Issue Date: June 28, 2016

Vantage point

MARKET OUTLOOK: NEUTRAL
STRATEGY: DEFENSIVE WITH A POSITIVE PHILIPPINE OUTLOOK

Philippine Stock Exchange Index (PSEi) – 1 year chart

Source: Bigcharts.com

Unexpected

Last week proved to be one of the greatest upsets in forecasting, with analysts, pollsters, betting sites and hedge funds all expecting the "Remain" vote to win and they positioned accordingly. Thus, the stunning victory of the "Leave" vote in the Brexit referendum caught investors flat-footed. This unexpected result caused asset markets to reverse their bullishness prior to the vote. The sterling hit a 30-yr low, the Japanese stock market went limit down and European financials lost 20-30% of their value. Equity markets the world over were not spared from the carnage last Friday.

Uncertainty

Given the unprecedented nature of this vote, no one knows for sure what the long term impact of Brexit will be. However, it is precisely this high degree of uncertainty that market participants and businessmen do not like. Thus, the sharp down moves and high volatility we are seeing in Europe and other stock markets are not surprising.

Bearishness is also starting to emerge among some analysts. The S&P has placed a negative credit outlook on UK bonds while some analysts are dialing down their global and European growth forecasts. Even expectations for the next Fed rate hike have changed, with market participants now seeing it happen in December, if at all.

Risks abound

As a result of Brexit, investors flocked to safe havens such as the dollar and the yen. With the dollar strengthening, we have to watch out for weakness in EM currencies, as this may affect the peso, which has recently broken the 47 level. China also depreciated its renminbi, the sharp depreciation of which triggered a significant correction last year. With global growth forecasts being dialed down, sentiment for equities is naturally dampened, leading to inflows into bonds despite very low or even negative yields. In our case, there was PhP 24 billion worth of net foreign inflows into equities since elections. If this reverses, then a correction is likely.

Swift and decisive action from central banks

Thus, to avert a possible "Lehman moment", swift and decisive action from central banks is key. With liquidity in FX market lacking as fears mount, along with opportunistic hedge funds ready to pounce, central bank vigilance is crucial. Thus, the Bank of England's promise to provide $250 billion in liquidity is a welcome development.

Japan also set a good example when it acted decisively to stem the panic. It was reported that Prime Minister Shinzo Abe asked for various measures to stabilize markets. Finance Minister Taro Aso, BoJ Deputy Governor Hiroshi Nakaso and Chief Cabinet Secretary Yoshihide Suga met with Abe, who ordered the BoJ to aggressively intervene to hold back the strength of the Japanese yen. According to Nakaso, Abe also ordered them to support the financial system and ensure liquidity. This has proven to be effective as the Nikkei ended Monday up 2.4% and the yen is back at 102 after breaking the 100-level momentarily. With these 2 central banks indicating that they are going to act and limit the fallout from Brexit, we believe that other central banks act quickly, aggressive, decisively, and in a coordinated fashion if possible.

Least exposed

Even with central bank action, however, we are still going to enter a prolonged period of uncertainty and instability where some countries will suffer worse than others. Europe and the UK are clearly at the bottom of the barrel as they are at the epicenter of this event. In Asia, some investment houses have flagged HK, Singapore and Malaysia as the most exposed to a Brexit.

Fortunately, the Philippines is rated as the least exposed. We estimate that the UK accounts for only 6% of OFW remittances and <1% of exports. Even though business and investments slow down in Europe, we note that the UK accounts for only 3% of FDI.

Safe haven

It is also a pleasant surprise that the PSEi was up yesterday despite the bearishness elsewhere. With instability hounding developed markets, we may now be viewed as a safe haven that is relatively insulated from Brexit and other global growth concerns. Note that the PSEi saw nearly PhP 500M in net foreign buying yesterday. Japan also ended higher by 2% yesterday, another encouraging sign. Though risks still abound, the Philippines fundamentals are clearly better than those in developed markets. The economic policies of the incoming administration, such as tax reform and the relaxing of foreign ownership limits, are likewise bullish for the economy for stock market. Thus, even if global equities were to correct as a result of Brexit, we believe that the PSEi's outstanding fundamentals will allow it to outperform in a post-Brexit world.