2013 Outlook

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CascadeAsia Advisors

2013 Country Outlook: Philippines

Research Team

Ryan Hakim
Economist
rhakim@cascadeasia.com

Aldo Claparols
Senior Market Strategist
aclaparapols@cascadeasia.com

Liam Hanlon
Senior Political Analyst
lhanlon@cascadeasia.com

- **Domestic demand remains strong**
- **Trade performance will likely weaken**
- **Strong peso erodes remittances and consumer spending**
- **Expect public spending to increase, particularly in H1**
- **Election spending to add tailwind to GDP growth in H1**
- **Inflation – Expect prices to rise**
- **Monetary policy – Expect rates to hold through 2013**
- **2013 midterm elections to be a litmus test for Aquino's first three years and the country's political stability**
- **Peace process in Mindanao will proceed, albeit gradually**
- **FDI likely to remain low with notable dividends from mining**
- **Tensions with China will heighten in the South China Sea**
- **Still room for upside in the PSEi**

Cascade Asia Forecast:

	Q1	Q2	Q3	Q4	2013	2014
Real GDP (%, y/y)	5.0	5.5	6.1	6.0	5.3	5.4
CPI (%, y/y)	5.4	5.8	3.9	3.8	4.7	4.5
Trade Balance (% of GDP)	-2.8	-3.2	-2.2	-2.1	-2.6	-1.9
Policy Rate (%, eop)	3.50	3.50	3.50	3.50	3.50	3.25

Economic Outlook

Domestic Demand Remains Strong

We expect overall growth in 2013 to slow from last year, although government expenditure in infrastructure and low interest rates will help sustain positive growth. Domestic demand, led largely by investment, will be the biggest driver for growth in 2013, helping the Philippines offset external sector weakness. Much of this investment comes from the construction and infrastructure sectors, which is expected to remain strong

Cascade Asia Advisors
PO Box 51194
Seattle, WA 98115
info@cascadeasia.com
www.cascadeasia.com

as suggested by higher imports of capital goods and bank lending due to commitments to public infrastructure.

Trade Performance Will Likely Weaken

On the export side, we suspect that the strong Peso, which is well below the PHP42 level, will continue eating into export earnings in 2013. Given resilient demand for imports, the trade balance is set to worsen. Exporters are believed to have reached their breakeven points already, and have been cutting costs by rotating labor and accepting fewer orders. The outlook for electronic exports in particular remains uncertain as the SEMI book-to-bill ratio remains below parity, with no sign of bottoming out, foreshadowing further weakness in electronic exports. Moreover, it will take time before non-electronic exports become a more stable source of earnings.

Strong Peso Erodes Remittances and Consumer Spending

Remittances from the U.S. will also likely slow in H1 2013, which will create a knock-on effect to slow consumer spending as well. We are particularly concerned about the strong peso eroding the purchasing power of those households that rely heavily on remittance inflows for their personal consumption.

USD/PHP Depreciation (January 2012-2013)

Source: BSP

Government Finance – Expect Public Spending to Increase, Particularly in H1

The budget for 2013 includes a 16.4% increase from last year's budget in the allocation for economic services, which includes infrastructure. Much of this infrastructure spending is expected to accelerate in H1 2013, ahead of elections and supported by low real interest rates and well-anchored inflation expectations. Moreover, due to the implementation lag of public-private partnership (PPP) programs this year, the government is likely to fast-track delayed projects in 2013. We also expect the government to net an additional PHP35 billion (0.35% of GDP) with the passage of the sin-tax bill.

Elections spending to add tailwind to GDP growth in H1

Campaign funds spent in the run-up to the midterm elections in May will boost consumer spending and will be an added tailwind to GDP growth. Legislative and local election spending in 2007 added an estimated 0.34% to the country's GDP growth. Campaign spending this year may add as much as 0.5% to GDP growth in H1.

Inflation – Expect Prices to Rise

While inflation has been moderate due to the appreciating Peso and abundant food supply, we expect to see prices rise in 2013 particularly for the food index and from rising domestic demand pressures. We also expect speculative capital inflows to grow by approximately 10% this year to USD 4.5 billion given the economy's strong fundamentals. The BSP will be keeping an eye on this to avoid inflating money supply and destabilizing inflation.

Monetary Policy Outlook

Monetary Policy – Expect Rates to Hold Through 2013

With domestic demand expected to stay resilient and an expected increase in inflation, we rule out any further rate cuts in 2013, which are already at pre-2008 levels. Of course, the possibility of easing toward the end of 2013 will depend on strength of the recovery in developed markets and the severity of the Chinese slowdown, although this is not our base case. The fact that the BSP is considering capital controls, such as minimum holding-periods for portfolio investments and a cap on non-deliverable forwards, to curb speculative capital inflows confirms that policy rate reductions are an unlikely option. Previous rate cuts (in July and October) did little to prevent the appreciation of the Peso. As such, any further rate cuts at this point will likely only fuel inflationary pressures prematurely.

Political Outlook

2013 midterm elections – litmus test for Aquino's first three years and the country's political stability

The 2013 midterm elections in May will be crucial for President Benigno Aquino III and his Liberal Party. An estimated 18,000 local and national electable positions are up for grabs, including half the country's 24 senate seats. Aquino has garnered widespread approval through a platform focused on good governance and tackling corruption, stabilizing internal security, promoting economic growth, and overhauling the country's struggling infrastructure through large-scale public-private partnership projects. But pro-growth policies have lacked inclusiveness, as the country maintains one of the highest poverty and unemployment rates in the region. The elections will provide insight into whether Aquino's reform agenda is resonating with the public, and the ability to push through these reforms going forward.

The elections will also be a test for the country's fragile but recently sustained political stability. Political violence and voter fraud have historically marred elections, discrediting the electoral process and discouraging foreign investors. Aquino has attempted to quell these fears, issuing a 150-day ban on carrying guns, and a crackdown on private militias typically used by political dynasties to intimidate voters and rig elections. All signs indicate these elections will be peaceful and fair, particularly as the peace talks continue in Mindanao, which has experienced the brunt of the violence.

Peace process in Mindanao will proceed, albeit gradually

The Framework Agreement for Bangsamoro, a peace process aimed at ending the decades-long civil war with the Moro Islamic Liberation Front (MILF) in Mindanao, faces a pivotal year of development. Negotiators will finalize a number of sensitive issues, such as wealth and power sharing, the normalization program for rebel fighters, and the leadership of the council entrusted with drafting a local constitution for the region. Despite the obstacles faced in Manila and Mindanao, we expect negotiations to push forward. Aquino has expended precious political capital on this agreement, making successful negotiations increasingly imperative for his legitimacy. His recent Supreme Court appointments ensure that the plan will overcome the impending challenge to the agreement's constitutionality. However, the Aquino administration will be challenged in the coming year with assuaging potential conflict between the MILF and rival insurgent Moro National Liberation Front (MNFL) that could lay fertile ground for disillusioned fighters to join splinter organizations determined to resume the insurgency. The MILF must also do their part in relinquishing coveted space at the negotiating table to guarantee that other stakeholders throughout Mindanao recognize a brokered agreement.

FDI likely to remain low, with notable dividends coming from mining

Foreign Direct Investment (FDI) in the Philippines will continue to be hindered by structural and bureaucratic barriers. Despite attempts to attract investment through free trade areas and the Philippines Economic Zone Authority (PEZA), constitutional restrictions on foreign ownership in certain industries deter international investors. We do not foresee Aquino lobbying for constitutional amendments, particularly in an election year, as this complex and sensitive process will squander political capital needed for other legislative campaigns. Likewise, a cumbersome bureaucracy, sluggish dispute resolution system, and pervasive local corruption make the Philippines one of the most difficult Southeast Asian countries in which to do business. There is some optimism that peace in Mindanao will lure foreign investment towards untapped mining, palm oil and logging opportunities, but this depends on the government and MILF's ability to guarantee security in the region. President Aquino is expected to make progress in attracting foreign investment with the likely end to the country's temporary moratorium on mining – which has halted an estimated $850 million in projects – as the administration pushes through its mining reform bill later this year.

Tensions with China will heighten in the South China Sea

Failure to break the political impasse within ASEAN and arrive at a consensus in the handling of the South China Sea dispute will compel the Philippines to continue shoring up its strategic alliances with the United States and Japan. Aquino will also maintain pace in modernizing the country's outdated military apparatus through large-scale defense procurements, extensive training exercises to professionalize the armed forces and redirecting security resources historically reserved for maintaining internal security in Mindanao. We also project potential Chinese-Philippine disputes leading to deepening trade disputes that will adversely affect bilateral trade between the two countries, comparable to the temporary Chinese embargo on the importation of Philippine bananas during the Scarborough Shoal standoff in April 2012.

Market Outlook

Still room for upside in the PSEi

The Philippines Stock Exchange Index (PSEi) is expensive but is likely to get more expensive. There is further room for upside due to favourable economic conditions and fundamentals. At this range, the country's strong economic outlook is already priced in. At 6,000, the PSEi is already trading at 17x forward P/E, which is the upper end of its historical range. It is also trading at a premium relative to its global peers. We expect a year-end 2013 index target of 6600 if earnings are robust and resilient throughout the year. We remain overweight on the PSEi as strong earnings growth will justify and normalize the high P/E ratio at 18.5x and will underpin EPS growth of about 18%.

***Cascade Asia Advisors** is a risk assessment and strategic advisory firm focused on Southeast Asia. We combine quantitative and qualitative analysis with rich perspective to render convoluted information into actionable intelligence and uncertain environments into navigable terrain. Our specialized focus is monitoring and assessing what drives political, macroeconomic and financial market developments in frontier and emerging markets in Southeast Asia and how they impact organizations. Our clients find more prosperous market opportunities, modify their business planning with sharper focus and face challenges with greater clarity and confidence. We help organizations understand, adapt and prosper in the Pacific Century.*