GLOBAL MACRO

Trumpism

Redefining risks in 2017

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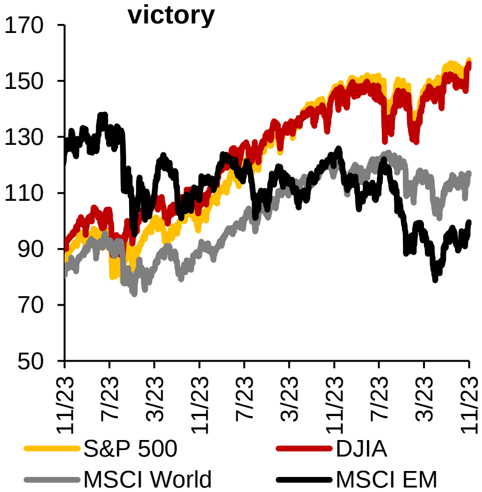
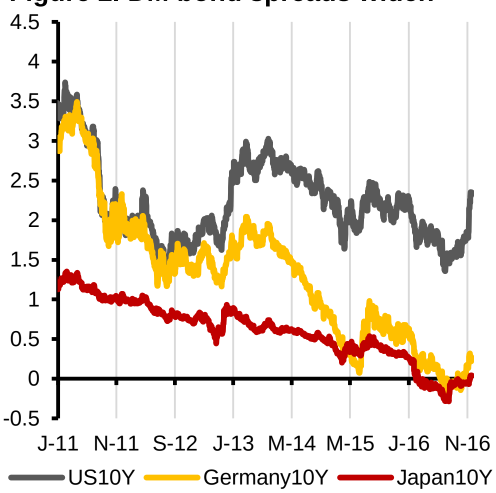
- **U.S. growth forecasts revised upwards amid speculation that Trump will follow-through on campaign promises**
- **Expect interest rates to remain on the rise in the short-term following Fed's hawkish statements and potential effects of Trump reflation trade**
- **Medium-term direction of US dollar is ambiguous but dollar to further strengthen in the short-term**
- **EM outflow to continue until further clarity on direction of the Trump gov't**
- **Strategy: go defensive, stay flexible—especially for local assets (bonds & equities)**

Figure 1. Market reaction post-Trump victory



Source: Bloomberg

Figure 2. DM bond spreads widen

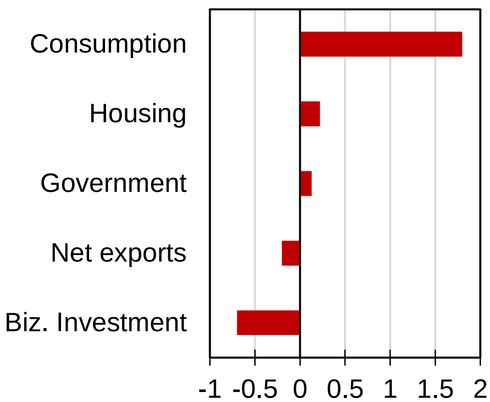


Source: Bloomberg

'Trumpism' a turning point for US growth. Misplaced optimism or not (refer to figure 1), there is no doubt that Trump's victory will be a net positive for the US economy; at least in the short term. Renewed pledges for a large increase in infrastructure spending, tax cuts in the first year of his administration alone and a significant hike in military spending should give the economy the much needed fiscal boost to complement the waning impact of the Federal Reserve's tired interest rate policy. The 'devil' of course is in the detail. President Trump and his team have yet to provide details as to how exactly they will fund the aforementioned fiscal boost and the schedule by which they will implement these changes. But the mere fact that Trump won with a strong mandate, resulting in the Republican Party controlling the Senate, Congress and the White House puts his administration in a strong position to follow through on a number of his campaign promises. **Not surprisingly, discussions of the US economy entering a period of 'secular stagnation' have died down and instead growth forecasts have been revised upwards from +2.1% to +2.3% year-on-year for FY17 and +2.7% from +2.2% FY18.**

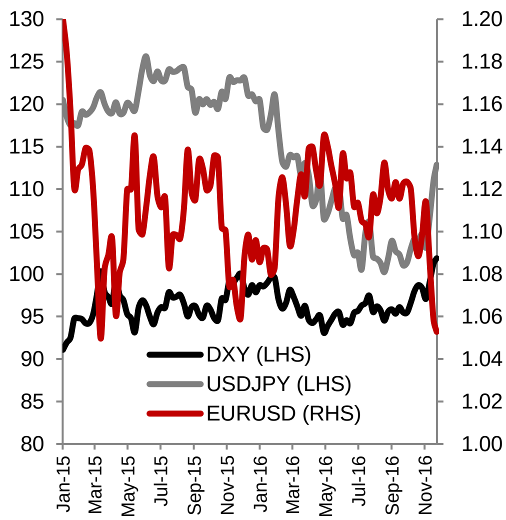
Interest rates on the rise for now. The 10YR US Treasury has surged to 2.35% (at the time of writing) on reflation expectations fueled by fiscal loosening on behalf of the Trump economic plan (refer to figure 2). **Moreover, recent statements from the Fed such as the 'case for raising interest rates have strengthened' our view that a 25-bpts rate increase in the federal funds rate can be expected this December 2016.** Whilst we share the consensus view that there is enough momentum technically to push the 10YR US Treasury to 2.5%, we quibble whether it will encourage the Fed to tighten more aggressively going forward. **We have concerns about the**

Figure 3. Contribution to year-on-year GDP growth in 2Q'16



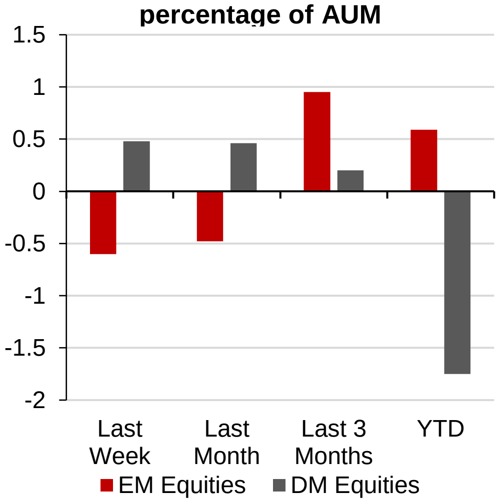
Source: Bureau of Economic Analysis

Figure 4. USD strength vis-à-vis other major currencies



Source: Bloomberg

Figure 5. Equity fund weekly flows as percentage of AUM



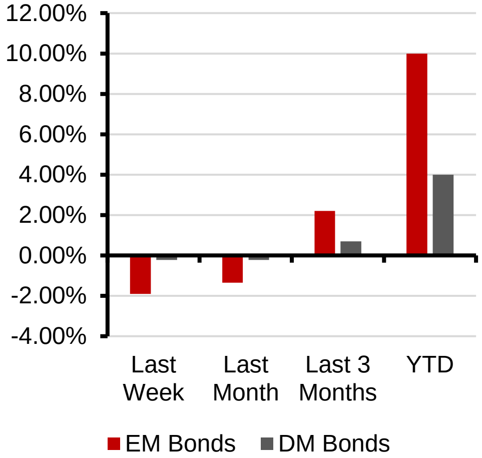
Source: EPFR Global

Trump budget falling short of expectations in terms of the actual GDP (and inflation) boost it will provide in the short run given that it features sizable spending cuts. Central to the Trump budget are tax cuts of USD$5.8trn and spending cuts of USD$1.2trn. With an elevated consumer's savings ratio and falling levels of business investment (refer to figure 3), which Janet Yellen has described as 'disturbing'; tax cuts will have less of an impact relative to spending cuts in terms of its multiplier effect in the economy. The IMF has recently stated that the multiplier applied to spending cuts was 3x that of tax changes. **Hence, absent more details from the Trump economic team, the reflation trade will continue to gain momentum but as we head into the 2H2017 we expect the lack of inflation pressure will once again cause yields to fall.**

Long live the USD. The USD has appreciated 3.9% in the last week climbing to levels not seen since the internet bubble of the early 2000's (refer to figure 4). **It's no secret that the strength of the USD of late is underpinned by the reflation trade and by the belief that the Fed will have to tighten more aggressively as a result.** Furthermore, the Bank of Japan's (BOJ) recent surprise announcement to buy an unlimited amount of securities to maintain its yield-curve target only reinforced the market's view that both the Euro and JPY will succumb to higher capital outflows triggered by the rate differentials. The outlook for the USD is uncertain since on one hand the US economy being the only growth engine globally gaining momentum will continue to attract capital inflows. But on the other, a strong USD is counterproductive to the goals of the Trump administration. It hurts exports, lowers corporate profits of US multinational corporations and puts the US manufacturing sector at a clear disadvantage to competition. **So while the reflation trade in the short run should translate to an even stronger USD, the medium term outlook is more ambiguous.**

Emerging Market outflow to continue. The uncertainty created by the Trump presidency has resulted in higher than usual capital outflows from Emerging Markets (EM) in the recent weeks (refer to figure 5 & 6). **The exodus from EM assets, both bonds and equities, is expected to continue at least until we have clarity from the Trump administration about its foreign policy and trade.** Much is expected from the Trump team between now and the inauguration of Donald Trump (20January2017) to clarify his stance on trade. Taking his pre-election trade policies at face value, such as imposing a 45% tariff on goods and services from China and/or Mexico will be vitriolic for EM. Raising tariffs on goods and services from China across the board will cause exports to the US to contract by 50%yy in the first year alone. **Looking it at another way, the long run ramifications of the US adopting aggressive protectionist policies will hurt the US manufacturing sector**

Figure 6. Bond fund weekly flows as percentage of AUM



Source: EPFR Global

Figure 7.a. Expected trajectory for the Philippine peso*

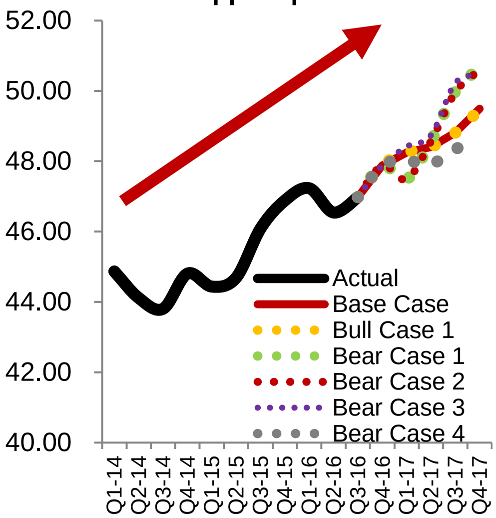


Figure 7.b. Expected trajectory for the Philippine peso (legend)*

Legend	
Base Case	Two Fed Rate Hikes, Small Positive Foreign Flows
Bull Case 1	One Fed Rate Hike, Small Positive Foreign Flows
Bear Case 1	Two Fed Rate Hikes; -US$ 5mn/day Foreign Flows
Bear Case 2	One Fed Rate Hike; -US$ 5mn/day Foreign Flows
Bear Case 3	Two Fed Rate Hikes, Small Positive Foreign Flows, Current Account @ -1.5% of GDP
Bear Case 4	Two Fed Rate Hikes, Small Positive Foreign Flows, Current Account @ +1.5% of GDP

Source: Bloomberg, BPI AMTG Estimates

and could tip the economy into a recession. The impact on China is less severe given that it has more room in its balance sheet (44% public debt to GDP) to expand its current fiscal policy and compensate for lower trade volumes. A less isolationist trade policy from the Trump administration may reduce cross-asset volatility but the strength of the USD will weaken the appeal of EM assets and compel investors to seek greater value to compensate for the additional risks in the short-term.

Get defensive, be flexible. Even if we assume a trade war between the US and its major trading partners is unlikely, we advocate reduced risk taking in asset allocation at least in the short term. The prospect of foreign capital inflows coming back with renewed enthusiasm will be inconceivable in the short term given the strength of the USD. For this reason, not only should asset allocation be defensive but be flexible as well, to take advantage of tactical opportunities resulting from the heightened volatility. Technically, there is enough momentum for the Php to depreciate further and breach the Php50.8250 level in the short term (figures 7a & 7b). **Hence, increasing exposure in money market funds (Peso/USD) makes good sense since it allows to take advantage of tactical opportunities arising from event driven spikes in volatility.**

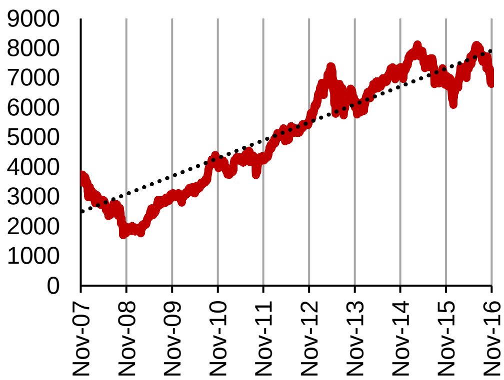
Peso Fixed Income conservative stance maintained. The most immediate reaction to the US reflation trade is to **reduce duration and increase holdings of corporate notes/bonds. This has been the preferred strategy since December 2015 and should prove even more appropriate heading into 2017.** The outlook for Peso bonds in 2017 is not optimistic since we foresee the BSP raising the policy rate by at least 25bps (from 3.00% to 3.25%) just to stay ahead of the Fed in terms of reigning in liquidity in the financial system. Currently we expect the Fed to raise the federal funds rate by only 25bpts every year, but we won't be surprised if they hike more aggressively on the back of rising inflation expectations as a result of the coming fiscal boost (refer to figure 8). Should the Fed motion for more aggressive tightening action in 2017, expect the BSP to closely follow suit.

Figure 8. 2017 Economic Forecasts

Economic Indicators	2015	2016	2017
Global			
US Fed Funds Rate	December 2015	December 2016	June 2017
Philippines			
GDP (% YoY Growth)	5.81%	6.30%	6.50%
Inflation (12 mo ave)	1.4%	1.8%	3.50 – 3.75
Monetary Policy			
ODF* (%, eop)	2.5%	2.5%**	2.75
RRP (%, eop)	4.0%	3.0%**	3.25
RRR (%, eop)	20.0%	20.0%	20.0
USD/PHP (eop)	47.06 (-5.2%)	49.50 – 50.50	49.50
PSEi	6,952.08 (-3.9%)	7,387	

Source: Bloomberg

Figure 9. Movements in the PSEi



Source: Bloomberg

Figure 10. 3Q 2016 Earnings Tracker

Versus	Con.	AMTG	%
In line	2	3	11%
Behind	15	14	50%
Ahead	13	13	46%
W. Ave Earnings Growth	**14%**	**W. Ave Rev. Growth**	**6%**

Source: Bloomberg, BPI AMTG Estimates.

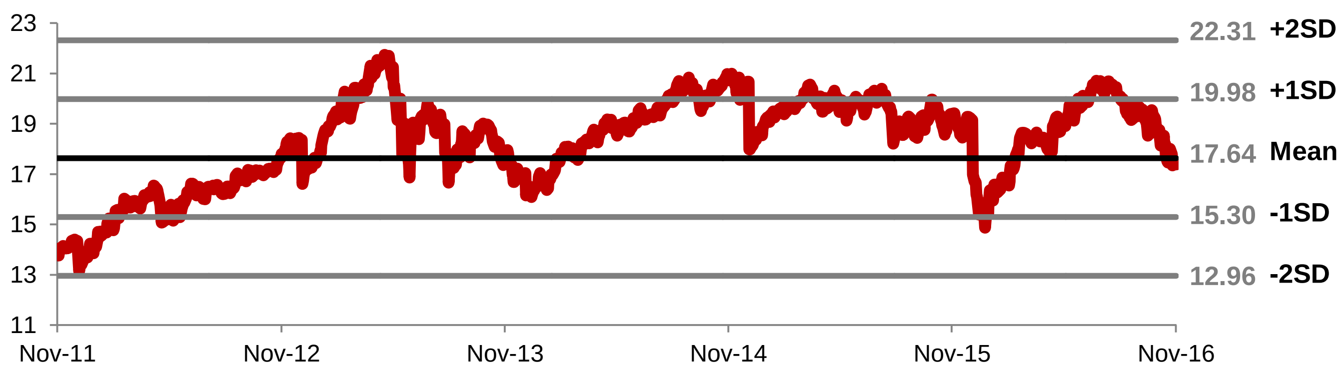
Peso Equities not so bullish. We still maintain a somber outlook for Philippine equities in the short run despite the economy posting a +7.1% yy GDP growth for 9M17 and forward earnings expectation of +11% yy for 2017. Absent concerns about a strengthening USD and potential fall-out from Trump's trade policies, investors will continue to adopt a wait-and-see attitude on whether President Duterte will be able to execute much needed expansion in infrastructure spending and the tax reform program. Until President Duterte is able to pass through Congress and Senate at least phase 1 of his much publicized tax reform program, the PSEi will trade below the previous high of 20xPER for 2017 and instead trade up to 1 standard deviation below at 15.3xPER (refer to figure 12). President Jokowi's experience in Indonesia for the past 18 months sets a precedent for the PSEI. The JKSE contracted -22% 12 months after Jokowi assumed office as investors lost confidence in his ability to manage the budget of the economy. It was only after the tax amnesty program was implemented did foreign sentiment actually improve. Fundamentally, based on an earnings trajectory of 11% yy for 2017, the PSEI should trade at 8,440 or 19.5x forward PER. However, given the implied political risk premium that foreign investors have imputed on the Duterte Administration we find the PSEI trading between 6,923.71 and 7,356.44 or 16x-17xPER based on 2017 earnings until fiscal concerns are pacified (refer to figures 11 and 12).

Figure 11. PE and PSEi sensitivity analysis using EPS growth rate of 11% for 2017

	2016PE Ratio	Market Level	2017PE Ratio	Market Level
Current Level	**17.53**	**6,889.78**	**16.34**	**6,889.78**
	21	8,227.78	21	9,087.37
	20	7,835.98	20	8,654.63
	19	7,444.18	19	8,221.90
	18	7,052.38	18	7,789.17
	17	6,660.58	17	7,356.44
	16	6,268.78	16	6,923.71

Source: BPI AMTG Estimates, Bloomberg

Figure 12. 5-Year PE Mean of 17.6x; Current PE (17.5x) is a -0.74% discount to 5y PE avg.



Source: BPI AMTG Estimates, Bloomberg

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