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# One for the Books: Philippines Now Investment Grade

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Last week, the Philippines was finally awarded the much-coveted Investment Grade status (BBB-, with a 'stable' outlook) by major credit rating agency Fitch Ratings. It should be noted that markets have already priced in the upgrade since last year, as evidenced by the country's CDS spread which is at par with spreads of other sovereign bonds with even much higher sovereign ratings.

| | Fitch Rating | 5Y CDS (bps)* |
|---|---|---|
| Philippines | BBB- | 111 |
| Indonesia | BBB- | 168 |
| Thailand | BBB+ | 102 |
| Malaysia | A- | 92 |

*as of April 1, 2013

**Why it happened**

In one of our earlier reports (Upward and Onward: The Philippines' Quest for an Investment Grade Rating 12.27.12) we mentioned that the jump to Investment Grade would be triggered by a number of improvements in the country's economic condition. Among its Asian counterparts, the Philippines is one of the fastest-growing economies in the region in 2012, trailing only behind China's 7.8%. This, coupled with a growing current account surplus (US$2,249 Mn for 3Q2012), reinforced by resilient growth in OFW remittances and BPO receipts, provided Fitch Ratings with an excellent rationale to upgrade the country's credit rating.

Fitch also cited other factors which contributed to the country's advancement including but not limited to, improvements in fiscal management and a strong monetary policy framework. All of these are indeed evident as the Aquino administration stays keen on the country's balance sheet and continues to boost the economy. Aside from the impressive 2012 economic growth figure, the budget deficit for the first month of 2013 came out at Php19.5 Bn, up 23% from the Php15.9 Bn in 2012 amid spending hikes in efforts to jump start the economy.

**What happens now**

There is no doubt the achievement of attaining investment grade status will attract more foreign funds into the country's financial markets. Note that to be included in portfolios that are mandated to invest only in investment grade assets, the country must attain an investment grade from two out of the three major credit rating agencies. We expect an investment grade rating from either S&P or Moody's in the 2H2013. Until this time, a surge in inflows is to be expected as foreign investors are anticipated to position ahead of more credit rating upgrades.

Needless to say, receiving an investment grade rating will also improve the government's attempts to attract investments needed to address the infrastructure bottlenecks. Major Philippine companies (Ayala Corporation, Metro Pacific Investments, JG Summit, San Miguel Corporation and Aboitiz Equity Ventures), should see further reduction in their borrowing costs brought about by the country's lower risk premium. Lower cost of funding will benefit these Philippine conglomerates many of whom are vying for capital-intensive US$17 Bn Public Private Partnership (PPP) projects that are being rolled out by the government. The government has already earmarked a total of US$2.7 Bn PPP projects to be awarded and another US$1.5 Bn of projects to be opened for tender in 2013.

Obtaining Investment Grade status will undoubtedly put more pressure on the peso, as investors consider the divergent fortunes of rising default risk in the Eurozone and the strengthening economic fundamentals of the Philippines. The BSP has repeatedly stressed that it would intervene to curb excess volatility in the currency market. Against this backdrop, we believe that the BSP will cut SDA rates further and narrow its interest rate premium over the 91-day treasury bill (effective yield of 0.05% per annum). We are maintaining our peso forecast of Php40.00-40.50 by year end despite the early upgrade, as we are a firm believer the BSP will be more active in employing prudential measures to stem the impact of portfolio flows borne out of the upgrade.

**What we will do**

The local equities market is expected to continue its rally in 2013 as investors' (both foreign and local) confidence in the country is buoyed by the Investment Grade rating. The Philippine Stock Equity Index (PSEi) appreciated 2.74% on March 27, post the investment rating upgrade. Barring any external shock, we believe this rally will be sustained despite its lofty valuations on the back of strong earnings momentum (2013 and 2014 ex-PLDT corporate earnings are expected to expand 13% and 17% year-on-year, respectively) and a rerating in lieu of lower funding costs (contraction in equity premium across all issues). This is contrary to episodes of credit rating upgrades to investment grades in the past decade, which saw the local equity market index revert to its pre-investment grade levels (usually 3-weeks later).

We are revising our best case scenario from 7,100 to 7,200 for the PSEi, 24% higher than last year's close (5,812) driven by foreign fund flows looking for Philippine exposure. We expect foreign investors to take positions in large-cap companies, particularly index constituents due to liquidity and concerns about valuation. We reiterate our preference for rate-cyclicals (banks, property, conglomerates and consumer stocks) which we believe will continue to benefit from the BSP's low interest rate regime.

For the local fixed income market, we continue to prefer bonds of longer duration (10-year tenor buckets and beyond) as we expect yields to go down further. Any sell off on the back of the IG upgrade will be more than offset by new foreign funds looking to invest in Philippine assets for yield enhancement and for flight to quality reasons.

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