Philequity Corner (March 25, 2013)
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The Cyprus Correction

After experiencing a run-up which lasted more than 2 months, the PSE Index experienced its first significant correction for 2013. From an intraday peak of 6,867 on March 11, 2013, the PSE Index fell 8.1% to an intraday low of 6,310 on March 20, 2013. Many investors were caught off-guard as the recent events in Cyprus triggered a correction. Since the correction was sharp, fast and vicious, many investors are probably wondering why a tiny and little known country like Cyprus caused a correction in the Philippines. In this article, we shall discuss the problem in Cyprus and the other reasons that precipitated our stock market's most recent correction.

What is Cyprus?

Cyprus is a small island-country in the East Mediterranean Sea. It has a population of 1.1M and GDP of ~$24B. This makes Cyprus the 3rd smallest member-state of the European Union (EU). Because of the recent troubles of its banks, Cyprus became the 5th member-state to ask for an EU bailout.

What is happening in Cyprus?

Like other EU member-states who asked for bailouts, the problem of Cyprus emanates from its banks. Unless they receive a bailout package or emergency funding from the European Central Bank (ECB), Cypriot banks will soon become insolvent and run out of cash. The latest troubles of these banks and the talks of imposing a one-time levy on deposits have caused anxiety and panic among Cypriot depositors. To prevent bank runs, Cyprus closed its banks to the public and declared successive bank holidays. With a freeze on the country's banking system, Cypriots now transact on cash basis even as cash runs scarce.

Although an EU bailout seems to be the natural solution to this problem, this episode has played out quite differently from previous ones. This time, EU authorities are asking Cyprus to do a bail-in as a pre-requisite for a bailout. This means that Cyprus has to raise cash from internal sources before a bailout is granted. More specifically, the EU authorities are asking Cyprus to raise €5.8B before a €10B EU bailout package is released.

How does Cyprus plan to raise the money needed for its bail-in?

The deposits on Cypriot banks are disproportionately huge relative to the size of its economy. Because of this, EU authorities have asked Cyprus to impose a one-time levy on bank deposits in order to raise cash. Under the initial plan, deposits would be levied with a one-time tax of as much as 9.9%. The plan was very controversial since it involved forcing depositors to take an effective haircut on their bank deposits, which are supposedly risk-free, guaranteed and insured. As such, the measure was voted down by the Cypriot government last week. Cyprus then turned to the Russian government to ask for an emergency loan but was swiftly denied by the Russian Finance Minister.

Why do the events in Cyprus affect us?

Although Cyprus is one of the smallest members of the EU, its problems clearly show that the European sovereign debt crisis is still far from solved. If Cyprus raises money for its bail-in and is eventually bailed-out by EU authorities, the one-time levy on deposits may give the impression that deposits in banks of other troubled EU countries may also be slapped with levies, if needed. On the other hand, if Cyprus fails to raise money for its bail-in, it will not be bailed-out by the EU. Its banks would then fall and the country would ultimately be forced to exit the EU. And although Cyprus is a small country, the decision to let it fall may cause a similar panic that was triggered by the collapse of Lehman Brothers in 2008.

Is it just Cyprus? Are there other reasons why the Philippine stock market is undergoing a correction?

The PSE Index had already entered a corrective phase even before the problem in Cyprus erupted. Below, we enumerate the other reasons that contributed to the recent correction of our stock market.

1. **The run-up.** From the start of the run-up on mid-December 2012 (*The Run-up*, January 21, 2013) to its peak on March 11, 2013, the PSE Index increased more than 22% and traversed more than 1,200 points. Because the run-up was too fast and too steep, it is natural for our stock market to experience corrections.
2. **Black swans**. We wrote about the black swans that EDC, FGEN and the other Lopez stocks experienced (*Black Swans, Broken Blades & Landslides,* March 11, 2013). These caused EDC to fall 11.4% and FGEN to decline by 8.0% in a single day. The decline of EDC and FGEN ultimately caused a 1.2% decline of the PSE Index on March 1, 2013.
3. **Placements**. On March 7, 2013, ALI and RCB conducted placements that amounted to P18.3B. The huge volume of the placements, which were done in a single day, sapped liquidity from the stock market and caused a 1.6% decline of the PSE Index.
4. **Upcoming offerings**. Aside from ALI and RCB, there are other companies that are planning to do mega-placements. LT Group (LTG) and Melco Crown Philippines (MCP) are planning to conduct massive offerings of up to $800M and $400m, respectively. There are market talks that AC, SM, JGS, BPI and ICT might be possible candidates for placements. If completed, these big-ticket transactions may further sap liquidity from the stock market and trigger corrections in the future. However, since the stock market is in a corrective phase, these might be put in the backburner for the meantime.
5. **SM block sales.** We noticed that foreign funds are gobbling-up shares of SM. It is likely that these funds are getting SM shares from the Sy family or from other big block-holders at pre-determined prices via block sales or synthetic crosses. We estimate that foreign funds have taken P7.0B worth of SM just for the month of March 2013. These block sales are very similar to placements because they also sap huge amounts of liquidity from the stock market.
6. **Dividend payments**. The ex-cash dividend dates of TEL, AEV and AP coincidentally fell on March 14, 2013. Because the dividends that these companies declared were relatively big, their stock prices corrected quite significantly on the ex-date. Since TEL, AEV and AP account for 20% of the index, their declines paced a 1.2% decline of the PSE Index for that day.
7. **BLOOM's casino opening and the sell on news.** There was a lot of anticipation regarding the opening of BLOOM's casino on March 16, 2013. Though the stock experienced a brief run-up because of its casino's grand opening and its inclusion in the PSE Index, there was already a lot of selling prior to and after the casino's opening. Buying in anticipation of an event and selling after the event, or selling on news, is a typical behavior of stock market pundits. In BLOOM's case, the selling

on news caused a vicious correction and a 23.0% drop from its peak to its trough. BLOOM's brutal correction contributed to the weakness of the PSE Index and other local casino stocks.

8. **Heavy foreign selling.** While strong foreign buying contributed to the run-up of our stock market, it was strong foreign selling that caused its correction. Net foreign selling over the past 8 trading days amounted to P8.0B. The events in Cyprus prompted foreign funds to take some risk off the table and bring down their equity exposure. Moreover, since the Philippines is one of the countries that experienced a large run-up, it has been tempting for foreign funds to take some profits and sell down their Philippine equity exposure.

Will these recent events and risks change the bullish outlook for Philippine stocks?

We are always mindful of risks. We can clearly see that the emergence of various risks, both on the global and local fronts, may trigger severe corrections. Nonetheless, we are confident that these risks will not derail our country's structural growth story (*Secular Bull Market*, January 28, 2013). Considering this, we remain bullish on Philippine stocks over the long-term despite the risks that we enumerated.

What should investors do when the stock market corrects?

Since we already had our first meaningful correction, it is possible that our index will continue to experience dips in the near-term. Unless we see new positive catalysts emerging, we are likely to see the index consolidate for the meantime. 6,800, which was the previous high of the PSE Index and was our original target, may prove to be a resistance for now.

Because the bull market is taking a breather, we advise investors to review their asset allocation and equity exposure. For those who are heavily exposed to stocks and are on margin, this might be an opportune time to lighten-up and take some profits. For those who are underexposed or have very little equity exposure, we advocate buying on dips and buying in tranches, as this corrective phase might be volatile. Moreover, since volatility is back, we advise investors to focus on liquid stocks that have solid fundamentals and are representative of the country's unique growth story.

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