Philequity Corner (January 7, 2008)
By Valentino Sy

Volatility and opportunities abound in 2008

Last year, global equities markets experienced the biggest volatility swings since the global bull market run began in 2003. The US housing market bubble burst. Not only did the US mortgage business contract, it also quickly spread to other credit and financial market segments. Further aggravating the situation were the disclosures of a number of hedge funds and US banks on their exposure to the US subprime mortgage mess. Concerns of a possible US recession further added to the stress.

Bulls vs. bears

Investors should expect this extreme volatility to continue throughout much of the first half of 2008 as the bulls and bears play tug-of-war. Below, we enumerate the factors that will likely affect equity markets this year.

The major risks for equities (bearish factors) are the following:

- **A recession in the US led by weaker consumer spending**. The falling house prices in the US and its negative wealth effects on the consumer could lead to a decline in consumer spending. Meanwhile, the lingering credit crisis which affected numerous US banks and mortgage lenders could lead to major job cuts and a downturn in investments this year.
- **High oil prices pushing inflationary pressures.** With oil prices now at the $100 per barrel levels, global economic growth is now being threatened. Rising inflationary pressures will put cuffs on central banks trying to stoke the economy thru rate cuts. Dashed rate cut speculation, particularly in the US, would put additional pressure on global equities markets. The Philippines, being an oil-importing country, would be more disadvantaged.
- **Foreign selling in emerging market stocks.** The unwinding of carry trades and the flight to quality as a result of the US housing crisis has led to foreign selling of emerging market equities. In emerging Asia, for example, net foreign inflows to equities turned negative for the first time since 2002, mostly coming out of Korea. Meanwhile, the net inflows into the Philippines (while staying positive for the whole year) experienced its worst months of foreign selling in November and December.

Meanwhile, the major catalysts (bullish factors) for equities are as follows:

- **A soft-landing in the US economy**. Most US companies, except those from the real estate and mortgage sectors, are healthy. Meanwhile, a reinvigorated export sector (due to the weak dollar) should partially mitigate the effects of the housing crisis. While 1H08 GDP growth is expected to slow down, the economy is likely to reaccelerate in 2H08. Most analysts estimate the US economy to grow by about 1.5 percent in 2008.
- **Growth in Asia and other emerging markets to spur global growth**. The growth in China, India and other emerging economies should partially offset the slowdown in US, Europe and Japan. Asia ex-Japan is expected to grow between 7.5 to 8.0 percent in 2008. Domestic demand and investment are strong in these emerging economies and should buffer the slowdown in exports.
- **Fed will continue cutting rates.** The Fed is expected to continue lowering rates until a recession is avoided. Similar to 1990 when the Fed cut rates from 8.25 percent to 4 percent, the Fed now is moving to quickly extinguish the threat of a recession. Moreover,

other central banks are moving to counter the economic downturn with their own rate cuts. The U.K. and Canadian central banks already started cutting rates late last year. Meanwhile, the ECB may follow soon, particularly if the euro remains strong.

- **Valuations are cheap as multiples rise.** Lower yields and the expectation of further rate cuts generally point to expanding price-to-earnings (P/E) ratios. Thus, the valuation of equities both in absolute and in relative terms (vs. money market and bonds) remains attractive. In fact, the big drop during the first week of the year has made stocks even cheaper.
- **The rise of the sovereign wealth funds.** Sovereign wealth funds have become a powerful investing force in the global financial markets with approximately $2.5 trillion in assets today. Recent high-profile investments by these funds into Citigroup and UBS have provided relief in the markets. The long-term horizon of these funds allows them to be a stabilizing influence. It has also mitigated the damages brought about by the US sub-prime housing mess.
- **Rising gold & metal prices are bullish for Philippine economy.** Unlike, surging oil prices, rising gold and metal prices are bullish for the country which is considered one of the most mineralized countries in the world. Rising metal prices should spur further investments in this sector of the economy and should translate to stronger export revenues down the road.
- **Local institutions are buying Philippine equities.** Absorbing the selling of foreign investors are the local institutions. With interest rates so low and the Philippine banking system very liquid, a huge chunk of local funds are flowing into equities. The good news is that local institutions are dedicated buyers with a long-term time horizon, thus providing support to the market. When foreign investors turn around to become net buyers, they will be the ones to push the market higher.
- **The political noise is dissipating.** People are not supporting calls for people power and coup d'etats. All eyes are now on the presidential elections in 2010. In fact, presidential aspirants are now jockeying for position. Political destabilization efforts should dissipate over the next two years.

Outlook on the peso

With regard to the peso, we expect its strength to continue. However, the run-up this year may not be as strong as in 2007 when peso strengthened by 15.8 percent against the US dollar. Putting it in perspective, the peso has already appreciated by 27 percent from its high of 56.50 in 2005. At the current rate of 41.01, the peso is just 7 percent off our 2008 target of 38 which we previously published in our column (see "*Peso at 38 by 2008*" in the October 14, 2007 issue of *The Philippine Star*). Currently, we are closely watching out for further signs of stabilization in the US dollar which may signal a pause to the appreciating peso.

Outlook on Philippine equities

With regard to Philippine equities, we expect prices to remain volatile this year, especially during the first few months. Because of the volatility, we are scaling down our 2008 PSEi forecast of 4,500 to 4,200. We may review and upgrade again our forecast when things stabilize, especially with regard to the US financial markets.

Nobody knows for sure how long this volatile environment will last. But despite the volatile environment, the market provides a lot of opportunities depending on each investor's risk threshold and asset allocation. Investors, therefore, should have to be nimble and opportunistic at this point.

If one has a long-term horizon, investors with one to two years holding period should now be looking to buy dips. Meanwhile, for those with a short-term horizon, trading the stocks in one's portfolio is the best option. The wide volatility provides a lot of trading opportunities and quick gains.

However, those without equities in their portfolio or those with minimal equities position, buying in bullets or buying in a staggered basis would be a good idea. For diversification purposes, one should consider buying an equity mutual fund. But for those who prefer buying individual stocks, choose the more liquid and bigger capitalization stocks, especially those with high dividend yields.

Meanwhile, those investors with international exposure should diversify into different asset classes to protect their portfolio and generate higher returns. Oil, gold and even agricultural commodities are now making new highs (see our previous articles on oil and gold in the Oct 29, 2007 and Nov. 5, 2007 issues of *The Philippine Star*). There are now exchange traded funds (ETFs) for oil like United States Oil Fund (symbol:USO); for gold like Street Track's Gold Shares ETF (symbol:GLD); and for agricultural commodities like Powershares DB Agriculture ETF (symbol:DBA).

In sum, 2008 will not be as easy for equities as in the past four years. However, even the turmoil in the markets provides opportunities to every investor. As always, investors should practice sound asset allocation, exercise prudence and perform due diligence in choosing the right companies to invest in.

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