Philequity Corner (December 30, 2013)
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From Best to Worst

Last week, Bloomberg wrote an article about the Philippine stock market. In that article, Bloomberg mentioned how the PSE Index turned into one of the worst performing indices recently after being one of the best performers in early 2013. At its peak in May 2013, the PSE Index was up 27.4% vs. year-end 2012 and had gained 339% since its bottom in October 2008. At that point, our index was one of the world's best performers, next to Japan's Nikkei 225. Since that peak, the PSE Index has fallen 20.4% and is on its way to becoming one of the worst performers for the 2nd half of the year. Considering this, many are probably wondering why our index swung from best to worst in the span of 1 year.

Reasons for the Downturn

1. **Too fast, too soon.** Though the run-up of the PSE Index in early 2013 was not without reason, it happened a bit too fast and too soon. The performance of our index from year-end 2012 to May 2013 almost eclipsed the impressive 33.0% return of our index in full-year 2012.
2. **Valuations rise**. The steep run-up also pushed the valuations of Philippine stocks significantly higher. At the peak, the PSE Index had a 2014 P/E (price-to-earnings ratio) of 21.5x. Note that this was reached even before the halfway mark of the year.
3. **QE tapering.** The talks about the tapering of the Fed's quantitative easing (QE) program triggered large-scale unwinding, deleveraging and repatriation of funds. It has been one of the main reasons why foreign funds have been reallocating from emerging markets (EM) to developed markets (DM).
4. **Asian scare.** The exodus of funds that was triggered by talks of QE tapering exposed the vulnerabilities of Asian countries with huge current account deficits, such as India and Indonesia. The selldown in these countries inevitably affected other Asian countries such as the Philippines.
5. **China's problems.** Concerns about a possible hard-landing and liquidity crunch continue to hound the biggest country in Asia. These concerns have weighed down on China's stock market, the Shanghai Composite, which is down 7.4% year-to-date (YTD). China's problematic situation has also dragged down other EM and Asian indices.
6. **EM to DM shift.** While EM indices continue to face various headwinds, the economies of the bigger countries are starting to show signs of improvement. Also, the headwinds that haunted them before have abated. This is why the S&P 500 is up 29.1% YTD, the Euro Stoxx 50 is up 18.0% YTD while the Nikkei 225 is up 55.7% YTD.
7. **Torrent of shares.** Local corporates continued to take advantage of the strong demand for Philippine shares by conducting their respective equity fundraisers. While the new capital that was raised will help those companies expand, the torrent of share issuances and placements significantly contributed to the weakness of our stock market.
8. **Pork barrel scam.** The pork barrel scam exposed the web of corruption that has been happening in the government for years. It is not the doing of the top leaders of the current administration, but the issue has been muddled.

9. **Zamboanga siege.** The Zamboanga siege, staged by a rogue faction of the MNLF, has tarnished the image of our country.
10. **Various natural disasters.** Even though our country is used to the occurrence of natural disasters, we experienced some of the strongest earthquakes and typhoons this year.
11. **Yolanda.** Before Yolanda came, our index was still holding up near the 6,500 level, despite all the headwinds and problems that our country was facing. However, because of the damage brought by Yolanda, our index finally succumbed and fell.

Vulnerabilities Exposed

Yolanda dealt massive destruction in terms of death tolls reaching thousands and damage to property and infrastructure amounting to hundreds of billions of pesos. Aside from these, it exposed the vulnerabilities of our government and our country. Before, global investors only looked at impressive numbers that highlighted our country's strong economic and fiscal performance. When Yolanda struck, everyone saw many images and footages of destruction and poverty. These probably prompted investors to ask why they should keep paying premium valuations for a country that is still suffering from widespread poverty and is constantly threatened by natural disasters. These, along with the other problems that our country had been facing, turned investor sentiment for our country from positive to negative.

Unimpaired Fundamentals

Despite everything that hit us and the recent weakness of our stock market, our country's fundamentals remain strong and unimpaired. We can confidently say that the reasons behind the run-up of our index in the early part of the year have not changed. Our country's economic growth is still very high and we remain as one of the fastest growing countries in the world. Moreover, OFW remittances and BPO revenues, two of our economy's most important drivers, continue to remain strong.

Government stimulus will help economy recover

Government focus on the post-Yolanda reconstruction and the roll-out of its PPP program will accelerate our country's recovery. These efforts will provide the much-needed upgrade of our country's infrastructure. Moreover, these will create more jobs and boost our country's economic growth. Consequently, they are crucial steps in regaining the confidence of investors in our country.

Eyes on the Prize

Moving forward, it is important for our government to stay fair in balancing the interests of businesses and consumers. The government must not succumb to populist actions.

Aside from this, the government must maintain continuity and consistency in the implementation of existing policies. Businessmen and investors are wary of sudden or mid-stream changes in the rules.

Moreover, our government should be prudent and avoid belligerence. It would be best to stay out of diplomatic rows with other countries and instead focus on bringing foreign direct investments (FDIs) into our country.

Observe the flows

Though we are now witnessing a shift from EM to DM, we have to watch changes in flows very carefully. Because of this shift, the valuation premium of DM indices vs. their EM counterparts has been widening. Moreover, the stronger growth in DM countries will inevitably lead to stronger global growth and consequently, stronger economic growth in EM countries. These may be the catalysts needed to trigger a shift from DM back to EM.

Watch China closely

It is clear that concerns over China have dragged down Asian and emerging stocks, especially the stock markets of commodity-exporting countries. Consequently, Chinese stocks have been perennial laggards. This is why we have to watch China very closely. If and when its problems are solved, we expect China to lead Asian and emerging stocks back up.

Study valuations

Because of the recent decline of our stock market, cash dividend yields of local stocks have gone up. Moreover, valuations of Philippine stocks have become more reasonable, especially in relation to their earnings growth. Considering these, companies whose earnings are not affected by global headwinds, especially those with steady dividends and consistent earnings growth, have become more attractive.

Turning the Tide

Sentiment changes over time. We clearly benefited from a sentiment change when our country was re-rated positively. However, this year, we also saw how sentiment can turn against us. Yet, we at Philequity are confident about our country's prospects because our fundamentals remain unimpaired and strong. And because of our countrymen's trademark resilience, we are convinced that our country would be able to overcome recent adversities. This process would be hastened if the government plays its cards right and focuses on the tasks at hand. Though the short-term picture may be murky and unclear, we are confident that our stock market will do well in the long run.

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