Market Focus

Investment Themes for 2014

January 22, 2014

We would like to take this opportunity to update you of recent market trends, our outlook on financial markets, as well as their implications on our investment and asset allocation strategies for the coming year.

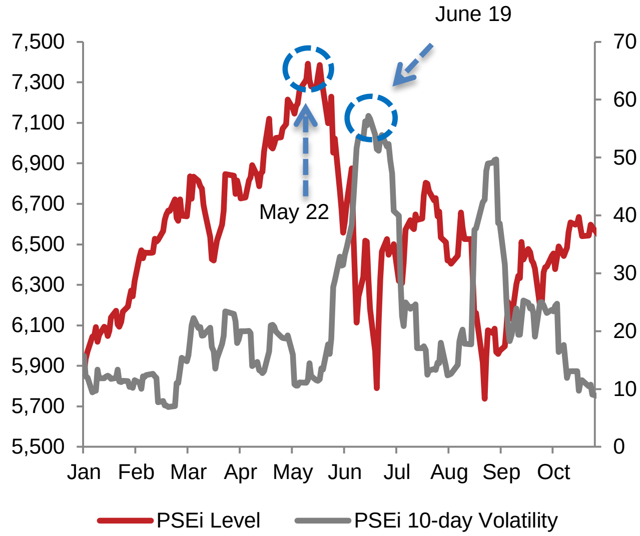
Looking back. 2013 was a challenging year for global financial markets as volatility persisted across the globe. After having peaked in the first five months of 2013 (25% gain), the Philippine Stock Exchange index (PSEi) ended 2013 with a modest gain of 1.33% year-on-year. Returns on dollar-denominated Philippine sovereign bonds, as measured by the JP Morgan Asia Credit Index (-5.10%), likewise posted a significant drop from 2012's close. The local currency depreciated along with its regional counterparts, weakening by 7.53% for the year and completely reversing the 6.80% gain posted in 2012. Nevertheless, local bonds (+5.13%) continued to meet strong demand as uncertainty in the global economy was countered by optimism in the country's solid fundamentals.

Recall that the turbulence began in mid-May, when US Federal Reserve (US Fed) Chairman Ben Bernanke announced that the central bank could begin to scale back its ongoing bond purchase program (Quantitative Easing 3). The statement caused rates to rise as investors anticipated gradual tightening in global liquidity levels on account of accelerating economic activity in Developed Markets going forward. It similarly caused a reversal in fund flows from Emerging Markets to Developed Markets, the same funds which had driven Emerging Markets to record highs in recent years. As of end 2013, approximately US$17 billion worth of funds have flowed out of emerging market equities compared to the US$50 billion inflow in 2012.

What to expect in 2014? We view 2014 in a better light now that the US Fed has decided to taper the size of its monthly asset purchases beginning January of this year and improving guidance on future policy action. In terms of global growth, developed economies are expected to continue with their recovery, while emerging economies will likely exhibit decelerating growth. On the local front, the Philippine economy should maintain its above-trend expansion given its strong macroeconomic fundamentals.

We summarize our key investment themes which we believe will shape financial markets and investors' behavior in 2014:

PSEi Level vs. 10-day Volatility



Source: Bloomberg

IMF Global GDP and Inflation Forecasts

	GDP Forecast (%)		Inflation Forecast (%)	
	2013	2014	2013	2014
ASEAN				
Indonesia	5.3	5.5	7.26	7.54
Malaysia	4.7	4.9	2.00	2.60
Thailand	3.1	5.2	2.20	2.13
Singapore	3.5	3.4	2.28	2.70
Philippines	6.8	6.0	2.81	3.54
Vietnam	5.3	5.4	8.80	7.36
Emerging Markets				
Brazil	2.3	2.3	6.35	5.77
Russia	1.5	2.0	6.73	5.71
India	4.4	5.4	10.88	8.88
China	7.7	7.5	2.74	2.97
Advanced Economies				
Euro area	-0.4	1.0	1.51	1.47
US	1.9	2.8	1.39	1.51

Source: IMF World Economic Outlook report January 2014

Market Focus

Global growth will accelerate as economic activity in developed economies modestly expand on improving conditions. As a result of the extraordinary stimulus measures that major central banks have implemented in recent years, growth in Developed Markets is seen to accelerate as domestic demand recovers further. The International Monetary Fund (IMF) forecasts that the global economy will expand by 3.6% in 2014, coming from an estimate of 2.9% in 2013. In particular, as unemployment slowly declines and household wealth increases in the US, consumption should start to pick up and with it, economic growth. The Euro-zone will likewise register expansion after having finally exited recession during the third quarter of 2013. Conversely, emerging economies will exhibit lower growth levels as current account concerns will continue to hamper these countries.

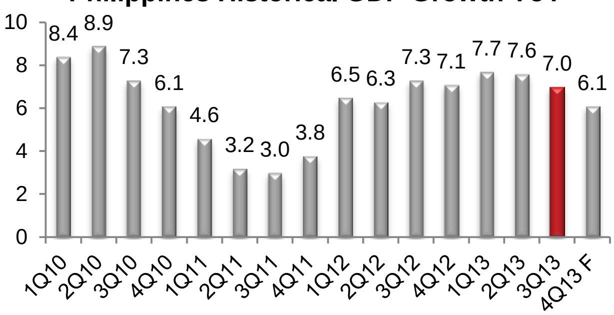
Global inflation will remain soft in 2014 due to weak demand and oversupply, though upside risks remain. By and large, inflation was not a problem in 2013 and we think that this trend is likely to continue in 2014. Food prices should remain stable, so long as weather conditions remain favorable. Softer growth in China, as well as down trending world oil prices due to increased oil production in North America, will help keep energy costs at bay. With all these contributing to temper price pressures, the US Fed, Bank of Japan, and the European Central Bank should keep policy rates low throughout 2014.

QE Tapering will be gradual, contingent on employment and inflation figures, and policy rates are expected to be kept low. Moreover, QE Tapering should not affect markets as much as it did in 2013, especially with the strengthening of forward guidance from policy makers. Despite its decision to begin scaling back bond purchases by January 2014, the US Federal Reserve has been firm in keeping its near-zero policy rate until unemployment and inflation targets are reached (6.5% and 2.0%, respectively). Tapering concerns have also subsided as the Federal Reserve has been surprisingly successful at decoupling monetary policy from the end of Quantitative Easing.

Thus, given the inevitable rise in interest rates as bond purchases are slowly phased out, investors can take comfort in the fact that the increase will not be as sharp relative to rate adjustments experienced in May and June of last year.

Philippine economic growth will continue to be above-trend, while inflation is expected to remain manageable. We expect the country's economic growth to register at 6.2% year-on-year in 2014, still above the 10-year average of 5.2% year-on-year (2003 to 2012). Robust economic growth rate is attributable to continued expansion in personal consumption (+5.5% year-on-year in 2014) and announced increases in government expenditure (+15.0%) which are seen to propel growth on the expenditure side and the supply side (industry and services sectors) of the economy. Moreover, reconstruction works on typhoon-stricken areas would provide a boost in public infrastructure spending (raised to 3.5% of GDP from 2.5% of GDP historically). Manageable inflation expectations for the year will allow the BSP to keep policy rates accommodative and supportive of growth.

Philippines Historical GDP Growth YoY



Source: Bloomberg

We expect market volatility to remain elevated in the short term, in line with investor concerns about the progress of the Federal Reserve's commitment to end Quantitative Easing. Our view takes into consideration the entry of the new Fed Chairperson, Janet Yellen, who will be looking for firm evidence in the economic data of sustained improvement in employment levels (in particular improving labor participation rate and wage increases). Despite the relief rally experienced in the first two weeks of 2014 (as a result of disappointing US jobs data), we hold the view that yields of US Treasuries will inevitably rise.

Market Focus

Subsequently, we foresee global markets to regain full confidence only by the second half of 2014. By this time, value in Emerging Markets (including the Philippines) will seem compelling again (~15x price-earnings ratio) and we believe that flows will revert back to those with strong fundamentals; negating the impact of a strong US Dollar.

Against this backdrop, we will therefore implement defensive investment strategies that would limit the downside risks of our portfolios and alleviate the adverse effects of a weak peso in the short-term. For our local equity portfolio, we have raised cash positions to take advantage of buying opportunities that may take place in the 1st half of 2014. We will be increasing our allocation for global equities in anticipation of improving investor sentiment and economic conditions in Developed Markets. We have lowered our duration positions on both global and local fixed income assets in view of rising global interest rates.

The question to ask now is, “what will make the Philippine story different?” Investors in Developing Markets are accustomed to the volatility in investment returns caused by shifts in global macroeconomic events that lead to massive inflow or outflow of funds.

2014 In-House Forecasts	
National Account	
Real GDP (growth in %)	6.2
External Indicators	
GIR (in Bn US$)	85
Import Cover (x cover)	13.6
Current Account (CA, as % of GDP)	3.1
Monetary	
M3 (growth in %)	20.5
Outstanding KB loans (growth in %)	18
Prices	
CPI Inflation (2006-based)	3.9
USD/PHP (EOY)	45.400
BSP O/N	3.5
PSEi	6,300-6,640

While we are not making the case for the Philippines’ decoupling from the rest of Emerging Markets, we believe that investors can at least take comfort in the sustainability of its strong economic growth (regardless of shifts in market sentiment) underpinned by robust domestic consumption growth. Thus, even though some currency volatility is to be expected in the short-term as investors adopt a preference for Developed Market assets, investors can also rely on the country’s high level of gross international reserves and current account surplus to cushion external shocks to the peso.

Turbulence in global markets is perennial. We believe, however, that the country’s favorable fundamentals should be able to outlast any external turbulence (please refer to 2014 In-House Forecasts). The country’s favorable demographics and prudent government reforms should likewise minimize the impact of any external shock locally going forward. Thus, while we maintain our defensive stance in the short-term, our long-term view on local economic growth and local financial assets remain very much positive.

We consequently acknowledge downsides risks that may prompt us to change the course of our investment decisions, these being:

- The risk of deflation in the Euro-zone amidst protracted improvement in the labor market
- A hard landing for China, should growth come in below 7.0% and
- Rising territorial tensions in Asia, which could negatively weigh negatively on sentiment.

The points we have enumerated above reflect what we believe are the key investment ideas this year and these factors will shape our investment strategy going forward. We are aware of the ever changing nature of financial markets, even more so in 2014 relative to 2013 given that it’s a transition year from the point of view of US policy. We are optimistic on the prospects of financial assets generally given encouraging developments in most parts of the world, even as we are mindful of the risks that lie in the immediate investment horizon.

Market Focus

BPI Asset Management Research

CONTRIBUTORS:

Carlos A. Jalandoni
Senior Investment Analyst
cajalandoni@bpi.com.ph

Juan Alfredo S. Patag
Investment Analyst
jaspatag@bpi.com.ph

Jacqueline K. Tanliao
Investment Analyst
jktanliao@bpi.com.ph

Marie Olivia F. Fabic
Investment Analyst
moffabic@bpi.com.ph

Rod Christopher L. Barit
Investment Analyst
rclbarit@bpi.com.ph

Jose Luis C. Lim
Investment Analyst
jlclim@bpi.com.ph

Michael Carlo B. Picache
Investment Analyst
mcbpicache@bpi.com.ph

Theodore M. Velez
Investment Analyst
tmvelez@bpi.com.ph

Disclaimers:

The views expressed in this report <u>reflect the analysts' personal views and not necessarily the Bank of the Philippine Islands'</u>. Furthermore, no part of any of the research analyst's compensation was, is, or will be directly or indirectly related to the specific recommendations or views expressed by the research analyst in this report.

The information contained herein is published by the Bank of the Philippine Islands Asset Management and Trust Group (or "BPI AMTG"). It is based on information obtained from sources considered to be reliable, but BPI AMTG does not make any representation or warranty, express or implied, as to its accuracy, completeness, timeliness or correctness for any purpose. All the tables are taken from publicly available sources or derived from proprietary data. Expressed opinions may be subject to change without prior notice. Any recommendation contained herein does not pertain to any specific investment objectives, financial situation and the particular needs of any addressee. The information herein is published for the information of addressees only and is not to be taken in substitution for the exercise of judgment by addressees who should obtain separate legal or financial advice. BPI AMTG, or any of its related companies or any individuals connected with the group accepts no liability for any direct, special, indirect, consequential, incidental damages or any other loss or damages of any kind arising from any use of the information herein (including any error, omission or misstatement herein, negligent or otherwise) or further communication thereof, even if BPI AMTG or any other person has been advised of the possibility thereof. The information herein is not to be construed as a solicitation to buy or sell any securities, futures, options or other financial instruments or to provide any investment advice or services. BPI AMTG and its associates, their directors, officers and/or employees may have positions or other interests in, and may affect transactions in securities mentioned herein and may also perform or seek to perform brokering, investment banking and other banking or financial services for these companies. The information herein is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use would be contrary to law or regulation.

All funds managed by BPI AMTG and affiliates are Trust and/or Investment Management Funds, which do not carry any guarantee of income or principal, and are NOT covered by the Philippine Deposit Insurance Corporation. Past performance is not a guarantee of future results. BPI Investment Funds are valued daily using the marked-to-market method.