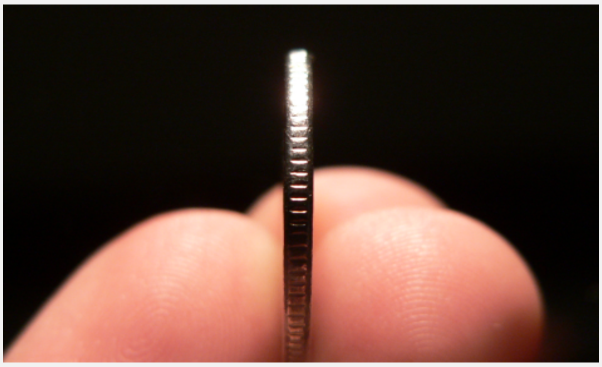
PHILIPPINES AUGUST 2018

TWO SIDES OF THE SAME COIN

- The Philippine economy seems to have a split personality. Yes, you are reading these unusual words to describe a national economy!
- GDP was 6.7% in 2017 and is projected by the ADB to continue this growth in coming years. Growth is being driven by rising domestic demand, remittances, employment & infrastructure spending.
- The country's external debt is declining and the sovereign become an investment grade credit with a positive outlook (S&P and Moody's).
- One big challenge is the projected infrastructure spending increasing from 4.5% of GDP recently to 7.3% by 2022.
- Many people would be very happy to have this side of the coin! ……. however ……



- Towards the end of 2012, PHP/USD was around 40.0. Since this time, it has steadily fallen to around 53.3 today.
- Consumer inflation has risen to 3.2% in 2017, and is over 5.5% the last few months (on an annual basis). On the street, many would make a strong argument that actual inflation rates are even higher!
- To respond, authorities have increased rates from 3 to 4% in the last few months – one hike being 50bp. The central bank is behind the curve chasing this outbreak of inflation.
- There have been measures being introduced to reduce this troublesome inflation. I wrote to a few of you about the authorities rather desperate measure to re-introduce 'dirty' fuel to reduce the impact of inflation!

And therein lies the dilemma – rising inflation requires raising interest rates. Higher interest rates compromise the aniticipated big infrastructure developments (which is key for supporting GDP growth and lifestyle improvements).

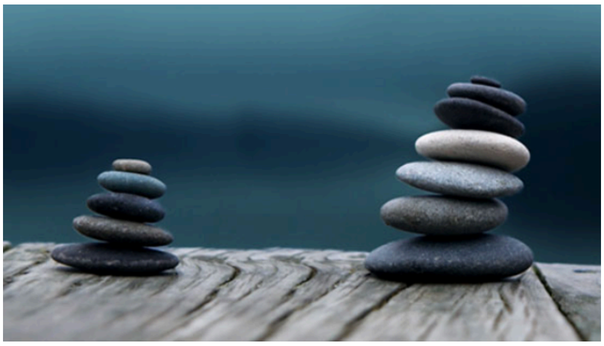
EXERTING OUR INDEPENDENCE

Given we are a truly independent financial advisor, we have used our 'freedom of selection' to source a few innovative solutions that have been incorporated into client portfolios to provide good growth potential and simultaneously have defensive qualities when the downturn comes.

At Arete Capital, we really have the capability to offer the better solutions amongst several providers – we will advise the solutions most suitable for our clients.

A Global mandate, promoted by many banks, is not exactly the ideal solution in todays uncertain markets. We have recently made several good investment recommendations and many of them are on our website. We encourage you to go take a look and see for yourselves what a truly independent adviser can offer.
www.arete-asia.com

Several of our existing clients have interests in the Philippines, so today we consider the domestic markets. Over the last few years, many local businesses have been doing exceptionally well. From an investors perspective, conditions are not as attractive - yields are rising, equities and the peso are falling. Unfortunately, this is not the only SE Asian nation in similar difficulties.



ASIAN EQUITIES FOLDING

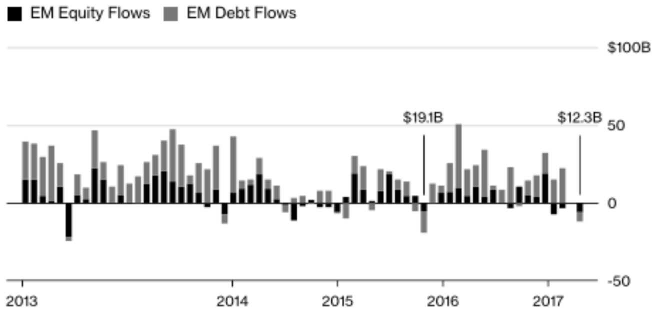
- Most Asian equity markets have not had much fun in 2018, posting declines; exceptions being India and Australia. In USD terms, from peaks set in January, several markets are down over 20%. Not a good thing for international investors!
- Euopean equities are in a similar situation.
- On most measures of value, Asian equites are considerably cheaper relative to the US market (price earnings, cyclically adjusted PE, price to book) … moreso after the declines in Asia!
- From the table below, a few things stand out. Philippines has one of the higher PE's and PB, with the lowest dividend yield! This is one of the more expensive markets in Asia.
- China has one of the higher dividend yields and low PE and PB valuations.
- Korea has a favourable relative valuations compared to other Asian markets.

GLOBAL FLOWS

- In April, investors were left in no doubt about the new Fed chairman's determination to raise rates more than previously indicated. This realization started a rise in global rates and the dollar.
- This recognition started a withdrawal of investments from emerging markets globally, so equity and bond prices began their slide.
- The persistence of the US threat to the global trading order has only added to the uncertainty and investors are now taking a more cautious approach.

EM Portfolio Outflows

Non-resident portfolio outflows from emerging markets accelerated to $12.3 billion in May -- 18-month low



Source: IIF

*As of 31 July 2018	CAPE	PE	PB	DY
China	16.8	7.4	0.9	4.3%
Singapore	13.6	11.3	1.1	3.7%
Korea	14.3	10.1	1.0	2.1%
Taiwan	21.8	14.3	2.0	4.1%
Australia	19.2	17.7	2.1	4.3%
Malaysia	16.8	18.9	1.7	3.2%
Japan	27.2	14.5	1.4	2.0%
Hong Kong	17.0	13.8	1.6	2.9%
Thailand	20.1	16.4	2.2	2.8%
Philippines	20.0	19.3	2.1	1.7%
Indonesia	17.5	18.5	3.0	2.5%
Avg Asian EM	17.5	18.5	3.0	2.5%
US	31.2	21.4	3.3	1.8%

EQUITY VIEWS

- On a regional basis, Philippines has, for some time, had one of the more expensive equity markets.
- The market also has the lowest dividend yield in emerging Asia.
- Combined with a persistently increasing inflation rate, and the clear realization that the US will definitely increase USD interest rates, global investors have taken action and started withdrawing investments starting in April/May. This partly explains the currency weakness from that period.

From a global perspective, these criteria are likely to persist for some time, so this is clearly not the best of times to be making new financial investments in Philippines.

Our advice at Arete Capital, to those of you that have an international footprint, is to consider reducing your PHP exposure in financial assets (both equities and bonds) by switching investments into markets in other countries. We have a few attractive investment ideas we could show you.

For those clients that generally hold a portfolio of Philippine equities, we would encourage you revisit your portfolio and maybe rebalance using some of the relative valuations explained in the box below.

PSEI INDEX

The PSEI has declined 12% year to date, and 17% from its peak on 29th January. This is clearly not great news if you have held postions over this period.
We believe the geo-political and the market forces will persist for the near future, so believe the downward drift will continue

We at Arete Capital suggest that investors can re-allocate some investments to another country. If investing in another country is not a practical solution then we have a few ideas that could help with decisions to move a Philippine equity portfolio to a less risky exposure.

We have run screens to indicate a few pertinent factors that could help in this decision making process…

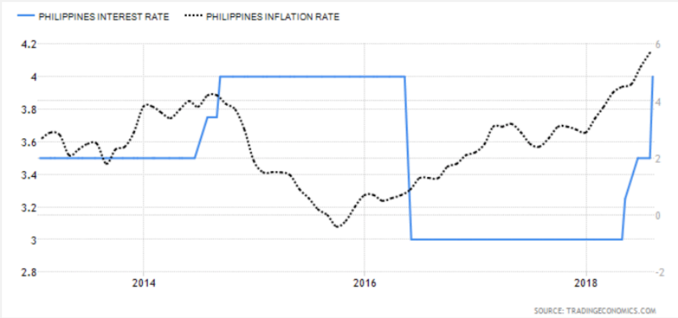
1) A list of a few stocks that are trading a long way from their fair value…….. with a catalyst that will drive a positive re-appraisal of the current valuation.
2) A list of stocks that are cheap relative to other stocks in the index: but have a strong balance sheet and the market has not yet identified emerging positive performance trends.
3) Financials that have not reported rising non performing loans.
4) Companies that have unusual asset/liability mismatches, in currency or tenor.

Of course, we are available to discuss particular ideas and investments when you are ready.

PHILIPPINE RATES

- With the central bank raising 3month rates from 3 to 4% over the last few months, interest rates are definitely on the rise. The cental bank is behind the curve on inflation – the inflation index in July was 5.7%!! Up from 3.2% last year.
- Like many countries around the world, long term rates in the Philippines are also increasing. At the time of writing, 10year PHP yields are 6.76%
- The Philippines interest rate space is not attractive for international investors. With the recent inflation figure, we suspect 10 year rates have further to rise. Other emerging markets are in a very similar situation!
- For domestic investors (like insurance companies) they will have to continue their search for real yield (market yield less inflation) and make the best from what is available.

PHILS 3m INTEREST RATES VS INFLATION



USD – PHP

PSEI INDEX