments overseas. In this sense and for the meantime, we have assumed a more cautious and defensive stance in light of the external macro conditions heavily influencing domestic markets. The sell-off in risk assets may persist amid our fervent belief that the local economy and consequently financial markets should perform favorably when the dust settles in Europe. Nevertheless, historically, sharp sell-offs driven mostly by fear have most often presented investment opportunities.

Tempered by less favorable economic developments overseas, our expectations for real GDP growth still remains at around 5.0 - 5.5.% in 2012, above the historical growth trend. Key drivers to growth are a recovery in public spending as well as associated spending geared toward infrastructure, a healthy pace of remittances supporting consumption, and a robust revenue stream from the growing BPO sector.

For local equities, we have taken a more cautious and defensive stance amid the recent volatility. We expect the key economic drivers we mentioned previously to provide broad support to many main sectors of the index going forward and effectively “lead the way out” from the red. Our base case is for the PSEi is to reach 4,500 – 4,600 in 6 – 12 months, assuming a 7-10% EPS growth rate, implying a 14x 2012F P/E multiple and 20.93% - 23.62% of upside from the current level of 3,721.22.

In local fixed income, our constructive view on the domestic economy’s resilience leads us to maintain our positive view on the peso- and dollar-denominated Philippine fixed income space over the long-term. However, as market conditions remain volatile and yields continue to face upward pressure amid protracted overhang from overseas, we find it prudent, at least in the short-run, to lighten exposure on the long-end of the curve, particularly in the more liquid securities. In doing so, we have trimmed for the meantime, the sensitivity of our portfolio to movements in interest rates, and simultaneously gives us scope to revert to an overweight stance (our long-term call) as market conditions stabilize.