Philequity Corner (July 31, 2006)
By Ignacio B. Gimenez

STAYING THE COURSE OF REFORMS

Congratulations to President Arroyo and her economic managers for staying the course of reforms. The Department of Finance, led by Secretary Gary Teves, is doing a wonderful job in managing the country's finances. The BSP, under Governor Amando Tetangco, Jr., has been successful in keeping interest rates low and stabilizing the foreign exchange. Kudos to Trade Secretary Peter Favila, National Treasurer Omar Cruz and NEDA Director General Neri for keeping the economic direction on track.

So far, the fiscal balance is well ahead of target. Both the BIR and Customs posted significant revenue increases for the first six months of the year, driving total revenues higher by 21.1 percent. Thus, the budget deficit for 1H06 was cut down to P31.5 billion, 53.3 percent lower than the P67.5 billion registered in a similar period last year.

National Government Fiscal Balance (in P billions)

	Jan. to June 2005	Jan. to June 2006	% Chg
Revenues	**389.0**	**471.1**	**21.1%**
Tax Revenues	337.4	417.8	23.8%
BIR	260.9	318.4	22.1%
Customs	72.2	94.8	31.3%
Others	4.4	4.6	5.4%
Non-tax Revenues	51.6	53.3	3.3%
Expenditures	**456.5**	**502.6**	**10.1%**
Surplus / (Deficit)	**(67.5)**	**(31.5)**	**-53.3%**

Source: Department of Finance

On a monthly basis, the national government was able to achieve its third consecutive budget surplus in June. This is the first time since 1995 that the country was able to post a surplus for three straight months - a good sign that it is indeed well on its way towards a balanced budget by 2008. More importantly, this indicates that the government now has the means to kick start the economy into high gear by funding major infrastructure and tourism projects, by extending the development to the countryside and by enhancing the quality of education and health services.

On the external sector front, the Philippines' balance of payments continues to register a surplus, rising 3.1 percent to $2.04 billion for the first half of 2006. The country's current account, which measures all trade in goods and services, continues to be positive on the back of a 15 percent growth in OFW remittances and 16 percent growth in export earnings for the Jan-May 2006 period. With the fiscal balance improving and the balance of payments in surplus, interest rates have remained low and the foreign exchange stable.

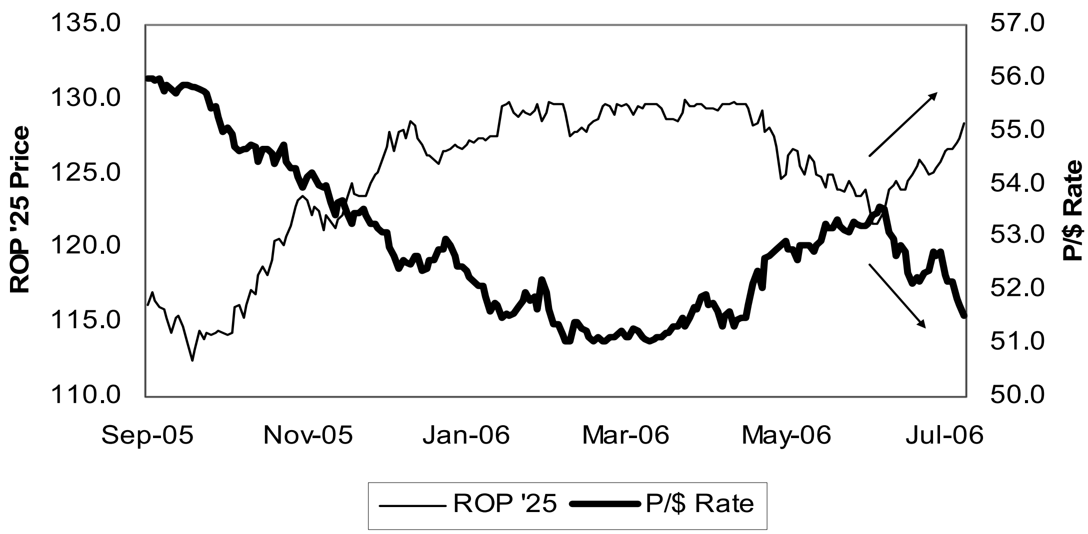
Vote of Confidence

What better sign of a vote of confidence coming from investors than last week's sale of $750 million bond float which was sixteen times over-subscribed. The Philippines sold 10- and 25-year dollar-denominated bonds which fetched yields of 7.53 percent and 7.819 percent, respectively. The better than expected pricing, we believe, is the result of the improving fiscal scorecard of the country and a testament to the investment community's view that the Philippine economy is moving in the right direction.

Also last week, oil refiner and retailer Petron Corporation successfully raised P5.5 billion from the sale of 5-year fixed rate notes. The company said it received bids totaling P11.2 billion for the original offer of P3 billion. The strong response allowed the company to increase its offer size and obtain a pricing of 8.875 percent, 53 basis points lower than the previous week's five year-MART1 rate. The size and the low pricing of this issue underpin the renewed confidence of investors towards Philippine corporate debt.

Indeed, Philippine bonds bottomed in June and have since recovered much of the losses from the across the board sell-off of emerging market bonds last May. The chart below shows the price of the 25-year bond (ROP '25) gaining back 5.5 percent from its low in June 26.

ROP '25 & Peso-Dollar Rate (Oct. 2005 to Present)



Source: Technistock

Keeping our peso-dollar target at 50 – 51

Mirroring the movement of Philippine bonds, the peso has since appreciated 3.8 percent against the US dollar after bottoming out last June 28 (refer to the previous chart).

Unlike some foreign banks which change their forecasts as quickly as short-term events unfold, we are maintaining our long-term outlook for the peso. If you remember, as early as October 2005, Philequity was forecasting a peso appreciation ***(Philippine Peso … The Strongest Currency in Asia - Philequity Corner, Oct. 24, 2005)***. Back then, most banks were looking for peso depreciation towards 57 to 58 against the US dollar. But when it was obvious that the peso was not going in that direction, some banks even went to the extreme and forecasted an appreciation to 47.50 to 48. We, however, maintained our peso target of 50 saying that this is the level the BSP is comfortable with and which, at the same time, addresses the concerns of the country's exporters ***(BSP Firmly at the Helm – Philequity Corner, Apr. 10, 2006)***.

Two weeks ago, one bank was again reportedly reversing its previous call for a peso appreciation towards 48, and saying that the peso is now likely to take a beating because of the brewing

Middle East Crisis. We, however, stand firm on our long-term peso target of 50 – 51 for the following reasons:

First, the current trend of US dollar weakening is very evident. There is a good chance that the Fed tightening cycle is over so the carry trade that was favorable for the US dollar last year has started to unwind. Year-to-date the British Pound is already higher by 8.2 percent and the Euro is up by 7.8 percent. Meanwhile, Asian currencies have appreciated an average of 3.3 percent, with the peso gaining 3 percent. The US economy is also in for a soft landing so the US dollar will continue to weaken against other currencies.

Asian Currencies vs. US Dollar	Rate as of End-2005	Rate as of 9/28/2006	% Chg Year-to-date
Indonesian Rupiah	9822	9070	7.7%
Thai Baht	41.01	37.88	7.6%
Korean Won	1011	953.8	5.7%
Singapore Dollar	1.6629	1.5782	5.1%
Philippine Peso	53.09	51.56	3.0%
Malaysian Ringgit	3.778	3.6665	3.0%
Chinese Yuan	8.0685	7.9705	1.2%
Taiwan Dollar	32.835	32.783	0.2%
Indian Rupee	45.025	46.685	-3.7%
Average			**3.3%**

Major Currencies vs. US Dollar	Rate as of End-2005	Rate as of 9/28/2006	% Chg Year-to-date
British Pound	1.7228	1.8634	8.2%
Euro	1.1837	1.2759	7.8%
Swiss Franc	1.3157	1.2326	6.3%
Australian Dollar	0.7327	0.7675	4.7%
Japanese Yen	117.68	114.65	2.6%
Average			**5.5%**

Source: Bloomberg, Philequity Research

Second, we showed you last week, that markets have the ability to withstand momentous "non-economic" events ***(Resiliency of Markets – Philequity Corner, July 24, 2006)***. Unless there is a significant disruption in oil supply or oil prices goes toward $100/barrel, we remain bullish on the peso and Philippine assets.

Last and more importantly, the fiscal reforms remain on track and that the country's economic fundamentals remain strong. Looking forward, we are counting on a resurgence of foreign direct investments (especially in the power and mining sectors) and government pump-priming on infrastructure and tourism projects to further boost economic growth.

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