Philequity Corner (July 4, 2016)
By Wilson Sy

With or Without You

See the stone set in your eyes
See the thorn twist in your side.
I wait for you.

Sleight of hand and twist of fate
On a bed of nails she makes me wait
And I wait – without you

With or without you
With or without you.

Through the storm, we reach the shore
You gave it all but I want more
And I'm waiting for you –

With or without you
With or without you.

I can't live
With or without you.

And you give yourself away
And you give yourself away
And you give, and you give
And you give yourself away.

My hands are tied, my body bruised
She got me with nothing to win
And nothing else to lose.

The lyrics above are from the hit song “With or Without You” by the famous Irish band U2. In this article, we are not writing about acerbic love or a troubled relationship between two lovers. Instead, we are still writing about nations, economies and stock markets. Specifically, we discuss Great Britain’s exit from the Eurozone (Brexit) and its effect on global stock markets.

Wild and woolly ride

Prior to the Brexit vote, markets moved sharply higher as most investors were anticipating the “Remain” camp to prevail. However, 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 on the wrong side of the trade.

This unexpected result caused asset markets to move violently to the downside. The sterling hit a 30-year low, the Japanese stock market went limit down and European financials lost 20-30% of their value in just one day. Equity markets the world over were not spared from this wild and woolly ride that saw big gains and even larger losses.

Doomsday scenario

After Brexit, major houses published bearish reports and initiated conference calls where they detailed doomsday scenarios that are about to unfold. Headlines of major dailies and business channels spoke of a global recession in the offing. S&P, Moody's and Fitch downgraded the credit rating of UK bonds, taking away its sterling AAA rating. This scared off many investors who were already quite jittery because of all the volatility.

Central banks to the rescue

Suddenly, things turned. The central banks once again came to the rescue. The Bank of England promised to provide $250 billion in liquidity, calming equity markets and the sterling. In Japan, Prime Minister Shinzo Abe ordered Finance Minister Taro Aso and the Bank of Japan to aggressively intervene to hold back the strength of the Japanese yen. Abe also ordered them to support the financial system and ensure liquidity.

As the Brexit results were being counted, the Japanese yen broke the 100-level. 100 is not only an important psychological level, but it is also a strong technical support. After seeing the yen break the 100 level, the BoJ aggressively intervened in the market, bringing the yen back above 102. The Nkkei promptly reversed course and rallied strongly. With these 2 central banks indicating that they are going to act aggressively and limit the fallout from Brexit, investor confidence was renewed.

Markets bounce back strongly

With central banks showing that they are ready to limit any potential damage or contagion coming from Brexit, markets around the world bounced back. Despite being the epicenter of Brexit, the UK's FTSE index gained over 7% last week, its best weekly percentage gain since 2011. In the US, equity indices rose by 3%, their best weekly gain in 2016. This shows how crucial it was that central banks act swiftly and decisively.

Lower for longer

As a result of uncertainty over Brexit and a strong dollar, expectations for the next Fed rate hike have also changed. Fed fund futures are now seeing the next rate hike happening in December, if at all. Many market participants are even saying that a rate hike may no longer be on the table. Whichever the case, what is clear is that interest rates are staying lower for longer. This bodes well for emerging market currencies and equities, including the Philippines.

TIP outperforms

Among emerging markets though, some countries stood out. The Philippines, Thailand and Indonesia outperformed significantly, with their stock markets up 12.2%, 8.2% and 12.6% YTD, respectively. Collectively called TIP, these countries are less affected by what is happening in Europe and clearly outpaced developed markets and their Asian neighbors. For hedge funds, the farther you are from Europe, the safer.

Philippines least exposed

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

Thus, it came as no surprise that before US and Europe started recovering, the PSEi had already started bucking the bearishness. Not only were we less volatile, but we also saw an additional PhP 5.9 billion worth of foreign inflows last week, bringing our post-election tally to PhP 30 billion. Instead of witnessing an exodus of foreign funds, what we witnessed is a stampede into the Philippines. In fact, on June 30 alone, net foreign buying amounted to PhP 3.2 billion – the biggest net foreign buy in a single day so far in 2016. With instability hounding developed markets, it seems that the Philippines is now being viewed as a safe haven that is relatively insulated from Brexit and other global growth concerns.

Nearly 8,000

With heavy foreign inflows into Philippine stocks, not only did we break our previous 2016 high of 7,792, but the PSEi also managed to nearly reach 8,000. At this year's high of 7,980, our stock market was up 14.8% YTD. Even though we failed to hold at that level, we still managed to end the week at the highest closing of the year - 7,830.

Uncertainty remains

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. Brexit fallout is still far from over. Likewise, the PSEi has gained 20% since elections. It is also near the all-time high which is a strong resistance level. Thus, a correction or consolidation may be warranted.

Future catalysts for the Philippines

Though uncertainty remains and the stock market may correct, the Philippines has many positive catalysts ahead of it. The economic policies of the new administration, such as increasing infrastructure spending, tax reform and the relaxing of foreign ownership limits, are bullish for the economy and stock market. President Rodrigo Duterte's statements during his inaugural address are also very encouraging. For example, he ordered his Cabinet to remove redundant requirements and reduce processing time of all applications. He also showed that he respected the sanctity of contracts, saying that "changing the rules when the game is ongoing is wrong." These should be positive for equities in the long run.

Life goes on

What last week's historic move shows is that, despite all the catastrophic doomsday scenarios post-Brexit, the markets were able to bounce back and move substantially higher. Thus, the lyrics of the song "With or Without You" by U2 can be quite appropriate. Even with all the risks posed by Great Britain's exit from the EU, investors with a long term view can hold on to their stocks knowing that life goes on **with or without you (Great Britain)**.

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