More Tightening In The Offing

August 12, 2014

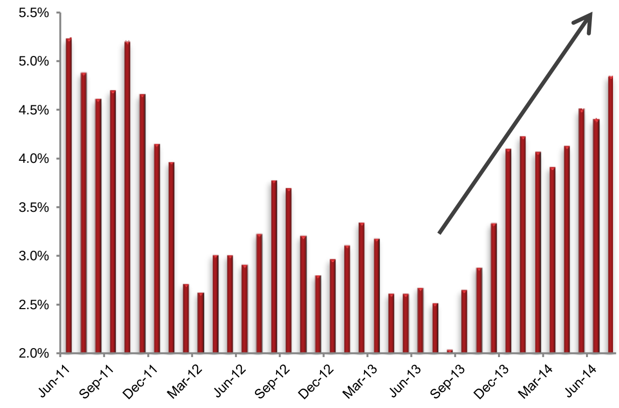
Inflation on the rise. Consumer prices for the month of July came in at 4.9% year on year, higher than the Bloomberg consensus estimate of 4.6%. This was likewise higher than June's 4.4% read and the July 2013 inflation read of 2.5% (see Figure I). Despite the rise, year to date average inflation (4.3%) remains well within the Bangko Sentral ng Pilipinas (BSP) 3.0-5.0% inflation target. On a month-on-month basis, inflation rose by 0.6% which is higher than the previous 3-month average of 0.5%. Core inflation (a measure of inflation that excludes volatile items such as food and oil) likewise picked up to 3.0% from 2.8% last month.

Rising non-food inflation is a cause for concern. Food inflation registered the highest pace of increase at 8.25% (see Table I), contributing 3.2% to inflation. Taking a closer look, rice prices which accounts for 10.0% of the inflation basket, drove food inflation higher (July +14.4% vs June +13.6%). Rice supplies further declined in July amid huge withdrawals due to losses brought by typhoon Glenda. What caught the eye of the monetary officials was the rise in the prices of non-food items, a sign that inflation was spilling over to the rest of the inflation basket.

Above-target inflation elicits more monetary policy tightening. Inflation has continued its ascent after it decelerated in June. We expect inflation to reach its peak next month (see Figure II), breaching the higher-end of the central bank's target of 5.0% but should stabilize for the balance of the year. Harvest season and arrival of rice imports in the 4Q will ease rice price pressures. Moreover, base effects will also come into play. For the rest of the year, we expect inflation to average at 4.6% translating to a 4.4% (higher than Bloomberg consensus estimates of 4.2%) average inflation for FY2014.

Moving forward, we expect inflation to remain elevated, possibly breaching the 2.0%-4.0% target for 2015 (see Figure II). Adding to inflationary pressure is strong liquidity growth which remains above 20%, albeit on a declining trend. System wide loan portfolio growth has expanded significantly from 10% year on year in July 2013 to

Figure I. YoY Inflation



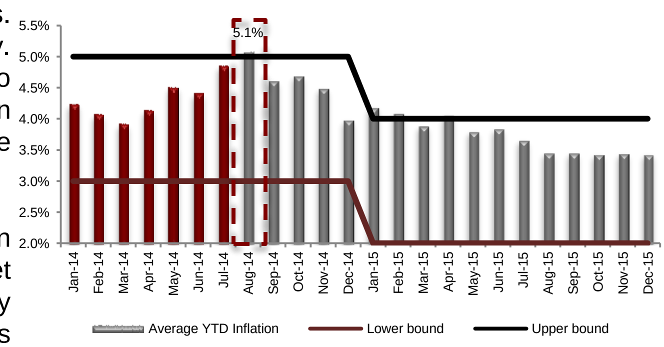
Source: National Statistics Office

Table I. July Inflation

Commodity Group	MoM	YoY
Food	**1.2%**	**8.2%**
Alcoholic Beverages & Tobacco	0.2%	3.5%
Clothing	0.2%	3.3%
Utilities	-0.2%	2.4%
Household	0.2%	2.6%
Health	0.7%	3.2%
Transport	0.5%	1.5%
Communication	0.0%	0.0%
Recreation	0.2%	1.3%
Education	0.3%	5.1%
Miscellaneous	0.2%	1.8%
All Index	0.6%	4.9%

Source: National Statistics Office

Figure II. Year-on-Year Inflation vis-à-vis BSP target



Source: National Statistics Office, BPI AMTG forecasts a high of 20% in May 2014 as corporates took advantage of the low interest rates prior to rising rates.

To avoid overleveraging, the BSP is seen raising policy rates further to temper credit expansion. The BSP aims to rein in liquidity and correct negative real rate of returns (short term time deposit rate less the inflation rate), amidst improving economic fundamentals in the US economy. Note that the Federal Reserve previously indicated the start of lift off would be at the end of 1H2015. Above-target inflation, coupled with greater certainty of a rate Fed rate hike in 2015, raises the possibility of another 25 basis point increase in Reverse Repurchase rate (RRP) or SDA as early as next month's (September) Monetary Board meeting.

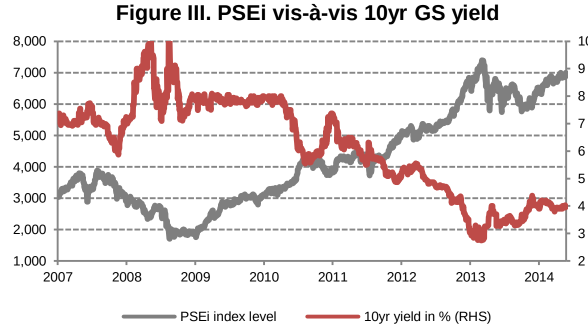
Financial Market Implications

USD/PHP to remain supported. In the near-term, expectations of more pre-emptive rate increases from the BSP in 2014 will keep the PHP well supported relative to the USD. However, as we approach 2015, investors will start to price in upward adjustments to US interest rates, inducing the Peso to weaken (funds are expected to flow back to the USA as Fed rates rise). We reiterate our year end forecast of Php44.256 to USD$ 1.00.

Shorts to rise further. As at August 11, yields on the short-end of the yield curve have risen by 111 basis points year-to-date. More tightening actions from the BSP either an SDA rate hike or another increase in the policy rate, will place upward pressure on the yields of short date bonds. Likewise, the scheduled 20-yr FXTN auction this month is seen to lift yields on the long-end of the curve.

PSEi to rise despite rising interest rates. Historically, the Philippine Stock Exchange index (PSEi) declined during periods of rising rates (see Figure III). The natural tendency was for investors to raise allocation to safe-haven assets (short-tenored bonds and floaters) which provided higher yields and depressed share prices in the process. However, fixed income instruments with tenors shorter than 20 years are currently yielding negative real returns. The combination of declining fixed income yields and strong earnings growth of 15% year on year for 2015 (led by the Industrial sector +27.8% year on year in 2015) are compelling investors to allocate a greater proportion of their funds to equities (thereby providing strong support to the PSEI on weakness). At 19.50x PER for 2014 earnings, the PSEI is not cheap trading at a 56.2% premium to MSCI Asia ex-Japan. The risk of further downgrades in target prices on account of a higher discount rate (every 1% increase in long-term interest rate, industry NAV will decline by 7.13%) will only aggravate concerns about the wide premium Philippine issues currently have over their regional counterparts. Good earnings visibility in 2015 and having the least earnings vulnerability to interest rate risk (average gearing ratio of only 50% for stocks in the PSEI) will maintain both foreign and local investor interests in the PSEI high. All told, the imminent rise in interest rates will not have a dampening impact on the PSEi, thus we reiterate our in-house forecast of the PSEi of 7,033 by year-end.

Figure III. PSEi vis-à-vis 10yr GS yield



Source: Bloomberg

Table II. 2015 EPS Growth of Index Members

	2015 EPS Growth
Financials	13.4%
Holding Firms	14.9%
Industrials	27.8%
Mining & Oil	10.4%
Property	17.5%
Services	8.1%
PSEi	

Source: Bloomberg, BPI AMTG estimates

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