Philequity Corner (April 1, 2013)
By Valentino Sy

Investment Grade

After experiencing a swift and deep correction, the PSE Index closed the quarter strongly at a new all-time high of 6,847, up 2.7% from the previous day's close. Our market moved sharply higher because of extremely positive surprise news. Last Wednesday, Fitch Ratings gave our country its first ever investment grade rating. The debt watcher, which is one of the three major credit rating agencies, upgraded our country's credit rating to BBB- from BB+. In this light, we shall discuss why our stock market bounced strongly after a vicious correction. Moreover, we shall talk about the implications of the investment grade rating on our country's economy and the local stock market.

The Comeback

We have always said that catching corrections is extremely difficult because there are many factors that may trigger it (*The Run-up*, January 21, 2013). In last week's article, we enumerated the events that contributed to the most recent correction of the local stock market (*The Cyprus Correction,* March 25, 2013). Below, we enumerate the reasons behind the sharp bounce of our market.

1. **SEC's enlightened guidelines on foreign ownership.** Last Monday, the SEC issued draft guidelines for the computation of foreign ownership. It is apparent that the SEC is looking to implement an enlightened version of the foreign ownership limit based on the dispositive portion of the latest Supreme Court ruling. This has been a very encouraging signal to foreign investors who want to enter the country or increase their exposure to the Philippine stock market. We view this as a positive development that is just as important as the credit rating upgrade.
2. **The Cyprus fix.** Last Monday, Cyprus and European Union officials reached a compromise for the former's bailout. Moreover, last Thursday, Cypriot banks opened quietly and orderly. While the long-term verdict for Cyprus is still out, its problem appears to be contained for now.
3. **Window dressing**. During the last days of the month or the quarter, some fund managers would usually buy-up the top holdings of their funds. This boosts the performance of their funds in time for month-end and quarter-end reporting. Last Wednesday, March 27, 2013, we saw some window dressing because it was the last trading day of the month and the first quarter.
4. **S&P 500's new all-time high.** Last Thursday, the S&P 500 Index closed at a new all-time high of 1,569. Even as the Dow and other US indexes have earlier established new highs, we think that last Thursday's milestone is more important because the S&P 500 is a broader index of US stocks.
5. **The credit rating upgrade.** Last but not the least, the credit rating upgrade from Fitch pushed our stock market higher. The upgrade came earlier than expected because the market was expecting it after the mid-term elections or in the second half of the year. We see this upgrade as a strong positive catalyst that may push the PSE Index to convincingly breakout past the 6,800 level.

Breakout Nation

Last year, Ruchir Sharma, Head of Emerging Market Equities and Global Macro at Morgan Stanley Investment Management, labeled the Philippines as a breakout nation. In a previous article, we discussed why we think the country will continue performing strongly over the long-term (*Secular Bull Market*, January 28, 2013). In that article, we enumerated the important elements and events that have contributed to our country's magnificent structural transformation. These were the same reasons that Fitch cited when they justified our credit rating upgrade. The investment grade rating therefore validates our main thesis that the country is currently in its strongest financial and economic position.

Strength Begets Strength

The much-coveted investment grade rating is a clear and formal signal to the international community. The rating signifies that the country has a strong economy and should be considered a legitimate investment destination. Bigger funds from strong countries, especially those who can only invest in investment grade rated instruments, will now look to invest in the Philippines.

The credit rating upgrade will translate to an increase in the weighting of Philippine stocks in the equity portfolios of international fund managers. This is an important catalyst that may further push our multiples higher. Moreover, it will lead to an increase in the trading volume of our stock market. Aside from these, we expect the upgrade to result to an increase in foreign direct investments (FDIs). Handled correctly, the expected inflow of investments might be the last vital cog that will allow us to sustain faster and stronger economic growth.

Virtuous Cycle of Growth

We believe that the country is in the midst of a virtuous cycle. This means that the country is in a positive situation that is self-sustaining and self-reinforcing. It is already clear that our country's resilient economic growth and strong financial position warranted this upgrade. What has not been talked about yet is how this investment grade rating will lead to tangible benefits that may further contribute to the acceleration of the country's economic growth. We enumerate some of these benefits below.

1. **Lower borrowing costs.** The direct beneficiary of the credit rating upgrade is the Philippine government. It will allow the government to borrow at a cheaper rate from international or local debt markets. Since borrowing rates are pegged against the government's borrowing rates, we expect borrowing costs of local corporates, small businesses and consumers to also go down.
2. **More investments.** Lower borrowing costs would generate savings and may encourage further borrowing. This incremental cash would likely be funneled into investments. For the government, it means that they can prioritize big-ticket items such as infrastructure spending or investments in education. In addition, local corporates can undertake capital expenditures more aggressively so that they can expand faster. Lastly, consumers would be more encouraged to invest in real property and small businesses.
3. **More jobs.** We expect investment-driven growth to result to more jobs. Moreover, government spending on infrastructure projects will likely lead to the development of our manufacturing and tourism sectors. These are sectors that can generate significantly more jobs for our countrymen.
4. **Higher income and more spending.** A combination of lower borrowing costs and more jobs will lead to higher earning power. This would then translate to more spending that will further boost domestic consumption. Note that domestic consumption accounts for more than 70% of our

country's GDP. As we have repeatedly said in previous articles, robust domestic consumption has been the key underpinning of our country's resilient economic growth.

Considering these, it appears that we are blessed with a tremendous, once-in-a-lifetime opportunity to become a stronger and more prosperous nation.

Seize the Opportunity

We must be aware of the wonderful situation that we are in. To drive this point further, we look at India and Russia, two countries which attained investment grade status in 2003-2004. In the five years following their upgrades, both countries delivered average economic growth in excess of 7%. The same thing could happen to our country if we work on making the most out of this opportunity.

We are fortunate that we have a government that is aware of its role. The government knows that there is much to be done in order to sustain GDP growth of 5-6%. To achieve this, the government has to jumpstart its ambitious infrastructure spending program. Moreover, it has to continue encouraging investments from both foreign and local sources. Also, it should look to develop other sectors such as manufacturing, tourism, agriculture and mining in order to further widen and diversify our economy.

Local corporates, on the other hand, should be bolder in pursuing investments. Focus should be given on investments that will support a rapidly growing economy such as ours. Lastly, we should not underestimate the contributions of our fellow Filipinos. Since we have already seen the kind of growth that is possible with good governance, it is imperative that we elect public officials that will continue implementing policies and reforms that will encourage sustainable and inclusive economic growth.

A Proud Moment for Filipinos

The investment grade rating is an important validation from a credible international institution. It is a recognition of the hard work and contributions of the government, local corporates and Filipino citizens in building a stronger and more progressive nation. It also validates what we have been saying about the country's structural growth story. We think that our growth story is one that will remain intact for many years to come. As this unfolds, our stock market will continue to be a reflection of how the Philippine economy performs. This is why we said that we are in a secular bull market. We firmly believe that we are in a bull market that will last for many years or even decades.

As we celebrate this historic milestone, we would like to thank and congratulate our clients, investors and readers who have followed our advice throughout the years. To those who have not yet invested in our stock market, it is never too late. We encourage those who are underinvested or not invested in Philippine stocks to use a portion of their passive cash or spare money to invest in the local stock market. This is an opportunity of a generation that should not be wasted. Do not just be a witness – be a part of this magnificent bull market.

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