Philequity Corner (05/23/2005)
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Getting our act together after taking the bitter pill of fiscal reforms

As of last week, crude oil futures have eased by more than $11 since hitting an all-time high of $58.28 in April following a relatively upbeat assessment of energy prices by U.S. Federal Reserve chairman Allan Greenspan. The U.S. Department of Energy also revealed that inventories continued to build up to its highest level since May 1999, dampening the bullish consensus and helping to curtail the recent price frenzy which saw some analysts predicting a "super spike" to $105 per barrel just several weeks back.

Much of this "out-of-consensus" movement originated from what has been happening behind the scenes. As Philequity director Washington Sycip pointed out during the last board meeting, most analysts have overlooked the fact that U.S. and Saudi relations have started to improve this year. Note that the two countries are coming off strained ties after the September 11 attacks and the visa issue being complained by Saudi nationals wishing to enter the U.S.

Just last month, Saudi Crown Prince Abdullah visited President George W. Bush in his ranch in Crawford, Texas – a sign that the US and the Kingdom of Saudi Arabia are coming back to terms. The meeting resulted in the announcement of a high-level joint committee meeting led by the Saudi foreign minister and the U.S. Secretary of State to work on "strategic issues of vital importance to the two countries" - in other words, oil prices and energy contracts.

Meanwhile, the board of Saudi Arabian Oil Co. (Aramco), will convene in Houston this week, reviving an annual tradition which has been suspended for two years. Aramco's president and CEO Abdallah Jum'ah said in a speech last week at Rice University's James Baker III Institute for Public Policy in Houston that Saudi Arabia could tap its massive reserves double its current output from its current 11 million barrels per day to over 23 million barrels per day by 2025 to meet increasing world demand. And just as Allan Greenspan's words are sacred to the financial markets, the head of Saudi Aramco's words are equally important to the energy markets.

With oil prices heading back to $45 per barrel and declining by almost 20% from its high, we wonder when the domestic oil companies will start rolling back their prices by a similar percentage.

The movement of the US dollar, likewise, is diverging from the previously held consensus (bearish) view. The US dollar broke major resistance last week to reach its highest level against the Euro this year at 1.2558, up 8% from the December high of 1.3667.

In a survey conducted by Bloomberg last week, 75 per cent of the 52 strategists, investors and traders polled predicted that the US dollar will extend its rally, up from 55 percent

the previous week. The last time the survey was this bullish was in August 2003. Among the reasons for the dollar rally are the continued increase in Federal Reserve rates and the better than expected US economic reports last week.

As a result, the Philippine peso pulled back to above 54.575 against the US dollar on Friday after breeching the 54 level a couple of weeks back. Last week's slide in the peso was the biggest since April 1. Further gains by the US dollar globally may push the peso back towards the 55 level. However, while we expect the peso to move in tandem with the rest of the region, the continued strong inflow from OFW remittances and the progress being made by the government on the fiscal front could act as stabilizers.

Meanwhile, trading in the Philippine stock market remained lackluster last week as foreign investors continued to shy away from emerging markets and have remained net sellers of Philippine stocks. Investors have so far underestimated (if not ignored) the positive news coming from the domestic front.

1) **Encouraging progress on economic reforms** – The first phase in President Arroyo's economic reform agenda - which includes revenue-raising measures such as the expanded VAT bill and the Sin tax bill, as well as administrative reforms to improve tax collection and minimize corruption - are already in place. The full-year effect of these front-loaded measures would be around P125bn to P130bn in 2006, well above the P80bn initially targeted when President Arroyo announced that the country is in a fiscal crisis back in July 2004.

   Also note that the government posted a P3.3bn surplus in April, the first fiscal surplus in four years as revenues rose by 11.8% from Jan to April, while expenditures expanded by 7.7%. The primary balance (or the fiscal surplus less interest payments) continues to improve, up 90% to P53.6bn from Jan to April.

2) **Strong corporate earnings** – Earnings results for the 1st quarter were better than expected led by banks which saw net interest margins improve by almost 50 basis points and healthy loan growth of around 5%. Likewise, the property sector registered robust growth due to stronger property sales and higher rental revenues. Earnings growth, however, may be tempered going forward as the removal of VAT exemptions on petroleum and power, higher corporate income tax rate (from 32% to 35%), and higher power rates take effect.

3) **Steady inflows of OFWs** – OFW remittances are expected to increase by 12% to $9.4bn in 2005 (not to mention those passing thru unofficial channels). This is also the reason why the exchange has been steady despite the recent US dollar strength. In fact, the peso has appreciated against most global and regional currencies year-to-date.

In the meantime, the Philippine market will follow its lead from the US markets and we continue to expect it to trade sideways in the near-term due to the continued net foreign selling and the current political ramblings over destabilization plots, jueteng scandals, etc.

However, in the long term, we feel that we have bitten the bullet and taken the short term pain of fiscal reforms. We also expect a possible credit re-rating if we continue to get our act together, which should put the market back on its bullish trend after this long consolidation.

With regard to the peso, we expect it to move in tandem with the rest of the region in the short-term, as previously stated. In the medium- to long-term, the peso will improve once the budget deficit is halved in 2006 and once we get a credit upgrade.

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