Market Focus

Positive PSEi Outlook Intact In The 2H2015

July 8, 2015

The Philippine Stock Exchange Index (PSEi) contracted 8.0% from its peak of 8,127 (April 2015) on the back of USD700M of net foreign selling in the 2Q2015 alone. Risk-off sentiment caused by anxiety on tighter monetary conditions in the USA saw investors shifting equity exposure from Emerging Markets (EM) to Developed Markets (DM), while others decided to partake of China's artificial stock market rally. The PSEi, which was trading at 20.2x PER based on 2015 earnings (significantly higher than the 20-year average of 17xPER), a 53% premium to the regional average of 13.5x PER (Asia-ex Japan; see current valuations on Figure 1), was particularly vulnerable to profit-taking. The PSEi's predicament was further aggravated after the economy posted only a +5.2% year on year (yy) 1Q2015 real GDP growth rate, well below the consensus estimate of +6.6% yy. Sluggish economic growth was equally reflected in the 1Q2015 corporate earnings result which saw 33% of companies in the PSEi report earnings below consensus estimates. The worrying aspect was that Blue Chip consumer names Jollibee Food Corp (2.62% index weight) and Universal Robina Corp (5.62% index weight) both fell behind analyst expectations for the period. All of a sudden, investors questioned the sustainability of the Philippines' strong economic growth rate as it became evident the economy was also vulnerable to declining global trade and weakening domestic demand. **As a result of the poor 1Q2015 GDP growth rate, we have reduced 2015 GDP forecast from +6.5% yy to +5.75% yy. Correspondingly, consensus PSEi earnings estimates were also reduced from +13.2% yy to +9.6% yy for 2015.**

We expect the PSEi to end the year at 7,800 (21x PER based on 2015 earnings). Investor support for the PSEi is overwhelming to say the least, highlighted by the fact that it declined less during the height of the Greek crisis (refer to Figure 2) relative to other Emerging Market (EM) counters. Underpinning investor confidence is the belief that the downside risks to the Philippine economy pale in comparison to the rest of EM. Whilst EM economies struggle with falling exports and disinflation (with some economies like Thailand, Taiwan and Singapore are experiencing technical deflation), **the Philippines' stable consumption growth (refer to Figure 3) ensures real GDP growth rate for 2015/2016 will remain higher than its long term average of +4.5% yy.**

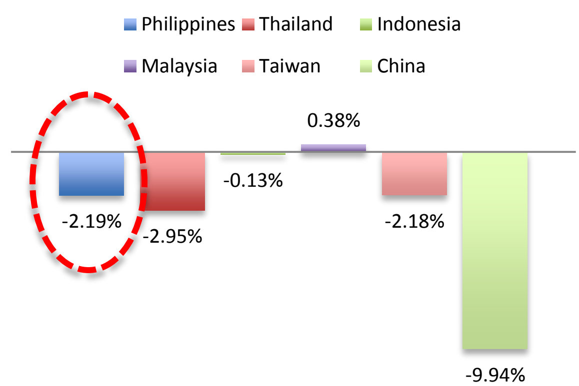
Our strong consumption growth outlook of +5.8%-6.0% yy for full year 2015 (versus +5.4% yy end 1Q2015) is derived from our expectation that remittance flows will be stronger in 2H2015 (+8%yy).

Figure 1. Philippines P/E vs Regional Peers

	P/E 2015F	P/E 2016F
Philippines	19.49	17.24
Malaysia	15.91	14.61
Indonesia	15.57	13.22
Thailand	15.05	13.11
Vietnam	13.88	11.73
Singapore	13.70	12.59
Average	**15.60**	**13.75**
MS Asia ex Japan	12.76	11.51
MSCI Emerging Markets	12.50	11.01

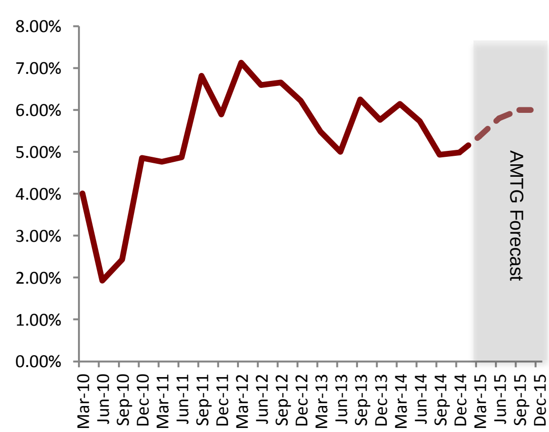
Source: Bloomberg as of July 6, 2015

Figure 2. Equity Index Change from June 26 to July 6, 2015



Source: Bloomberg

Figure 3. Philippines GDP Consumption Growth



Source: Bloomberg, Forecasts after 1Q15 in-house.

Remittance flows moderated at the end of 1Q15 (+5.5%yy) as the peso appreciated +1.48% during the period and OFWs held back their remittances wanting a more favorable rate.

This should reverse in the 2H2015 as we expect the peso to weaken to an average of Php45.50:USD1.00, in line with the Federal Reserve's first 25-pts rate hike (which we now expect in December 2015) and increased asset allocation to USD assets as a result of the Greek debt crisis.

Similarly, stable economic growth outlook and corporate earnings growth forecast for 2015/2016 reduces the risk of a meaningful depreciation in the peso unlike other EM currencies (increasing the attractiveness of peso assets). We expect the Philippines to post a positive current account surplus equivalent to +5.8% of GDP (versus 4.4% of GDP in 2014) in 2015. Improving terms of trade due to declining oil prices coupled with expanding BPO revenues (+17% yy FY2015) will provide a further boost to the current account. In contrast, Indonesia is expected to post a real GDP growth rate of only 4.8% yy in 2015 (the lowest since the Global Financial Crisis) as investments slow due to weakening demand. Whilst Thailand's economy continues to cool (+2.8% yy for 2015) as households continue deleveraging efforts amidst declining income levels attributable to a manufacturing sector slow down. **Subsequently, we expect the both the Bank of Thailand and the Bank of Indonesia to cut rates by another 25-bpts (in the 2H2015) to spur domestic demand, thereby putting significant downside risk to the Thai Baht and Indonesian Rupiah.**

The PSEi's 2015 corporate earnings growth (+10.7% 3-yr CAGR 2015E-2017 IBES estimates) is a standout in EM spurred by continuation of accommodative interest rate policy. For the 2nd year in a row, the PSEi is expected to post a +10.0% yy EPS growth rate in 2015 to be led by rate cyclicals– banks (+16%yy) and property (+14%yy). Naturally, index heavyweights SM (9.88% index weight) and AC (5.74% index weight) are expected to post strong EPS growth rates of +11.0%yy and +9.6% yy respectively on account of robust property earnings growth of 15% yy and expanding net interest margins of +7 bpts yy on average. **Both the property and the banking sectors continue to benefit from the BSP's negative real interest rate structure, which has been in place since 2013.** Our low inflation target rate of +2.2%yy (lower than the long term average of +4.0%yy) for 2015, provides the ideal monetary condition for the BSP to maintain such an accommodative interest rate policy.

In contrast, other EM countries like Chile (+14%yy eps growth), Poland (+22%yy eps growth) and Thailand (+22% yy eps growth) are expected to post stronger corporate earnings growth in 2015 relative to the PSEi. However, the threat of further earnings downgrades in 2H2015 (due to weaker domestic demand and rising non-performing loans), have led to capital outflows. Year to date, the PSEi still has a net inflow of USD398M in 2015 (31.7% of 2014 net total inflow of USD1.255B), which is still more favorable than Indonesia (USD310M net inflow year to date) and Thailand (-USD311M net outflow year to date).

Valuations (19.49xPER 2015) are currently stretched relative to the rest of the region (+52.76% premium to Asia ex-Japan). On the other hand, on a historical basis, the PSEi is trading only at 1 std from its historical mean (vs the peak of 2 std). Relative investor confidence in the ability of the Philippine corporate sector to grow revenues by +13% yy (2015) and ample liquidity in the domestic financial system (68% loan to deposit ratio), should keep the PSEi trading at a premium relative to other EM equity counters. Fund managers (both domestic and foreign) are paying a premium for growth and the PSEi is attractive because it is one of the few counters in the EM space that is expected to weather deflationary risks better given that household debt to GDP ratio is low (6% end 1H15).

In the short-term, we expect market volatility to persist as the PSEi tracks global markets in response to a potential Grexit (now at 80.0% probability). Uncertainty could result in the PSEi declining to 7,323 (significant support level) as fund redemptions overseas will pressure fund managers to reduce exposure to ASEAN in favor of DM assets. In addition, over the next six to twelve months we likewise see that the fast-approaching presidential elections may incite uncertainty regarding the next administration's ability to follow through with its promises, which could weigh on investor sentiment.

Nevertheless, we reiterate our view that the PSEi should be able to recover more quickly than other EM counters and rebound to 7,800 by end-2015. The combination of greater clarity from the Fed, high levels of domestic liquidity, resilience of the Philippine economic growth rate, and value emerging in the local corporates will result in the PSEi trading at 20.5x P/E heading into 2016.

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