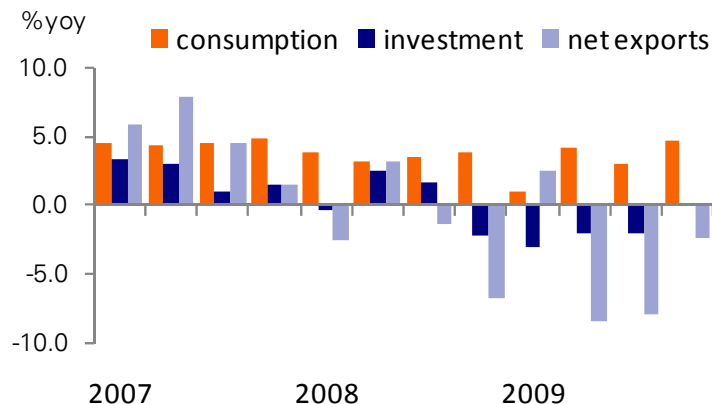




12 February 2010

Philippines Monthly Update

- **Economic outlook:** High frequency indicators suggest a clear economic recovery.
- **Main risks:** Inflation could rise faster than expected if world oil prices were to trend upward again.
- **Strategy recommendations:** On a risk-reward basis we like being short USD/PHP at current levels.



Source: Deutsche Bank

Market Update

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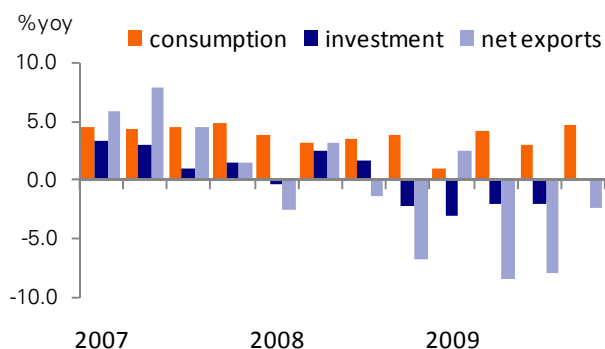
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Macro View

Clearer signs of economic recovery are emerging

Real GDP rose by 1.8%yoy in the fourth quarter of 2009. On the production side, growth was supported by industry (1.1%yoy) and services (4.2%yoy). Typhoons Ondoy and Pepeng hurt agriculture (-2.8%), particularly affecting coconut production (-11.4%yoy) and fisheries (-7.2%yoy). On the expenditure side, both private (5.1%yoy) and public (12.1%yoy) consumption grew strongly, likely helped by strong remittances and the fiscal stimulus program, respectively. Real investment growth, however, remained in negative territory (-0.8%yoy), while exports (-10.0%yoy) continued to drag down growth.

Contribution to real GDP growth

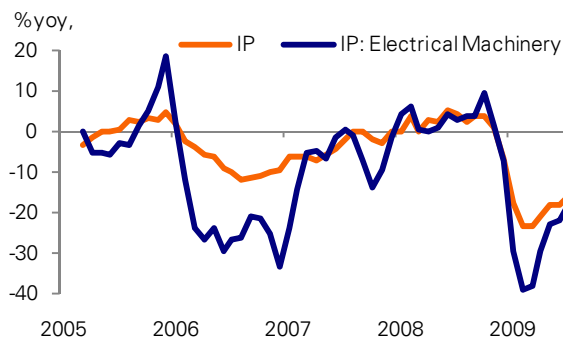


Source: CEIC, Deutsche Bank

Average growth for the year was 0.9%yoy, making it the weakest year since the Asian crisis. Going forward, we expect growth to pick up strongly in the first half of 2010, due to recoveries in investment and exports. There will likely be some drag though as the contribution from public spending wanes. Growth would likely average 3.5% in 2010, in our view.

Supporting the GDP development, Industrial production rose by 6.5%yoy in November, reversing from a 5.0% (revised) decline in October. By sector, electrical machinery (25.1% in Nov. vs. -5.9% in Oct.), petroleum products (22.5% vs. -22.3%), manufactures (56.7% vs. 24.5% .), basic metals (48.8% vs. 44.5%) and machinery excluding electrical (9.0% vs. -7.6%) all posted strong growth in November. Also, in value terms, IP improved in November, rising by 2.1% following 9.9% decline in October. Meanwhile, the average capacity utilization was broadly stable at 82.6% (82.3% in Oct.) in November. Looking ahead, we expect IP growth to improve further in the coming months on the back of strong external demand.

Industrial production is trending up



Source: CEIC, Deutsche Bank

Additional signs of recovery are apparent in the trade figures

Exports rose by 23.5%yoy through December, broadly in line with our expectations. 57% of total exports were electronic products (up 40.9%yoy), with exports growth to China and the US turning positive. Imports, through November, have also begun to pick up (up 4.2%yoy), primarily due to higher commodity prices.

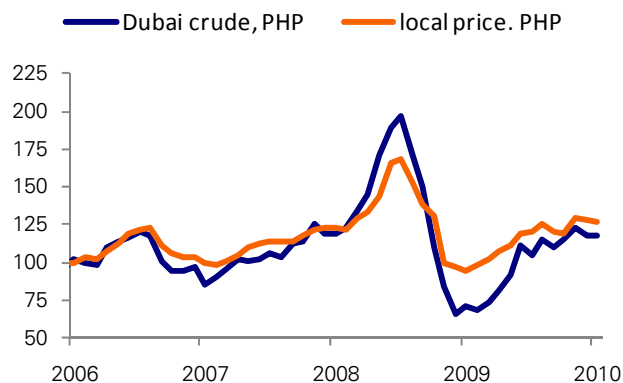
With respect to price developments, after a higher-than-expected outturn in December, January inflation was substantially lower than expectations. Inflation eased to 4.3%yoy from 4.4% in December (we had expected 5%yoy). Food and beverage prices remain remarkably muted, with the index up just 0.1%mom (4.3%yoy). Despite worries about the impact of poor weather late last year, rice (3.9%yoy) and corn (-0.1%yoy) prices remain remarkably under check. Last month's inflation outcome was driven by sharply rising fuel prices, but similar pressure was not replicated in January. As a result, categories like fuel/light/water (0.2%mom, 9.2%yoy) and transportation (0.9%mom, 6.9%yoy) took a breather in January. Core inflation eased to 3%yoy (3.2%yoy in December). **Given the benign inflation trajectory, we are changing our monetary policy call: we now expect that BSP would wait till May before it begins its policy rate hike cycle.**

This call is subject to the risk the global commodity prices shoot up

At present, domestic oil prices closely reflect international prices (see chart below). Our in-house forecast sees world oil prices either decline or remain flat for the rest of the year as inventories, demand outlook, and supply side developments point to a somewhat benign. Given our prediction for world oil prices to be higher by no more than 15%yoy in 2010, and our expectation that the peso would appreciate by about 4% on the back of rising export earnings and strong remittance flows, the upside risk to inflation from commodity prices is limited, in our

view. Hence price developments would be more a function of food production and domestic demand.

World crude price and local pump price, Oct 2005=100



Source: Bloomberg, Department of Energy, Deutsche Bank

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Investment Strategy

FX: The PHP has weakened in the past month due to heightened risk aversion in the region. Fundamentally, we think there remains scope for PHP appreciation, underpinned by solid growth in FX remittances and exports recovery this year. Moreover, we note that BSP has started to express its inclination to use currency appreciation to counter against inflation – minutes of the December MPC meeting recorded that “the appreciation of the peso resulting from foreign exchange inflows could temper the increase in domestic prices of imported commodities.” We like to sell into the recent bounce in spot (3M NDF entry at 46.80 and spot ref. at 46.35) with an initial target of 45 in spot, but keep a tight stop-loss at 47.20 due to weak market sentiments at this juncture. The risk to this trade would be a continuation of risk aversion which could lead to more equity outflows from the region.

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Deutsche Bank forecasts

	2008	2009F	2010F	2011F
National Income				
Nominal GDP (USD bn)	166.3	160.4	185.7	214.5
Population (mn)	89.1	90.2	92.5	94.8
GDP per capita (USD)	1867	1778	2009	2263
Real GDP (YoY%)				
Private consumption	4.7	3.8	3.2	5.1
Government consumption	1.6	8.5	3.0	2.9
Gross fixed investment	2.1	-3.5	4.9	6.3
Exports	-2.1	-14.2	2.2	5.0
Imports	2.7	-5.8	3.1	6.2
Prices, Money and Banking				
CPI (YoY%)	9.3	3.4	6.0	5.6
Core CPI (YoY%)	6.2	4.2	4.3	5.0
Broad money (M3)	8.1	9.5	10.0	12.0
Bank credit ¹ (YoY%)	12.7	7.0	10.0	14.0
Fiscal Accounts (% of GDP)				
National government surplus	-0.9	-3.8	-3.5	-2.6
Government revenue	16.2	14.5	15.4	15.4
Government expenditure	17.1	18.3	18.9	18.1
Primary surplus	2.3	-0.2	0.1	1.0
External Accounts (USD bn)				
Merchandise exports	48.3	37.4	45.3	49.8
Merchandise imports	61.1	45.1	53.0	58.2
Trade balance	-12.9	-7.7	-7.6	-8.4
% of GDP	-7.7	-4.8	-4.2	-4.0
Current account balance	3.9	6.6	8.7	9.8
% of GDP	2.3	4.1	4.8	4.7
FDI (net)	1.1	0.3	0.2	1.0
FX reserves (USD bn)	32.6	38.3	47.0	57.5
FX rate (eop) PHP/USD	47.5	46.4	45.0	43.0
Debt Indicators (% of GDP)				
Government debt ²	64.2	66.2	67.4	62.5
Domestic	33.5	35.1	35.5	33.5
External	30.7	31.1	31.9	29.0
Total external debt	33.9	34.8	30.5	26.8
in USD bn	53.9	57.5	56.0	58.0
Short-term (% of total)	13.0	13.0	14.3	14.7
General				
Industrial production (YoY%)	-14.2	-5.0	5.0	8.0
Unemployment (ILO) (%)	7.7	8.3	8.1	7.9
Financial Markets				
	<i>Current</i>	<i>3M</i>	<i>6M</i>	<i>12M</i>
BSP o/n repo	6.00	6.25	7.00	7.00
BSP o/n reverse repo	4.00	4.25	5.00	5.00
3-month treasury bill	4.10	4.40	4.90	5.15
10-year yield (%)	8.09	8.20	8.50	8.70
PHP/USD	46.5	45.5	45.0	44.8

Source: CEIC, DB Global Markets Research, National Sources
Note: (1) Deposit money bank credit to the private sector. (2) Incl. guarantees on SOE debt.

Appendix 1

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