

August 2009 Review and Near-Term Outlook

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In August, the S&P 500 Index rose 3.4% to close at 1,020.62, and the Dow Jones Industrial Average Index (DJIA) climbed 3.5% to 9,496.28, as economic reports ranging from consumer confidence to home sales beat economists' forecasts. Banking and financial stocks enjoyed by far the biggest gains for the month, with the S&P 500's financials basket rising 13%. This was more than triple the month-on-month (MoM) increase in that index's industrial basket, the sector which posted the second-fastest growth in August. It is worth noting that the S&P 500 has advanced for six consecutive months now – the longest uninterrupted stretch of monthly gains since January 2007.

Asian stocks rose as well, sending the MSCI Asia Pacific Index to 113.65 by end-August, or 61% above the five-year low touched last March 9th. Meanwhile, the Philippine Stock Exchange Index (PSEi) increased by 3.1% MoM and 54% YTD, ending at 2,284.18. The sense among investors was that various governments' stimulus packages and lower borrowing costs would revive the global economy.

Although world oil prices rose by 0.7% during August and 57% in the year to date (YTD) period, crude for October delivery fell by US\$ 2.78 / bbl, or 3.8%, to settle at US\$ 69.96 / bbl on the New York Mercantile Exchange.

For the second quarter of 2009 (2Q09), the Philippine economy expanded by 1.5% year-on-year (YoY), three times the pace expected by economists, thanks largely to stepped-up government spending. This better-than-expected GDP number calmed the stock market, lifted sentiment, and tamed foreign exchange and interest rates. Many analysts and government officials believe the economy should continue to avoid a recession, and remains on track to achieve a 1.8% growth target for this year.

Another encouraging indicator has been inward remittances, which climbed 3.3% YoY in June and 3% YoY for the first half of 2009 (1H09), reaching a level of US\$ 8.5 billion by end-1H09.

The Philippine Peso dropped towards the end of August, trading at PHP 48.81 / US\$, according to our affiliated firm, Tullett Prebon Plc. The currency's 3% YTD weakening has helped boost the equivalent Peso value of remittances, thus spurring growth. According to the Bangko Sentral ng Pilipinas (BSP), the Peso has room to soften further to as low as PHP 49.50 / US\$ in the current quarter, and this modest depreciation should help sustain private consumption.

Inflation has remained benign, as headline inflation for August contracted to 0.1% YoY. This was in marked contrast to the 12.5% peak rate posted for the same month last year. Indeed, falling inflation partly explained the recent rise in share prices, to the extent that increased consumer purchasing power has helped to fuel corporate earnings growth. Meanwhile, the downtrend in interest rates both trimmed borrowing costs and boosted asset prices (hence, equities' increased attractiveness compared to fixed income investments).

Your Funds continued their strong performance despite some instability toward the end of August. The ATR KimEng Equity Opportunity Fund appreciated 2.96% MoM and 34.66% YTD, closing at PHP 1.7302 / share. The Kabuhayan Fund similarly fared well, rising 2.11% MoM and 22.23% YTD to PHP 1.1336 / share. The MFMCP-Aizawa Trust Philippine Fund gained 1.10% MoM and 29.81% YTD to end at US\$ 65.28 / share.

Looking forward, at the rate the equity markets have been posting gains lately, one would think all those "green shoots" have turned into full-grown trees in just a matter of weeks. While a fundamental case can certainly be made that share prices have further to climb in the long term, in the near future, however, the market appears to be getting a little too frothy, and therefore fragile. Ominously, September has historically been the worst month for U.S. stocks, with the DJIA losing 1.3% MoM on average since 1928, according to data compiled by Bloomberg.

The second quarter results reporting season, meanwhile, is out of the way, with better-than-expected numbers already discounted by the local market. There is also the question of just how much of the 2Q09 growth was driven

by inventory rebuilding as opposed to end-user demand. As for interest rates, the indication is that the bottom has been reached; and inflation is expected to inch up beginning in September, in step with a widening budget deficit.

In the meantime, the PSEi's valuation has already bounced back to pre-crisis levels, i.e., to 17 times consolidated earnings of the past four quarters. This already marks a 10% premium to the 11-year average P/E of 15.4x, and is the market's highest multiple since June 2007 (17.9x then), just before the U.S. subprime mortgage crisis turned into a catastrophe affecting financial markets and real economies around the world. In addition, from a bottom-up viewpoint, there are more local stocks that are now fairly valued, if not overvalued.

Inflation could still come off in August, but will probably start creeping up thereafter, as we need to bear in mind the fact that oil prices peaked at US\$ 147 / bbl in July last year. Generally, low inflation translates to higher P/E multiples. However, the PSEi's average P/E during periods when inflation ranged from zero to 4% was only 16.6x, or slightly less than the current earnings multiple. Assuming that inflation remains at current levels, the market now looks fully valued, and bereft of near-term upside.

Either share prices must fall by about 23%, or profits must jump by 30% in order to justify current valuations. Tellingly, the 17x current market P/E also translates to an earnings yield of just 5.9%, which is well below the 8% return on 10-year Philippine Treasuries. From this standpoint, investors are now better off holding on to risk-free sovereign paper. Conversely, given the prevailing 8% Treasury yield, we estimate that a more appropriate market P/E should be 13.1x, which implies a 23% downside from the PSEi's current level. Given that a 30% upgrade in corporate profits seems unlikely to be achieved until next year, at the earliest, we anticipate a correction in the near term.