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Through the looking glass

Outlook for 2016: PH, moving forward

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"The only constant is change." –Heraclitus

Bird's eye view: A quick review of the year that was

A plethora of events, from the possibility of a "Grexit" to the much awaited "Fed rate hike" to the vaguely familiar "currency wars", directed the movement of investors and economies this year. In many ways, 2015 was another exciting year with an over-arching theme of an ever-evolving financial climate and economic landscape.

> *2015 was another exciting year.*

The Quantitative Easing (QE) trend

After the world economy nose-dived in 2008 as a result of the Global Financial Crisis, both emerging markets (EM) and developed markets (DM) alike enacted various measures to bring their respective economies back to more stable ground. One of the most significant and historic moves was the United States' massive bond-buying program which started more than five years ago and officially ended in late 2014. It infused over US$3.5 trillion into the U.S. Fed balance sheet to grow its assets fourfold to around US$4.5 trillion. This set forward a policy framework for other countries to prop up their trailing economies as the European Central Bank (ECB), People's Bank of China (PBOC) and the Bank of Japan (BOJ) took to easing monetary policy this year, with plans of continuing them even unto 2017.

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The Grexit

For the first half of 2015, Europe was in the limelight as economic tensions grew between the European Union (EU) and its member state Greece. Talk of Greece leaving the euro and even the EU, also known as the "Grexit", circulated as Greece's unresolved debt crisis threatened to bring down the whole EU with it, increasing investor worries that lingering effects of the global financial crisis were there to stay and that the recovery of the world economy would be halted. Eventually, negotiations with the Syrian-led Greek administration and Eurozone financial leaders resulted in a bailout deal for Greece that appeased investor concerns for the meantime.

On the other hand, across the Atlantic, the world observed the gradual revival of the U.S. economy. Signs of improvement in its labor and housing markets, close to its pre-financial crisis days, started to signal the advent of an interest rate lift off after close to a decade of near-zero levels. From this, investors have begun again to see promise in the U.S., with consensus forecast for the growth of its gross domestic product (GDP) to hasten to 2.40% year-on-year this year from a mere 1.50% in 2013. Such upbeat sentiment has strengthened the demand for the U.S. dollar over the past few months.

World Annual Economic Growth Rates

Country	2013	2014	Last (3Q15)	2015F	2016F	2017F
World	3.30	3.40	2.83*	3.00	3.30	3.50
USA	1.50	2.40	2.20	2.40	2.50	2.40
Euro Zone	-0.30	0.90	1.80	1.50	1.70	1.70
Japan	1.40	0.00	-0.80	0.60	1.10	0.70
BRICS	5.70	5.40	5.60	4.60	5.30	5.60
China	7.70	7.30	6.90	6.90	6.50	6.20
Asia (ex-Jap)	6.30	6.30	5.80	5.90	5.90	5.90
ASEAN	5.20	4.60	4.50	4.40	4.80	5.00
Singapore	4.40	3.00	1.90	2.00	2.50	3.00
Indonesia	5.60	5.00	4.70	4.70	5.10	5.50
Philippines	7.10	6.10	6.00	5.70	6.50	7.00
Thailand	2.80	0.90	2.90	2.70	3.20	3.50
Malaysia	4.70	6.00	4.70	4.80	4.50	4.90

Source: Bloomberg, BDO estimates

EM currency depreciations were driven by major reversal of current account positions from surplus to deficits.

The currency war illusion

This rising trend for the greenback however acts like a double-edged sword. It posed as a problem for world currencies, as investors lost appetite in their domestic FX and other currencies in favor of the U.S. dollar. In order to stay competitive in the foreign exchange market, economies resorted to depreciating their currencies against the U.S. dollar with analysts dubbing the devaluing phenomenon as the “currency wars”. However, in reality, EM currency depreciations were driven by the major reversal of current account positions from surplus to deficits, particularly among commodity-dependent EM economies. This reversal is owed to the plunge of commodity prices such as copper, crude oil, gold, and tighter liquidity flows as capital favored US assets on expectations that the U.S. Fed finally ends its zero interest rate policy (ZIRP). Among the key currencies, the Malaysian ringgit had fallen the most against the dollar, declining by close to 20% from its levels last year, closely followed by the Indonesian Rupiah and the Euro. In fact, a key event in the foreign exchange market this year was the Chinese Yuan’s state-intervened devaluation that shook financial markets back in August. This had supported the view that the second largest economy in the world was in trouble.

World Currencies

Currencies	2013	2014	2015	Y-O-Y%*	2016F	2017F
Euro	1.3743	1.2098	1.0862	-10%	1.06	1.10
Japanese Yen	105.31	119.78	120.45	1%	128	123
British Pound	1.6557	1.5577	1.4736	-5%	1.52	1.57
Swiss Francs	0.8929	0.9943	1.0021	1%	1.05	1.02
Chinese Yuan	6.0543	6.2055	6.4937	5%	6.60	6.60
Philippine Peso	44.395	44.72	47.06	5%	47.06	47.00
Indonesian Rupiah	12,171	12,388	13,788	11%	14,744	14,550
Malaysian Ringgit	3.2757	3.4973	4.2943	23%	4.40	4.27

World Currencies

Currencies	2013	2014	2015	Y-O-Y%*	2016F	2017F
Thai Baht	32.705	32.91	36.030	9%	37.00	36.90
Singapore Dollar	1.263	1.3255	1.4185	7%	1.47	1.45
South Korean Won	1,049.8	1090.98	1,175	8%	1,220	1,190
Vietnamese Dong	21,095	21388	22,485	5%	23,000	23,322

Source: Bloomberg, BDO estimates

*Note: A positive change reflects a depreciation while a negative change reflects an appreciation.

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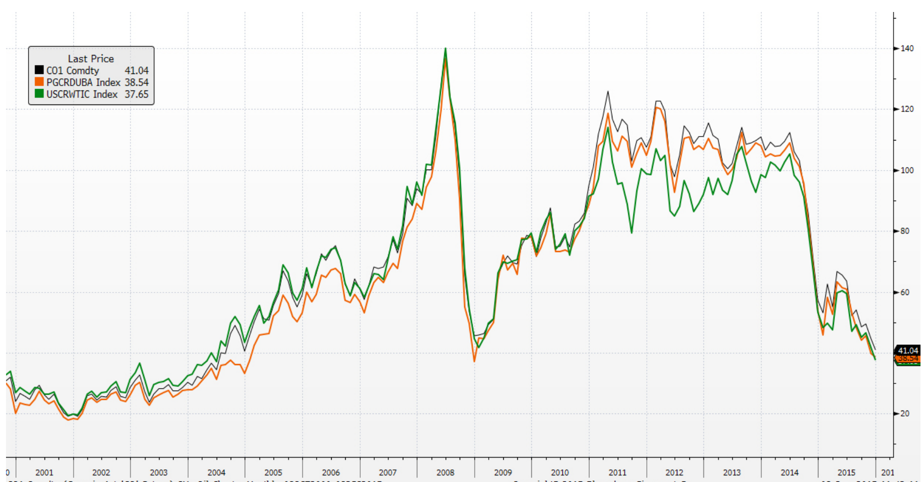
Low commodity prices and the oil supply glut

The growing demand for the greenback has also contributed to keeping dollar-denominated commodities at bay, with the global benchmarks Brent crude, Dubai crude and West Texas Intermediate crude prices trading at record lows below US$40.0 per barrel levels, half their prices just a year prior. Also keeping oil and commodity prices low was yearlong oversupply from the weakening of Chinese trade and continued US oil buildup. China, one of the main importers of oil, had suddenly begun to import less and less throughout the year leaving inventories untouched. Meanwhile, though geopolitical tensions in the Middle East seemed to support the view that the turmoil in the Middle East would hamper oil production, in the United States, oil inventories continued to build up and did not seem to stop anytime soon.



Source: Bloomberg

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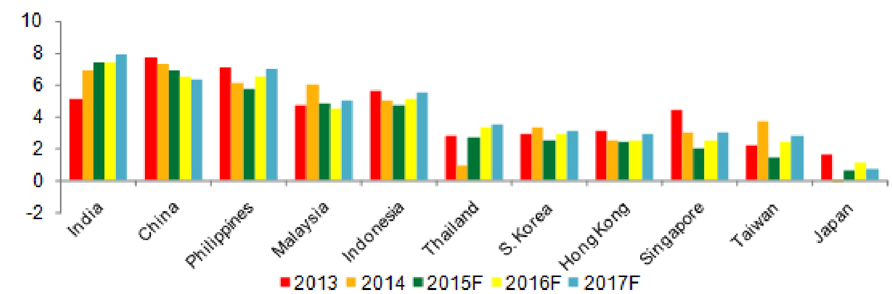
The Philippines, Asia's 3rd fastest growing economy

On the local front, the Philippines remained a bright spot in Asia for much of 2015. Just looking at the annual growth rates of its economy in comparison to its regional peers, the Philippines can still boast of maintaining its top third spot, with an average economic growth rate of 6.28% over the past five years and rosy prospects of even overtaking China in around two years time. The Philippines' nine-month GDP for 2015 rose 5.6% year-on-year (YoY), with the third quarter posting a growth of 6.0%, the fastest for the year. According to the Bangko Sentral ng Pilipinas (BSP), this quick-paced growth is owed to the government finally addressing spending bottlenecks as public spend rose at a surprising rate of 17.4% YoY from less than even 5% in the last two quarters.

Asian Economic Growth Rates 2013-2017F



Source: Bloomberg, BDO estimates

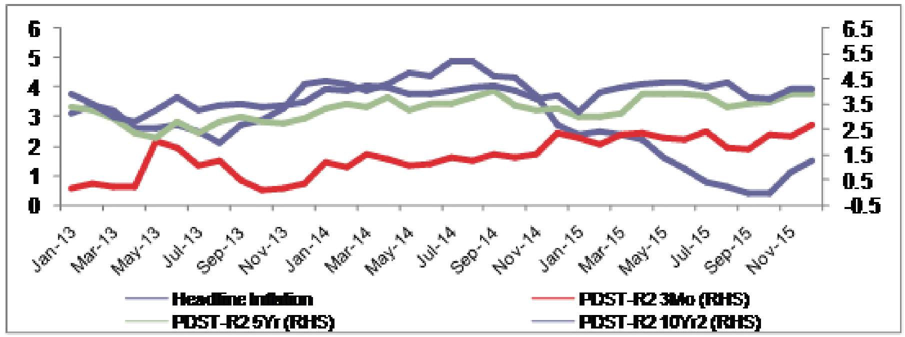
> *Amid all these, the Philippines is maintained by strong investor and business sentiment sustained by a manageable inflationary and interest rate environment.*

Strong fundamentals support the Philippines

For the period January to October of this year, the balance of payments (BOP) surplus amounted to US$2.8 billion, exceeding government targets of US$2.0 for the year and registering a reversal of last year's BOP deficit of US$2.9 billion. Despite an overall weakening of export demand, the Philippines' external position remains robust as its current account logged a surplus of US$4.69 billion in the 1st half of 2015, or around 3.3% of GDP for the same period.

Amid all these, the Philippines is maintained by strong investor and business sentiment sustained by a manageable inflationary and interest rate environment. Despite the scare of an El Niño hiking up the overall level of prices, ample food supply and low global oil prices keep local inflation in check, to reach fresh lows of 0.4% for September and October and average at 1.4% year-to-date (YTD), below the Bangko Sentral ng Pilipinas (BSP)'s target 1.6% full year forecast. Meanwhile, the BSP kept rates unchanged for the tenth straight monetary board meeting in December with the view that current policy settings remain appropriate. However, come second quarter of 2016, the BSP is slated to introduce an "interest rate corridor" (IRC). The IRC is a new auction facility that the BSP believes will aid the market determine its main policy rate. In a sense, the overnight lending rate (repurchase rate or RP) currently at 6% will act as a ceiling while the special deposit account (SDA) of 2.5% will be IRC's floor rate. Keeping the overnight borrowing rate (reverse repurchase rate or RRP) at 4% through the term deposit auction facility will give banks the space to deposit money with the BSP for a short term.

Philippine Inflation and Interest Rates 2013-2015



Source: Bloomberg, BDO estimates

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Changing consumer habits and business strategies

Consumer spending remains the lifeblood of the economy, firmly growing by 5.6% on average from 2010-2014. 2015 seems to be no different, having shown no signs of decay, from expanding at an average of 6.2% for the first three quarters of the year. It continues to contribute an estimated 70% of the economy with its robust performance fueled by the business process outsourcing (BPO) industry's expanding revenues and overseas Filipino worker (OFW) remittances. However, it is important to note that the spending habits of Filipinos are changing, most evident in the retail, food, and housing sectors.

In the commercial sector, we see an ever-evolving retail format beginning with the proliferation of convenience stores, suited for the booming BPO sector in the country. The most recent addition to the slew of 711's, Ministop's, Family Mart's and All Day Convenience Stores is Puregold Price Club debut of Japan's Lawson chain in the first quarter. Aside from the convenience store model, pop up restaurants, food trucks and food delivery services are paving a new path for the food and retail business. Malls are no longer the main retail space for budding businesses as becoming vastly popular in Manila are pop up food hubs in different parts of the metro. Due to the health trend, "healthy" or diet food delivery services catered to the everyday office worker have mushroomed throughout key Metro Manila cities.

In real estate, the gradually expanding middle class— especially driven by the growth of the BPO sector— has changed the strategy of real estate developers as they seek to take advantage of the shift in consumer dynamics. The congestion and heavy traffic in key cities like Makati, Taguig and Pasig is pushing the upper middle class to live in nearby provinces or suburbs. Commercial and housing development has branched out beyond the metro as developers and retailers consider areas like Cebu, Davao, Bacolod and Clark as preferred areas for their new projects.

On the other hand, due to the unconventional hours of many BPO employees, these call center agents prefer to live near their place of work in the city. In both cases, we see the trend of integrated development projects or 'self-contained communities' where residential properties, office space, schools and shopping centers are easily found near each other to create convenient pocket communities.

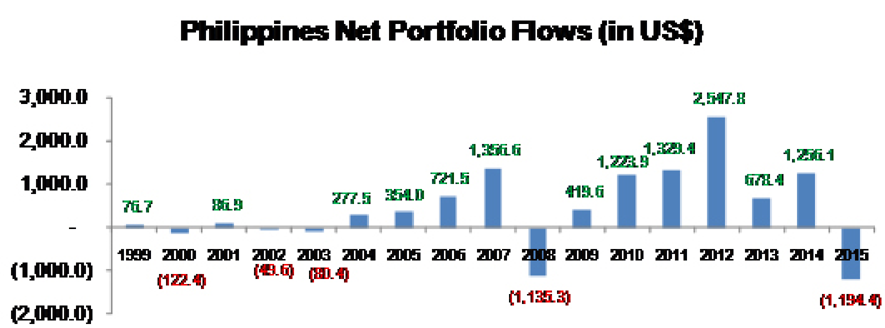
"Here the focus moves away from the National Heritage Sites and long-celebrated historical attractions to area-specific or activity-specific tourism.

Another business innovation in the Philippines stemmed from the government's thrust to promote tourism and showcase the natural beauties and attractions of the Philippines is boutique tourism. Here the focus moves away from the National Heritage Sites and long-celebrated historical attractions to area-specific or activity-specific tourism. Local communities are being promoted as their own go-to-destinations beyond the ever-famous white sands of Boracay or the great Banaue rice terraces. Now there are tourist spots like the Camarines Sur water sports complex, fondly dubbed "Cam Sur" or the surf haven of La Union and Siargao.

Investment can still grow

Despite all these business opportunities, foreign direct investment (FDI) in the Philippines remains in the lower bracket among its ASEAN neighbors. In 2014, the Philippines was only able to bring in US$6.2 billion, way behind Singapore, Indonesia, Thailand and even Vietnam. The FDI contribution to the economy also stands at a measly 1.4% to GDP as of 2013, the lowest in the whole ASEAN. Business sentiment remains hampered by restrictive business laws as well as political tensions in the country.

Philippine Historical Stock Market Net Portfolio Flows



Source: Bloomberg, 2015 figure as of 29 Dec 2015

This can also be seen in the stock market where net portfolio flows for the year logged a net outflow of approximately US$1.19 billion, a near reversal from the US$1.26 billion net inflow registered in 2014. 2015's net outflow already surpassed the lowest level of US$1.14 billion back in 2008. Between 2008 to 2015 however, we saw growing net foreign inflows from boosted investor confidence in the country and the bourse. However, market instability and volatility is driving investors away as less than half of the initial 10 new stock listings pushed through this year. The high valuations of the Philippines' equities could just as well be driving investors away as the low growth in returns does not match the high costs of the stocks.

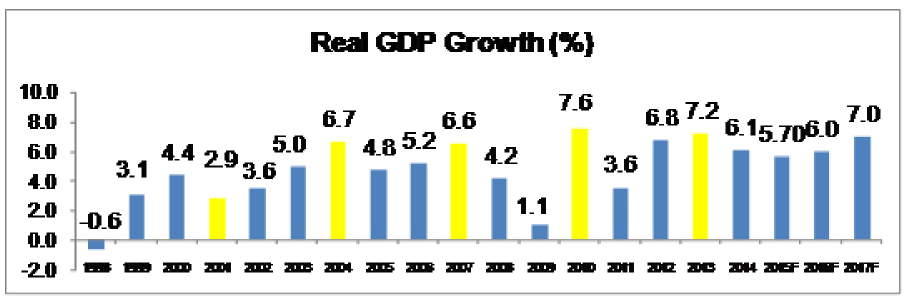
> *Despite the setback in investments, the Philippines remains to be on the path of growth and success.*

High hopes remain

Despite the setback in investments, the Philippines remains to be on the path of growth and success. This is especially true considering how 2016 is an election year. Looking into the expansion of the Philippine economy over the years shows a special dynamic between election years and the GDP. Except for 1998—the time of the Asian Financial Crisis—the Philippines expands at a higher GDP than previous years, especially for the 2004 and 2010 national elections.

> *…the Philippines will continue to expand by 6.00 – 6.50% range in 2016 and 6.50 % to 7.00% range in 2017, with interest rates and inflation gradually rising.*

Philippines Historical Annual Economic Growth (1998-2017F)



Source: Bloomberg, NSCB, BDO estimates

All in all, it can be said that 2015 is indeed a year marked with much uncertainty as well as much opportunity. Moving forward, the Philippines needs to work on continuing infrastructure improvements and policies that will help it catch up with the world and keep it competitive. BDO forecasts that the Philippines will continue to expand by a range of 6.00 to 6.50% in 2016 and 6.50% to 7.00% in 2017, with interest rates and inflation gradually rising. The stock market is likely to rise to the 8000 levels in 2016 if investors raise again the premium on local stocks to more than 20x price-to-earnings (P/E) ratio although a more prudent target of 7,400-7,600, P/E range of 18-19x is consistent with other stock markets globally. Potentially, investors can't discount the possibility that the local stock market could hit as high as the 9,000 level in 2017 with the assumption that the next President's administration implements and executes well major infrastructure projects needed to further boost investments. A virtuous cycle of investments, job-creation and sustained consumer spending should keep the Peso relatively stable to the 47.00 levels over the medium-term.

> *…we are cognizant of several risks and challenges that could temper our positive expectations. On the external front, geopolitical tensions in the Middle East could sharpen volatility in the prices of crude oil in the world market.*

Risks/Challenges are ever present

Despite our cautiously optimistic economic outlook, we are cognizant of several risks and challenges that could temper our positive expectations.

On the external front, geopolitical tensions in the Middle East could sharpen volatility in the prices of crude oil in the world market. Prolonged uncertainties could impact the ability of the country to deploy more Overseas Filipino (OF) work force in the region as higher fiscal deficits slow down construction activities in the region. Note that the Middle East accounts for more than 70% of the country's OF labor force and remittances. Second, China's slowdown will impact on the country's trade balance performance with exports and imports to China now accounting for 20% of our total trade balance. On the domestic side, the impact of the El Niño phenomenon exerts inflation pressure in the first half of 2015, affecting the trend in local interest rates.

"The key to navigating one's investment portfolio in a volatile and uncertain financial environment is simply to "DIVERSIFY, DIVERSIFY, and DIVERSIFY."

Navigating one's investment portfolio in uncertain times and volatile financial environment.

While our base case scenario is cautiously optimistic, investors should always structure their portfolio against a worst-case event or what others would call the "Black Swan" event. The prudent way of managing one's portfolio is to always remain diversified in the different asset classes and in currencies. Investors can look at diversifying his local investments given interesting opportunities outside of the Philippines. Investment in fixed income securities could be a mix of cash instruments for liquidity needs, investment grade bonds both sovereign and corporates, and a few non-investment grade fixed income securities to enhance yield of the portfolio. Also, having a mix of short-term to medium-term duration/maturity of fixed income investments provide opportunities for investors to re-invest maturing bond investments in a gradually rising interest rate environment or lock in their investment if rates stay persistently low in the next 3 to 5 years. Furthermore, an investor can add stocks in his/her portfolio to protect it from unexpected rise in inflation. Several studies show that stocks, while more volatile than bonds, provide higher returns than bonds over the long-run. Therefore, having an exposure of stocks (whether direct securities or combination of mutual funds) ranging from 10%-20% puts the overall portfolio in a position to take advantage of the base case scenario and as well as protect the portfolio in a worst-case event. Lastly, adding more asset classes in the form of alternative investments such as commodities, real estate investment trusts, enhance the investor's portfolio by reducing the volatility of the investments but at the same time enhancing the overall yield of the portfolio. The key to navigating one's investment portfolio in a volatile and uncertain financial environment is simply to "DIVERSIFY, DIVERSIFY, and DIVERSIFY".

Prices as of 29 Dec. 2015	**2014A**	**2015A**	2016F
GDP (%)	6.10	5.70*	6.00
CPI (%)	4.10	1.43	2.50
Interest Rates (%)			
BSP (O/N)	4.00	4.00	4.50
3M PDST- R2	2.54	2.6667	3.50
5Y PDST- R2	3.68	3.9250	4.75
FX (USD/PhP)	44.72	47.06	47.06
Stock Market (PSEi)	7,230	6,9 52.08	8,000

Source: BDO estimates

*Note: The latest GDP growth data is as of the third quarter, rising at 6.0% Y-o-Y. 5.70% growth is an estimate for the full-year 2015.