Philequity Corner (May 11, 2009)
By Valentino Sy

Bad is Good

"Bad is good." This has been the market's theme during the past two weeks. The market is up despite all the negative news that could potentially derail the recovery. These included the fears of an escalation in the number of Swine flu (H1N1) cases, the release of the stress test results of the 19 biggest US banks, further rise in unemployment and the worst performance of the US economy in five decades (shrinking 6.1% in 1Q09).

Marking nine straight weeks of gains, the MSCI World Index advanced by 6.4 percent for the week (YTD +3.6 percent), the MSCI Emerging Markets Index by 9.4 percent for the week (YTD +27.9 percent).

Meanwhile, the PSE Index gained 6.6 percent for the week (YTD 19.7 percent). And our own Philequity Fund is up 6.9 percent for the week (YTD 22.7 percent).

Bull signal

When bad news comes out and the market goes up instead of going down, this is a bull signal. Corollarily, when good news comes out and the market goes down instead of going up, that is a bear signal.

What we are seeing now is a bull signal, especially since the news that is coming out is less bad than people expect.

Stress test, no sweat

Last week, Tony Samson wrote about the importance of stress test to check the financial health of the US' biggest banks (see Philequity Corner's article *Stress Test* in the May 4, 2009 issue of **The Philippine Star**). Since the health of the overall economy is highly dependent on the stability of the banking sector, the results were expected to have significant market impact.

Bank of America, Citigroup and Wells Fargo were among the 10 large banks that need to raise a combined $75 billion in capital according to the government's stress test released last May 7. Goldman Sachs, JP Morgan, American Express, and Bank of New York Mellon won't need to raise more money to shore up their balance sheets.

Overall, investors cheered and the market rallied higher upon the completion of the stress test as it brings transparency and clarity over the health of the banking system. It was also a big help that financial markets have been recovering since March. Had the stress test snapshot been taken last year or early 1Q09, the banks would have needed to raise more capital and the markets would have crashed (not rallied).

Next step for banks

With the stress test results out, banks that need to raise more capital have one month to tell regulators how they intend to do so and six months from that point to carry out their plans.

Some banks even pre-empted the announcement of the test results by announcing plans of their own to raise capital through stock offerings. Wells Fargo and Morgan Stanley easily raised capital totalling $16.6 billion in stock and bond sales on Friday, becoming the first banks to respond to the government's mandate.

Wells Fargo sold $8.6 billion in stock, 43 percent more than it planned. Morgan Stanley raised $8 billion by selling shares and debt, up from $5 billion announced the day before. Meanwhile Citigroup is exchanging an additional $5.5 billion in preferred shares into common stock.

Companies that don't need additional capital such as American Express and JP Morgan Chase have announced plans to repay funds received through the Troubled Asset Relief Program (TARP).

Market likes underdogs

Shares of Bank of America, which was told to come up with $33.9 billion in new capital, gained 63 percent for the week.

Shares of Wells Fargo, which was told to seek an additional $13.7 billion in capital, jumped 44 percent for the week.

Shares of Citigroup, which was told to produce another $5.5 billion, rose 35 percent for the week.

Before the market recovery that started in March, the share prices of these three banks were the most badly beaten among banking stocks. In fact, shares of Citigroup and Bank of America fell more than 95 percent from their peak in 2007, whereas shares of Wells Fargo fell by 83 percent.

From rags to riches

Like the "from rags to riches" story of Manny Pacquiao, who rose from nothing to become one of Time Magazine's 100 most influential people in the world, investors are looking for stocks that were badly beaten but could provide the most potential upside.

This is the reason for the market's fascination for underdogs like the financial stocks and even the casino stocks like Las Vegas Sands and MGM Mirage whose share prices have gained seven times from their lows two months ago.

In contrast, the defensive sectors such as consumer staples, utilities, telecoms, pharmaceuticals and healthcare have underperformed during the past two months.

Philippine underdogs

In the local context, the same thing is happening. Cyclical stocks represented by the banking and property counters are now in vogue. This is why banks such as Metrobank, Banco de Oro and Phil. National Bank, and property companies like Filinvest Land and Megaworld, have outperformed the market in recent weeks.

Meanwhile, defensive sectors such as telecoms, utilities and consumer companies have underperformed.

From bear to bull

Given the market action during the past two months, the market appears to be changing from a bear phase to a bull phase. That is why we have always emphasized the importance of looking for signals that the bear is ending (see Philequity articles, *Bear Watching* in July 21, 2008 and *Opportunity of a Generation* in Nov. 3, 2008 issues of **The Philippine Star**).

The turn from bear market to a bull market can be very powerful. Corrections can be very shallow as most funds are underinvested. So far, corrections have been characterized by sectoral rotations, which is bullish. While price pull-backs may actually materialize, the longer-term direction of the market is clearly up.

More importantly, the markets keep going up despite all the negative news – which is another bullish signal (i.e. the market is anticipating that things will get better). As we said so many times before, "*Buy when everything seems bleak. Sell when everything appears rosy*." Bad is good.

For comments and inquiries, you can email us at info@philequity.net. You can also view our archived articles at www.philequity.net or www.yehey.com/finhance.