Philippine Financial Markets Outlook 2011

January 20, 2011

Passion to Perform

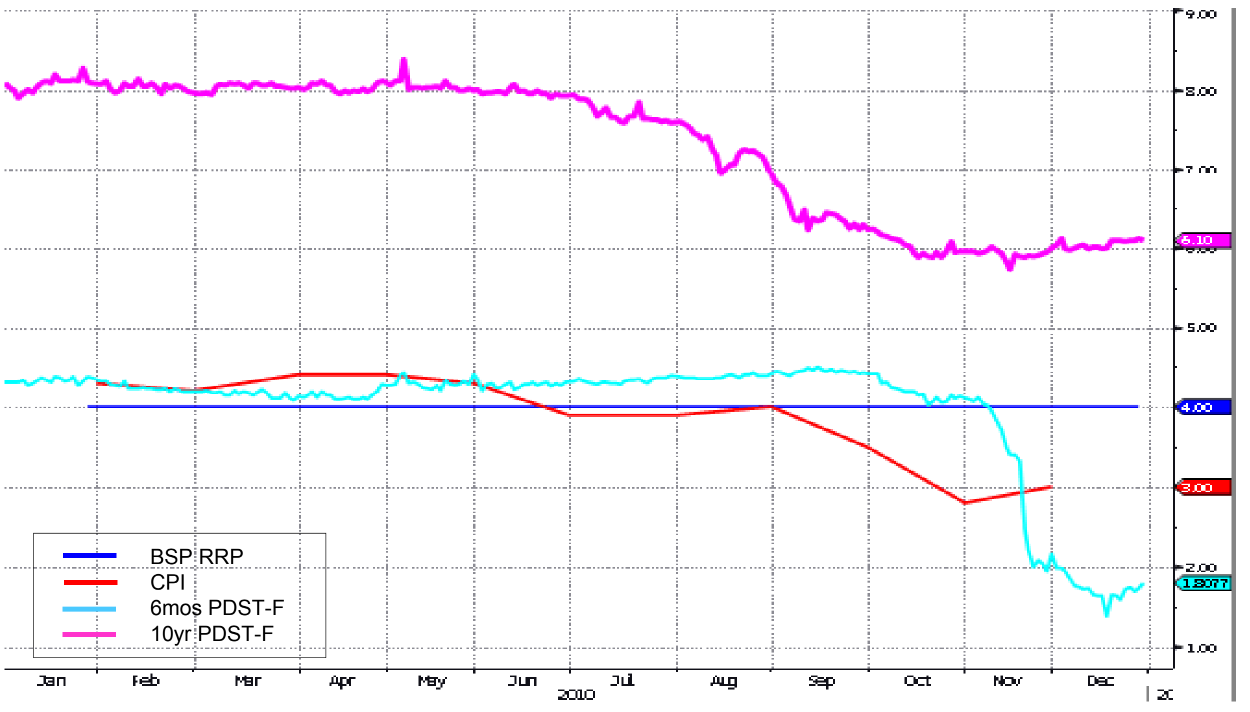
Outline

- 2010 Scorecard
- Global Outlook for 2011
- 2011 Philippine Outlook
- Risks

2010 Scorecard

Forecast: BSP O/N RRP 1.0% ↑
10yr FXTN 8.75%

- ✗ Flat BSP O/N RRP
- ✗ 10yr FXTN 6.10%



Source: Bloomberg

- BSP did not raise rates due to benign inflation averaging 3.8% in 2010 (versus 3.2% in 09) well within the government's forecast of 3.5% - 5.5%. Higher food prices offset by slowdown in fuel, light and water
- Domestic liquidity with over PHP 1.2trn parked in the BSP SDA and PHP 285bn in the BSP reverse repo
- Resumption of fiscal effort; cumulative deficit as of Nov 2010 posted at PHP 269.8bn, within the government's target of PHP 325bn full year budget deficit

2010 Scorecard

Forecast: PHP 44.00/ US$

✓✓✓✓ PHP 43.84 in 2010

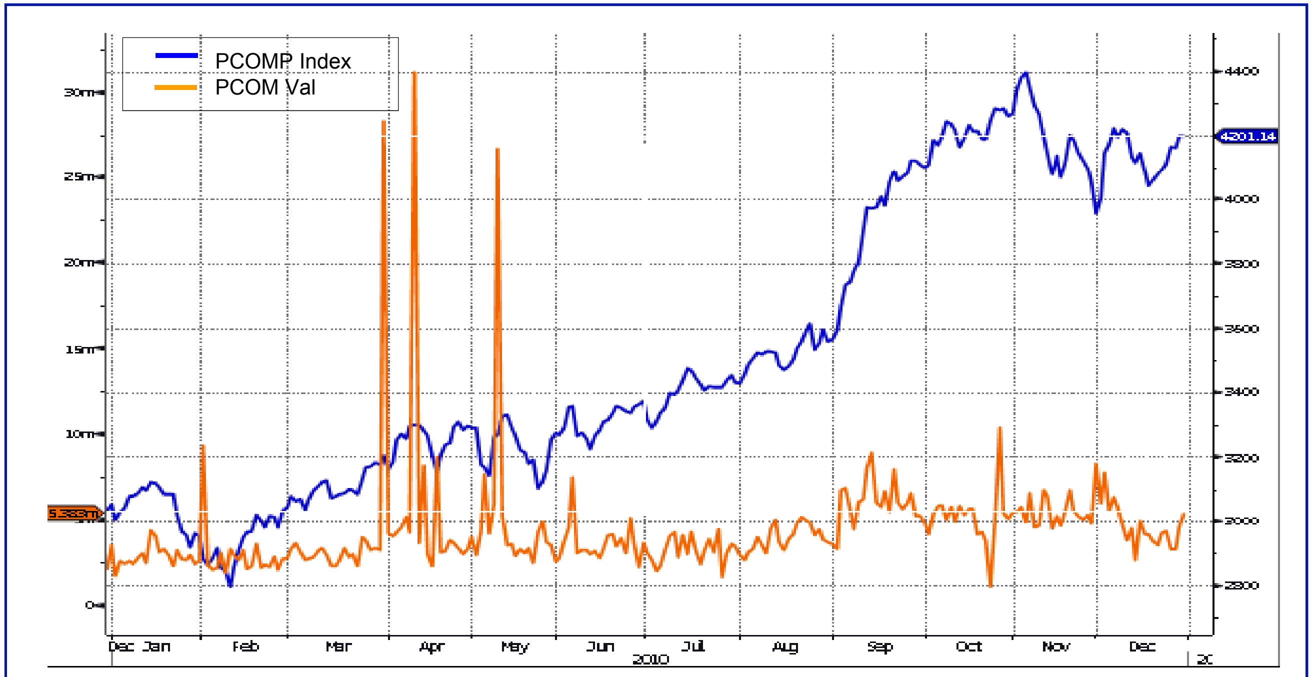
USD/PHP 43.84

Source: Bloomberg

- PHP appreciated 5% in 2010, ranking in the middle amongst its Asian peers (MYR and THB around 10% while KRW and CNY around 4%) on weak dollar global outlook
- OFW remittances remained strong posting a 8.2% yoy growth as of Nov 10 and BPO earnings estimated at USD 7bn, fuelling consumption and leading to a BOP surplus of USD 14.4bn in 10 and all-time high GIR level of USD 62.1bn (with FX swaps of USD 19bn)
- Positive business outlook
- Foreign portfolio investments at USD 4.2bn as of Nov 10, 9x higher than USD 431mn in Nov 09

2010 Scorecard

Forecast: Flat is the new UP/3200 × Massive overshoot 4201.14



Source: Bloomberg

- PSE index up 38.5% (from 3005.01) due to market earnings (up 36%) and sound macroeconomic fundamentals – low interest rate scenario, 6.8% (F) GDP growth, benign inflation and business optimism
- Ave. daily turnover increased from USD 64mn/day in 09 to USD 100mn/day
- Domestic investors looking for yield enhancement
- Flow from offshore investors shifting to EM assets- foreign investors increased contribution to ave. daily turnover from 35% in 09 to 43%

2010 Scorecard

Forecast: US Fed Funds 1.25%
10yr US Treas. 4.75%

×× ZIRP maintained in 10
×× 10yr US Treas. 3.29% in 10 vs. 3.83% in 09

Source: Bloomberg

- Fed maintained ZIRP due to continued concerns on solid economic growth
- European sovereign concerns led to massive flight to quality and further enhanced by QE2 pronouncements leading to sub 2.5% yield in 3Q10
- Towards year end, moderating expectations of QE2 saw yield rise again with 10 yr Treasuries at 3.29% by year end

2010 Scorecard

Forecast: EUR/USD 1.35 – 1.40 (1st 6 mos)

Source: Bloomberg

✓ EUR/USD 1.33 – 1.45 in 1Q
Low of 1.19 in June 8

	Gen. Govt Surplus/ Deficit			Gen Govt Debt		
% of GDP	2010F	2011F	2012F	2010F	2011F	2012F
Germany	-3.8	-2.8	-2.1	74.7	75.3	75.5
France	-7.6	-6.2	-4.8	83.7	87.3	89.2
Italy	-5.0	-4.1	-3.1	118.8	119.5	119.1
Spain	-9.0	-6.5	-4.8	65.0	70.2	73.2
Netherlands	-6.0	-4.6	-3.5	65.1	67.5	68.7
Belgium	-4.7	-3.9	-3.2	97.2	97.2	97.1
Austria	-4.4	-3.5	-2.7	70.2	71.5	72.2
Finland	-3.3	-2.2	-1.6	48.1	47.8	47.3
Portugal	-7.5	-6.0	-4.8	84.1	90.2	93.2
Greece	-9.9	-8.0	-6.6	140.9	147.9	148.8
Ireland	-11.8	-9.5	-7.9	95.0	113.8	117.9
EA-16	**-6.0**	**-4.8**	**-3.7**	**84.9**	**87.3**	**88.3**

Source: Deutsche Bank CIB Research

- Largest driver of EUR/USD was fiscal pressure in the EU periphery, also sovereign risk concerns and decline in equity inflow
- PIGS countries suffer from three problems:
  - excessive government deficits and debt
  - a very fragile banking system
  - a bloated non-traded goods sector and lack of international competitiveness

Key Trends in 2010

- In Nov 2010 the FOMC announced a new large-scale Treasury purchasing programme (QE2). It intends to purchase USD 600bn by mid-2011, a rate of about USD 75bn per month
- The European Union (and IMF) responded to the crisis through a number of measures including, a support package of EUR 85bn for Ireland, the Greek bail out package of EUR 110bn and the EFSF fund of EUR 440bn which combined with the EFSM and IMF's commitment provides a EUR 750bn support facility
- BIS 3 guidelines released in late 09/early 10 detailing financial sector supervision on bank capital framework, risk coverage, systemic risk, global liquidity standards, etc.

Global Outlook 2011

- Following its deepest downturn on record, the global economy has bounced back to modestly above-trend growth in 2010 and we project it to grow at a trend-like rate of near 4% in 2011 and slightly faster in 2012
- Global inflation has already rebounded from recession-induced lows. We expect it to pick up modestly but remain at or below target in the US, Europe, and Japan, and to remain elevated at 6% or more in emerging markets on average
- With inflation returning toward target levels, we expect the ECB to raise rates by Q3 2011; our US team has the Fed beginning to exit by year end 2011

Economic Forecast Summary

	GDP growth, %				CPI inflation, %			
	2009	2010F	2011F	2012F	2009	2010F	2011F	2012F
G7	**-3.7**	**2.7**	**2.2**	**2.6**	**-0.1**	**1.3**	**1.5**	**1.5**
--US	-2.6	2.8	3.0	3.4	-0.3	1.6	1.7	1.9
--Japan	-6.3	3.4	0.1	1.7	-1.4	-0.9	-0.9	-0.6
--Euroland	-4.1	1.7	1.2	1.4	0.3	1.6	2.0	1.8
EM Asia	**5.7**	**9.2**	**7.4**	**7.5**	**0.9**	**4.5**	**4.7**	**4.3**
--China	8.7	10.0	8.7	8.4	-0.4	3.3	4.1	3.5
--India	5.8	9.8	8.2	8.5	2.2	9.2	6.9	6.7
EMEA	**-5.2**	**4.5**	**4.5**	**5.0**	**7.9**	**7.7**	**7.1**	**6.8**
--Russia	-7.9	4.0	5.0	5.3	11.8	6.8	8.2	7.4
Latam	**-2.4**	**5.7**	**4.1**	**4.1**	**6.3**	**8.3**	**8.0**	**6.8**
--Brazil	-0.2	7.5	4.5	4.6	4.3	5.8	5.4	4.8
Ind. countries	**-3.6**	**2.5**	**2.0**	**2.5**	**0.0**	**1.4**	**1.6**	**1.6**
EM countries	**2.5**	**7.5**	**6.2**	**6.4**	**3.3**	**5.2**	**5.4**	**5.0**
Global	**-0.9**	**4.7**	**3.9**	**4.2**	**1.5**	**3.1**	**3.3**	**3.1**

Source: DB Global Markets Research

Global Outlook 2011- US Interest Rates

	Current	3 mos	6 mos	12 mos
10 yr US Treas	3.34%	3.50%	3.00%	3.25%

- Liquidity, limited pricing-power, balance sheet factor and lack of fiscal stimulus are likely to weigh on the recovery in the longer-term and remains supportive of the bond market
- Stretched US household balance sheets, impaired credit markets, elevated unemployment as well as risk aversion stemming from Europe could all support the US fixed income markets

Macro-economic activity & inflation forecasts

Economic activity		2010				2011				2010F	2011F	2012F
(% qoq, saar)		Q1	Q2	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F	% yoy	% yoy	% yoy
GDP		3.7	1.7	2.5	**2.7**	**3.5**	**3.3**	**3.3**	**3.2**	2.8	3.0	3.4
Private consumption		1.9	2.2	2.8	3.0	3.5	3.3	3.3	3.3	1.7	3.2	3.6
Investment		29.1	26.2	12.4	-1.6	8.1	7.7	7.6	5.7	18.2	7.4	6.6
Gov't consumption		-1.6	3.9	4.0	2.7	1.7	1.3	1.3	1.3	1.3	2.1	1.4
Exports		11.4	9.1	6.3	9.0	7.0	7.0	6.5	5.0	11.7	7.2	5.3
Imports		11.2	33.5	16.8	7.0	7.0	7.0	7.0	5.0	14.1	9.4	6.4
Contribution (pp):	Stocks	2.6	0.8	1.3	-1.1	0.0	0.0	0.0	0.0	1.5	0.0.	0.0
	Net trade	-0.3	-3.5	-1.8	0.0	-0.3	-0.3	-0.3	-0.2	-0.7	-0.6	-0.4
Industrial production										2.3	2.7	3.4
Unemployment rate, %		9.7	9.7	9.6	9.7	9.5	9.3	9.0	8.8	9.7	9.2	7.3
Prices & wages (% yoy)												
CPI		2.4	1.8	1.2	**1.0**	**1.1**	**1.7**	**1.9**	**2.0**	1.6	1.7	1.9
Core CPI		1.3	1	0.9	0.9	1.2	1.4	1.5	1.6	1.0	1.4	1.6
Producer prices		5.1	4.3	3.7	2.5	1.2	2	2.8	3.5	3.9	2.4	2.7
Compensation per empl.		3.2	1.7	1.4	2	3.3	3.6	4.0	4	2.1	3.7	4.0
Productivity		6.3	3.7	2.5	0.7	-0.7	-0.6	-1.5	-1.5	3.3	-1.1	-1.5

Sources: National authorities, DB Global Markets Research

Global Outlook 2011

Fed Funds

Current	3 mos	6 mos	12 mos
0-0.25%	0-0.25%	0-0.25%	0.50%

- Growth and inflation to rise enough to induce the Fed to begin raising rates by the end of 2011; while the economic news has been improving, the risks are still balanced toward a move being put off until 2012

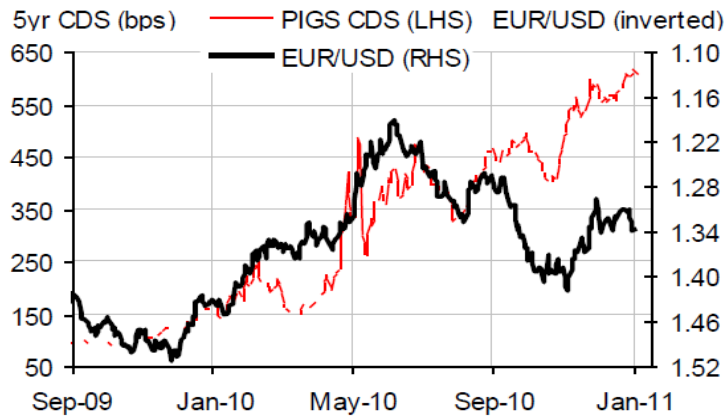
ECB Rates

Current	3 mos	6 mos	12 mos
1.00%	1.00%	1.25%	1.75%

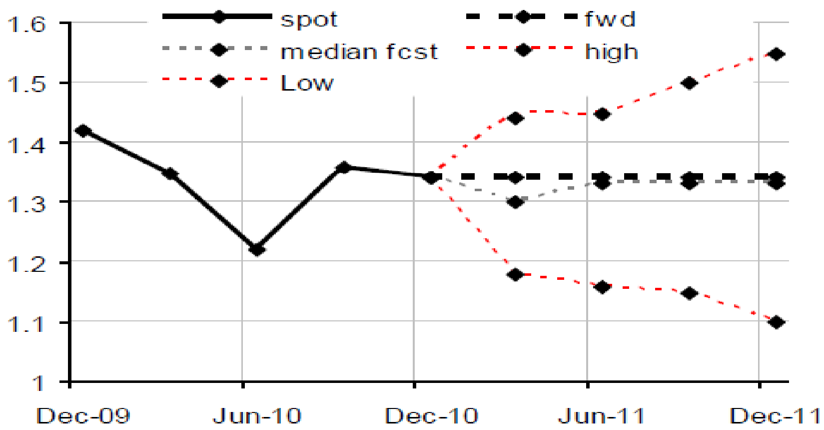
- Weaker banking sectors cut off from private funding are dependent on ongoing ECB liquidity support
- Achieving the appropriate policy stance for the euro area as a whole, taking into account stable financial and robust economic conditions in the core countries, likely means gradual rate hikes beginning in mid-2011 while liquidity remains generous
- We expect the first hike in Q2 and the refi rate to be 1.75% at end 2011

Global Outlook 2011

EUR/USD — Bearish EUR Q1, bullish beyond (1.20 – 1.40)



Sources: CEIC and Deutsche Bank CIB Research



Source: Bloomberg

- EUR trapped in choppy range but likelihood of crisis low
- No Euro collapse, despite many risks; Euro will survive because of the sheer costs of breakup
- In the near term, Portugal will go to EFSF/IMF, ECB will expand its involvement, EFSF role will be expanded
- Spain will be tested but will stay in the markets- this is key to survival of the Euro

Outlook for the Philippines 2011

- Lower growth at ≈ 5% and slightly higher inflation ≈ 3-5%
- Key factors that could help drive growth above 5% in the medium term:

  - Public spending geared toward infrastructure; on fiscal consolidation, current plans calls for the deficit to be reduced to around 2% of GDP by 2013

  - Consumption and investment are supported not only by exports, but also through steady flow of remittances, amounting close to 9% of GDP

  - BPO sector continues to expand rapidly, growing 25% a year

  - Construction sector activity has begun to pick up

  - PPP investment in road building, power projects, airports, and tourism is being encouraged by the government

  - Steady rise in working age population, which would likely push up savings and subsequently investment

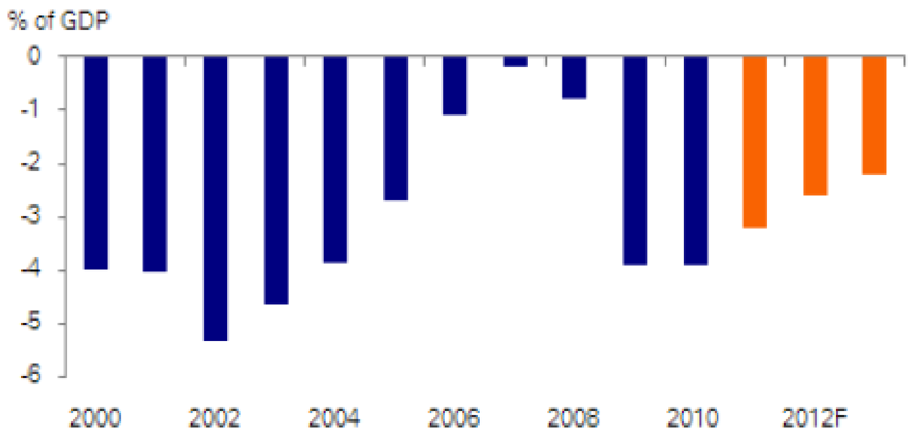
Outlook for the Philippines 2011

PHP Interest rates

	Current	3 mos	6 mos	12 mos
BSP o/n reverse repo	4.00%	4.00%	4.75%	5.00%
3mos Treasury bill	2.71%	2.50%	3.00%	3.75%
10yr yield	7.06%	6.40%	6.70%	7.00%

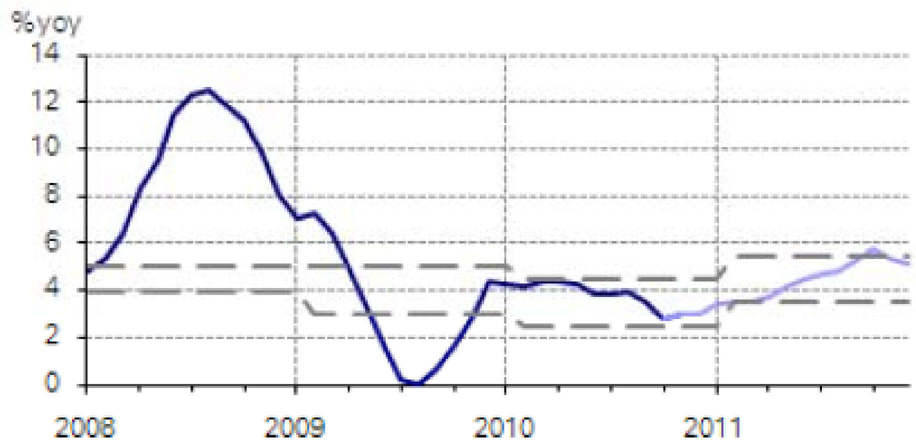
- Sustain fiscal efforts, both on revenue and expenditures likely to keep deficit at bay
- 2012 budget will be under scrutiny; tax measures a must
- Inflation could rise, monetary policy needs to be proactive

Overall fiscal deficit



Sources: CEIC and Deutsche Bank CIB Research

Inflation



Sources: CEIC and Deutsche Bank CIB Research

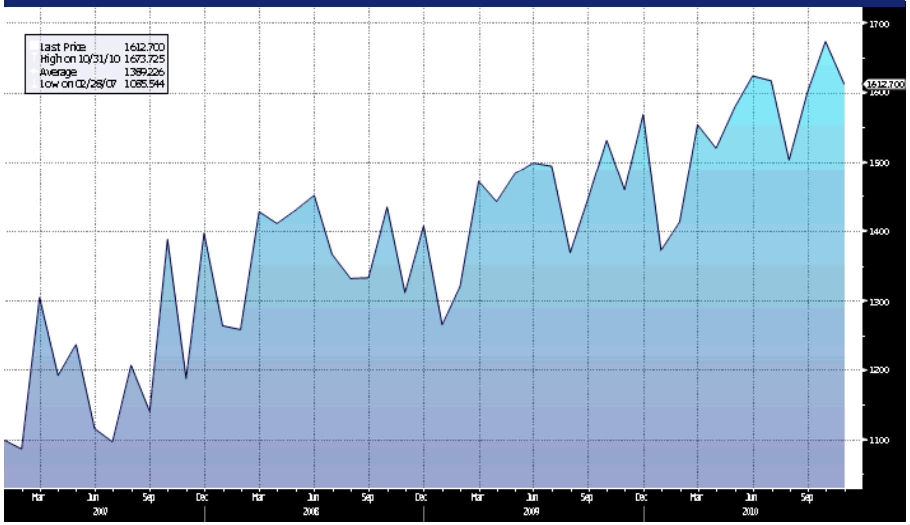
Outlook for the Philippines 2011

USD/PHP

Current	3 mos	6 mos	12 mos
44.46	43.50	43.20	42.80

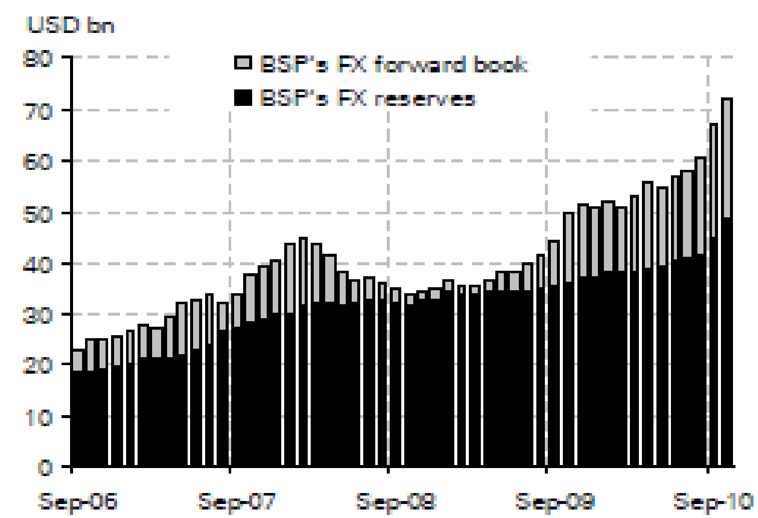
- PHP to appreciate over the medium-term, as the country’s current account is well supported by workers’ remittances and revenue inflows of the outsourcing sector
- GIR level of USD 62.1bn and FX swaps of USD 19bn can cover 1.45x external liabilities
- BSP USD liquidity management to impact the exchange rate

OFW remittances strong



Source: Bloomberg

BSP’s FX reserves and forward book



Sources: Deutsche Bank, IMF

Outlook for the Philippines 2011

Equity Market Index target 4720

- Philippines experienced a bull run in the last 2 years due to steady growth in remittances, surge in savings, availability of cheap, long-term Peso funding
- Market expected to rise with increased earnings growth forecast of 13%
- Buy infrastructure plays, construction, banks; look for strong brand, low-cost producers
- Fair valuations at 15x P/E

Year end	PCOMP	%YoY	EPS	%YoY	PER
2003	1442	42%	105	34%	14
2004	1823	26%	131	25%	14
2005	2096	15%	146	11%	14
2006	2983	42%	173	19%	17
2007	3622	21%	203	17%	18
2008	1873	-48%	164	-19%	11
2009	3052	63%	204	24%	15
2010	4202	38%	278	36%	15
2011F	**???**		**315**	**13%**	**???**

Source – PSE, Deutsche Bank

Key Risks to Philippine Outlook

1. Fiscal consolidation and commitment to improving tax collection
2. Growth levels in major trading partners US, China
3. Aquino administration honeymoon period to last (?)
4. Weather disruptions
5. Capital flow management complications to persist
6. Inflation

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