Philequity Corner (07/11/05)
Volatility amid an overly dynamic political landscape

By Ignacio B. Gimenez

Market volatility on the rise. The domestic political situation has been very fluid over the past few weeks with new developments happening almost daily. The tug-of-war between improving macro fundamentals and an overly dynamic political landscape has caused a short-term spike in market volatility lately. This was compounded by the temporary restraining order (TRO) issued by the Supreme Court on the implementation of the Expanded Value Added Tax Act (E-VAT) causing alarm on most investors. Investors fear that delays in implementation would only serve to derail (if not endanger) the country's fiscal reform program where the government stands to lose P130 million a day in foregone E-VAT revenues due to the TRO.

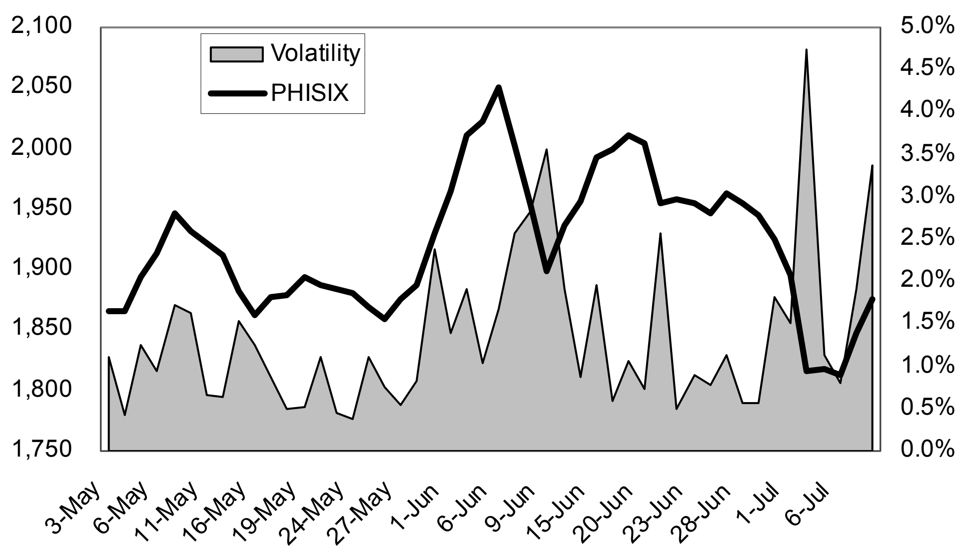
In previous articles, we have mentioned that lingering political uncertainty would be bad for the markets as it results in increasing volatility in all asset classes – stocks, bonds, treasury bills, forex – in the short-term.

Stock prices for example have widely fluctuated since the first week of June when the tape allegations was first exposed to the public. During that period, there were six instances where the Philippine Composite Index (PHISIX) traded in a daily range of at least 50 points.

While this kind of market brings a lot of opportunities for aggressive but nimble speculators, the volatility it brings could also take its toll on the nerves of most investors, as seen in the 4.2% plummet by the PHISIX last July 4, which culminated with TRO on E-VAT.

On that day, the PHISIX traded between 1805 and 1895 – *a range of 90 pts or equivalent to 4.74% of the index level.*

Philippine Composite Index (May 3 to July 8)



The damage was also felt in the credit markets where ROP bonds fell across the board. At the same time, the treasury bill auction failed last week when the Bureau of Treasury rejected bids on the 91-day, 182-day and 364-day Tbills.

Meanwhile, the peso closed at a six-month low of 56.28 against the US dollar last Thursday and may test its all-time low of 56.45. This caused the BSP to raise the reserve requirements of commercial banks by 200 basis points from 19 percent to 21 percent in order to curb speculation and stabilize the forex rate.

Short-term effects of unexpected events. Lucky for us, our stock market was already closed when terrorist attacks hit London last Thursday enabling the PHISIX to preserve its 1.9% gain – the biggest in three weeks. The London bombings initially rocked global markets and sparked sell-offs in European equities and even in crude oil futures. Markets, however, recovered on Friday when investors realized that these attacks won't have serious long-term effects on the global economy.

We have previously made a study on the effects of unexpected shocks on the markets - during the WTC bombing in 2001, the invasion of Kuwait by Iraq in 1990, the Kennedy assassination in 1963, the Cuban missile crisis in 1962 and the attack on Pearl Harbor in 1941.

We have found out that on each of these events, stock prices as measured by the S&P 500 index declined by an average of 3.2% during the initial day. Yet the number of days the market was in freefall was only 5 days with an average total decline of only 6% before prices bottomed. What's more surprising is that it only took 62 days before the S&P 500 traded at a new high (and a remarkably short 14 days if Pearl Harbor is excluded).

In other words, while negative news events have historically triggered short-term panic sell-offs, markets have a natural tendency revert back to fundamentals.

Sticking to fundamentals. With an increasingly fluid political dynamics, it is very hard to predict how the final outcome will turn out and more so how it will change the macroeconomic policies already in place. *This is why Philequity's policy is to stick to our line of expertise, i.e. letting our investment decisions be driven by economic factors.* And just like what happened during the unexpected shocks mentioned above, we believe that the markets will revert back to fundamentals.

Our long-term view is that the necessary fiscal reforms are already in place and that the improvement in collection efficiency (especially by the BIR) will gradually lead the market to re-focus back on the improving credit fundamentals.

However, we are closely watching the Supreme Court deliberations on the E-VAT. The major issues being contended are 1) the constitutionality of the stand-by authority given to the President to raise the VAT rate from 10% to 12% next year, and 2) the "no pass on'' clause which prevents businesses to pass on the additional tax to the consumers.

We already saw the effects on the market by the TRO. The 4.2% freefall in the PHISIX last July 4 is a magnitude not been seen since the Asian Crisis period. If not resolved soon, then we must brace ourselves not only on the debilitating effects of higher oil prices but also on a possible credit downgrade if things turn out for the worst.

Next week, we'll focus our article on the upcoming shareholder meeting of Equitable-PCIBank where we expect aggressive jockeying for board control. As previously mentioned, the Philippine banking system is ripe for consolidation. Last week there were reports that BPI was close to acquiring Prudential Bank. The bank has not confirmed anything yet but has mentioned that it continues to explore various acquisition opportunities.

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