Philequity Corner (May 23, 2010
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The Perfect Storm

Two years after the financial markets suffered the worst of the US subprime and credit crises, another perfect storm is brewing across the horizon. In fact, several crosscurrents are currently sweeping through the markets, causing increasing turbulence. These are the following:

1) **European debt crisis** – The debt crisis in the Eurozone started with Greece and has spread to the so-called PIGS countries, which include Portugal, Ireland, Italy and Spain. The bigger problem, however, is that the PIGS are far from alone in terms of running up its fiscal debt. So despite a $1 trillion rescue program by the EU and IMF, financial conditions continue to deteriorate in the Eurozone.

   Last week, contagion concerns were reignited after Spain suffered its second credit downgrade for the month from Fitch Ratings. Spain now holds the record of having the highest unemployment rate in the Eurozone at just above 20 percent.

   Fiscal concerns are also starting to hound Eastern Europe. The Hungarian forint fell 5 percent against the euro the past two trading days after government officials said that their country was at risk of a Greece-like crisis. Hungary's incoming government has charged the previous government of manufacturing the budget deficit figures.

2) **Euro's weakness** – The weakness of the euro has exacerbated the volatility in the markets in the sense that commodity prices and stock markets worldwide have gone down whenever the euro goes down. The euro closed last week at 119.69, down 19 percent year-to-date. A lot of market analysts are now pointing to a euro-dollar parity (see our article last week, *The Demise of the Euro?,* May 31, 2010).

3) **China slowdown** – Since last year, concerns of an asset bubble in China have led economic officials to restrain monetary policy and engineer a soft-landing. They have reined in bank lending, unveiled a series of measures to cool the property market, raised banks' reserve requirements and slowed the pace of government spending.

   Recent statistics show that China indeed is slowing down. Manufacturing activity expanded at a slower rate in May. Meanwhile, China's auto sales dropped 14 percent month-on-month in May after 18 months of robust growth. While Beijing is cautious not to over-tighten, investors continue to be wary of the effects that a slowdown in China will bring to the other economies in the region.

4) **US financial reform –** Investors are also bracing for some tough times ahead in terms of regulations. Two weeks ago, the US Senate has passed the US financial reform bill. Included in the bill are measures that ban banks from proprietary trading, tighten regulations on derivatives, create a new financial watchdog agency to protect consumers, increase transparency and insulating taxpayers from the fallout of failures of large banks and financial firms.

   The bill, when it comes to law, will ensure tighter regulations for banks and reduce the industry's profits for years to come.

5) **The oil spill in the Gulf of Mexico –** The oil spill is the worst in history, and if left unchecked, it could decimate the ecologies of nearby bodies of water like the Mississipi River and spread throughout the Gulf of Mexico. The ecological and economic damage could last for decades.

   The oil spill is not only punishing the culprit British Petroleum, whose stock price is down 38 percent from its April high. It has also dragged down the rest of the oil and oil services sectors on the back of a growing regulatory clampdown.

Volatility on the Rise

The crosscurrents from this perfect storm are the factors why the volatility in the markets is increasing. In fact, during the past several weeks, we have seen the Dow Jones Industrial Average (DJIA) move up 200+ pts on some days and down 200+ pts on other days.

The VIX (a.k.a the investors' Fear Index) has jumped as high as 45 last month. Note that this is the highest reading for the VIX since March 2009 when the S&P 500 index plunged to its bear market lows.

Temporary Setback in Asia

Asia has not been immune to the recent bouts of risk aversion. In fact, the MSCI Asia Pacific ex-Japan index is down 15 percent from its peak in April. But with regards to Asia, we believe that it would likely prove to be no more than a temporary setback.

Given the debt problems hounding Europe and sub-par growth facing the US going forward, there are numerous reasons why we believe Asian shares will outperform global shares over the next few years. Enumerated below are the reasons:

1) Asian countries have low private and public sector debt. This is particularly true after the Asian financial crisis of 1997. Most of Asia's fiscal deficits are below 6 percent, which is very manageable. The Philippines is targeting a deficit equivalent to 3.5 percent of GDP this year. In comparison, Greece, Spain, the US and UK have deficit-to-GDP ratios of 10 percent or more.

2) Unlike in the US and Europe which faces financial reforms and stricter regulation, the financial system in Asia is not likely to be constrained. In addition, the loan-to-deposit ratio of banks are at very conservative levels (in the Philippines, 0.6x). Hence, the potential for credit growth is higher in Asia.

3) Asian exports' exposure to Eurozone is minimal, accounting for only 11 percent of total Asian exports. In contrast, intra-regional trade now accounts for more than 55 percent.

4) Lastly, Asia generally benefits from more favourable demographics: higher population growth, higher growth rate in the labor force and hence higher potential economic growth overall.

PSE Index (PSEi)- Quo Vadis?

With the looming perfect storm in the horizon, the question now everyone is asking is: What will happen to Philippine stocks?

In past articles, we have said that we continue to be bullish on Philippine market which is among the best performing markets in the world (see *Philippines, Best Performing Stock Market in the World*, May 23, 2010). In fact, we have upgraded our target from 3,350 to 3,500 for 2010 after the successful election last month

From a timing standpoint, however, we have also said that it will highly depend on the movement of the global markets. "*If the global markets soften, the PSEi will consolidate between the 3,100 to 3,350 levels. If the markets stabilize, our immediate target of 3,500 is on track* (see *Noynoy Upgrade*, May 17, 2010)."

True to form, the PSEi fell to 3,100 on May 25 and went back up to 3,357 by last Friday. Given, the new bout of volatility in the global markets, we expect the PSEi to consolidate further in the 3,100 – 3,350 range. If not for this, the PSEi would have already broken out of this range.

PSE Index (January 2010 to present)

Source: www.stockcharts.com

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