Mid-year 2008 Outlook

June 23, 2008

We look back six months into 2008 and investors would likely be experiencing "tennis neck" pains now as global financial markets react from the US sub-prime mortgage crisis to recession fears, and fears of run-away inflation due to record crude oil prices and commodities prices. As a result, financial markets have experienced one of the most volatile asset price movements in recent memory. In hindsight, overweight cash and zero-weighted positions in all other asset classes would have been the perfect tactical asset allocation strategy. Unfortunately, we don't live in a perfect world. Suffice it to say, the current financial market turmoil is still far from over. How long should investors wait for better markets? We may be seeing better market conditions towards the end of 3Q08 and see a relief rally or a bounce in global financial markets in 4Q08 as investors position themselves for 2009.

Philippine Macro Outlook

Our GDP growth estimate for this year has been revised lower to 4.8% from 5.8% previously. The slowdown is on account of higher than expected inflation where we forecast an average of 8% this year vs 7% earlier. Our outlook however may face downside risk if the price of oil price or food rises for the balance of the year. As we see our import bill for oil go up while our exports weaken, we have also downgraded our 2008 USD/Peso forecast to average P44.00.

Over the next year, we should see GDP growth above current year projections while inflation may subside as the expected global slowdown may dampen the demand for commodities like oil and therefore provide some room for prices to either correct or stabilize. The Peso should see a more stable year in 2009, averaging about P45.00. The only consolation we are looking at for 2009 is a better macroeconomic outlook of higher GDP growth and a more predictable cost of doing business, which hopefully, may lead to higher financial asset prices. We are still constructive on the outlook for financial assets in the next 12-18 months but in the near-term, investors should brace themselves for further market turbulence and volatility.

Philippine Peso Fixed Income

In the short term, our Funds will maintain a defensive position through shorter duration positions versus the benchmark index as we remain wary of the international price of oil. We would like to see a downtrend or at least a stabilizing trend in oil in order for us to start buying domestic bonds. We would also like to see moderate food prices, namely in rice and vegetables, which are seasonally volatile during the third quarter rainy season. With inflation expected to average around 8% to 9% in 2008, we see the BSP hiking its overnight rates by 50 bps to 75 bps during the year in order for it to re-anchor inflation expectations.

Nonetheless, the next few months may provide medium term investors with a window of opportunity to buy fixed income securities at higher yields. With inflation expected to rise to over 10%, market yields could begin to appeal to investors, especially for those in Special Deposit Accounts who currently earn yields slightly over 5%, as opposed to over 7% for government securities of tenors of 2 years or more.

We adopt a constructive view that over the next year, inflation may trend lower, which could lead interest rates to decline correspondingly. As the rising cost of goods and interest rates start to erode demand, commodity prices could perhaps stabilize. And should we see the momentum of the economic slowdown turn significantly below trend, it is possible that we could even see some monetary policy reversals.

USD Fixed Income

Our Fund will continue to maintain a shorter duration versus the benchmark index over a challenging environment near term. We saw the US Federal Reserve recently signal a reversal in its policy stance to one of neutral to tightening. And while the US Treasury market has corrected significantly, we remain wary that the US CPI may continue to potentially pose a threat to the bond market. No doubt, oil price remains a key risk to this outlook. Furthermore, we may see sustained pressure on spreads on the back of global bond supply, risk aversion and higher default rates.

As the market reduces its position on the back of these negative developments, prices could drop to levels that medium term investors may find quite rewarding.

More importantly, we should see this cycle eventually turn favorable for fixed income investors as commodity prices stabilize due to the slowdown in global demand and growth while default rates peak.

Philippine Composite Index

The Philippine Composite Index (PSEi) is down 28.8%YTD at 2,578.57 points (a 20-month low), earning the unwanted distinction of being Asia's 3rd worst performing Market. Only Vietnam (-60.51%YTD) and China (-46.18%YTD) are worse off. Month-to-date, PSEi is down -8.802%. Liquidity has fallen substantially, with the average daily turnover down 36%YTD to US$70mn. For the month of June, volumes have further slipped to US$60mn.

Industry Performance

The Property Sector was the hardest hit (-38.91%YTD), followed by Philippine Conglomerates (-31.85%YTD). In contrast, best performers include the Financials (-22.13%YTD) and Mining & Oil (-16.42%YTD). The market was dragged by First Holdings (-70.34%YTD), Megaworld (-62.67%YTD), First Gen (-52.94%YTD), Filinvest Land (-51.47%YTD), Robinsons Land (-46.67%YTD) and Ayala Corp (-38.41%YTD). In contrast, Piltel (+4%YTD) and Philex Mining (-0.11%YTD) bucked the trend, while Manila Water (-2.70%YTD), PNOC-EDC (-20%YTD), and PLDT (-22.20%YTD) were down but did manage to do better than the market.

Equity Outlook

Though the year-to-date debacle can be traced to investors wary of a deep U.S. recession, the more recent drop may be charged to: (a) concerns that inflation may breach 10% next month and (b) government apparently fighting inflation through populist moves-- or clamping down on companies involved in basic services. In our view, inflation poses the biggest risk, as it threatens to spur higher interest rates and slash 2008 corporate earnings growth expectations. To aptly capture this, we previously cut our '08 earnings growth estimate to 7% from 14%. Meanwhile, regulatory risk has risen as the government has launched a 2-pronged attack against inflation via planned subsidies and through price cuts on essential services (i.e. PLDT, Meralco).

Definitely there are headwinds in the short term, but with the market down almost 30%, value has indeed emerged. Based on downgraded earnings growth estimates (7% in 08E and 10% 09E), PSEi is now trading at 9.6x 2008 PER and 8.8x 2009 PER. These present massive discounts to both regional stock markets' 13x (-26%) and to the PSEi's historical 16.5x (-42%). RSI of 37 indicates that the market is trading in oversold territory; however, the general trend looks weak after the index broke through 2,600 with all major supports taken out on the downside. Ultimately, the revisions prompt a 10% downgrade on our yearend target to 3,200 points, implying at least 21% upside from current index levels. The forecast, however, assumes oil does not breach the US$150/bbl level. Estimated long term returns may exceed 40%, as average cash dividend yield improves above the current 4% level, as inflation stabilizes toward 4.5% and as GDP and corporate earnings growth prove resilient.

Philippine Equity Fund

As inflation and the specter of weakness in the US economy lingers, sentiment will continue to be negative for the short term, with the PSEi potentially testing the major support level of 2,450 points (7% downside). This may present value entry points to help generate considerable, long term investment returns. Though we still expect share prices to recover over the long term, prudence dictates retaining existing cash levels for the funds, while investing very selectively on market weakness. We prefer sticking to defensive counters such as Utilities and profitable Mining companies, with the more attractive names being Petron, Piltel, Manila Water, and Philex Mining. Cyclical stocks in the property and banking sectors present deep value but could remain out of favor, amidst rising inflation & interest rates. Petron, which comprises a hefty portion of our equity portfolios, presents sizeable and secure investment profits--due to attractive valuations and an impending tender offer from Ashmore Investments. This is evidence that opportunities like Petron do exist, amidst the turbulence plaguing the financial markets.

Summary

In the near term, the risk that asset prices could cheapen further certainly exists. Our funds therefore will keep a defensive stance as we wait for signals that inflation, oil prices and other commodities have started to stabilize. In the meantime, as markets correct and values emerge, we would start to find investible levels where the risk/rewards will be compelling. We believe that the second half of the year will offer that opportunity.

As in the past, we realize that cycles in the market eventually turn. The headwinds that we have and are experiencing now in the market will not forever be with us. Hence, the challenge for us and for other medium term value investors is to be able to act when the right time and opportunity comes along for us to start investing again.