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COLing the Shots

The worst is Over!

COLing the Shots is a monthly publication by COL which provides insights on investment opportunities based on global and local developments that could affect the market. COLing the Shots aims to provide timely and relevant information and analysis as well as a model portfolio for successful investing.

Key Highlights

- There are currently four key themes that we believe “matter most” to investors right now. These themes include 1. The Philippines is fundamentally more resilient compared to other countries; 2. The bull market is not yet over; 3. Volatility will remain in the short term; and lastly but most importantly 4. The worst is probably over.
- Based on our assessment, the greatest risk facing investors in today is the uncertainty on the level at which the US’ 10-year T-bond rate would stabilize as a result of the Fed’s exit from its ultra-accommodative monetary policy. From a low of 1.6% before concerns of the Fed tapering materialized, the US 10-year T-bond rate jumped to a high of 3.0%, dangerously close to the Philippines’ peso denominated 10-year T-bond rate of 3.5%. Rising US 10-year T-bond rate is a major risk since it increases the likelihood that the Philippines’ peso denominated 10-year T-bond rate would also increase. It also increases the likelihood that the peso would weaken. Nevertheless, in a scenario analysis where we assumed that the US 10-year bond rate would stabilize at 3.5%, while the Philippines’ 10-year T-bond rate would climb to 5.5%, our end June 2014 target for the PSEi would be 6,450. The said level is not far from the market’s current level, implying that the risk of rates rising significantly is already being priced in.
- Our view that “the worst is over” is also supported by the improving technical picture of the index. Note that the PSEi recently broke above the critical 6,400 level in response to the Fed’s surprise move – the first indication that the downtrend has been broken. According to our Chief Technical Analyst Juanis Barredo, as long as the PSEi stays above 6,000, it is safe to say that the market has exited the correction phase and is now in a consolidation phase.
- For retail investors that are still waiting on the sidelines, **now is the best time to start entering the market.** While the market could stay here and remain volatile for a while, now would be the perfect time to start accumulating stocks to position for the next wave up in this bull market! Admittedly, the volatility of the market can make the process of buying stocks very emotionally stressful. To remove the emotion out of trading, adopt a peso cost averaging approach – slowly buying a fixed amount of stocks over time. You can also use our “good till cancelled” or GTC order feature. This feature allows you to potentially execute your buy order at a cheaper price, even without you being physically present in front of the computer.
- We are maintaining all the members of our COLing the Shots portfolio. While some stocks are trading at prices that are lower compared to their level two months ago, we are of the view that they are only undergoing a healthy correction. We have increased the fair value estimates of most stocks in the portfolio as we rolled over our estimates to end 2014. Meanwhile, although we reduced our fair value estimate for EEI, we are maintaining it in the portfolio since EEI’s growing backlog implies that earnings will recover in the next 18 months after weakening temporarily early this year. Moreover, the stock is also very cheap, trading at only 9.1X 2014E P/E.

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What matters most to equity investors?

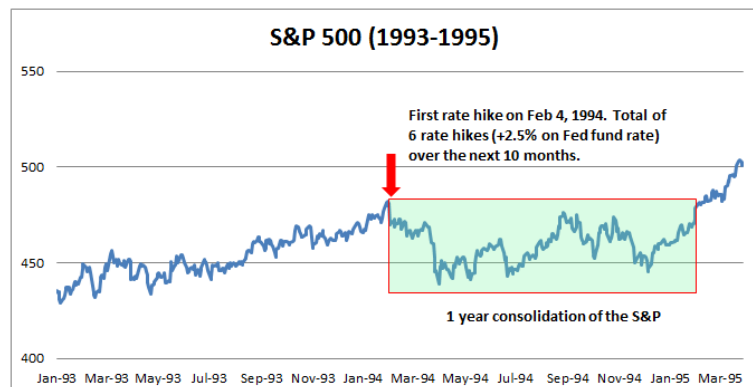
The past two months have been very challenging for investors. While the PSEi is barely changed compared to its end July close of 6,639.12, the volatility has been quite significant as the index fell by as much as 14% before recovering back to where it is right now.

Nevertheless, we would like to share four key themes that we think “matter most” to investors right now, the most important of which is that “the worst is probably over.”

1. The Philippines is fundamentally more resilient compared to other countries. We have continuously said this ever since the market began to fall in May. We do not see any reason to change our view as economic data released during the past few months continue to support this argument. In 2Q13, the Philippines’ GDP grew by 7.5%, the fastest in Asia. OFW remittances remained resilient, growing by 6.6% in July, bringing total remittances for the first seven months of the year higher by 5.8% to US\$12.6 Bil. Consequently, while other Asian countries suffered from a deterioration in their current account position, the Philippines saw its current account surplus more than double to US\$5.6 Bil during the first half of 2013 from US\$2.7 Bil during the same period last year. Finally, despite the recent weakness of the peso, the country’s inflation rate remained benign at 2.5% in July and 2.1% in August.

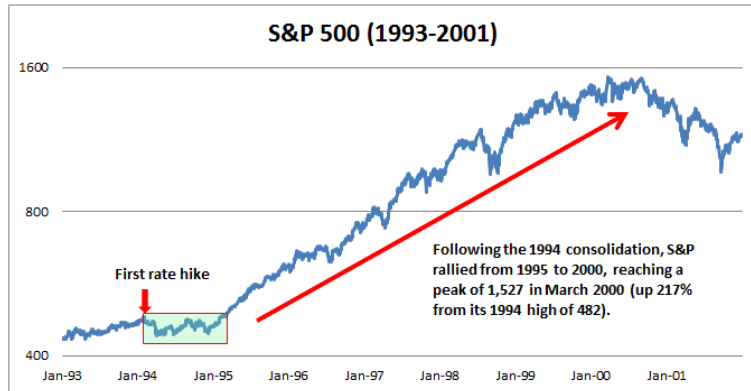
2. The bull market is not yet over. Concerns that interest rates would go up soon triggered the global market selloff in May. However, we would like to point out that in the past, bull markets took place even while rates were going up. In 1994, the S&P 500 fell by as much as 8.9% when the Fed started raising interest rates. However, it managed to more than double, climbing by another 217% compared to its 1994 high before the bull market ended in 2000! Meanwhile, in 2004, the S&P 500 fell by 8.2% after then Fed Chairman Alan Greenspan changed the wordings of his statement implying that interest rates would start to increase soon. However, the market eventually recovered, exceeding its 2004 high by another 35% before entering into a bear market in 2008. (*see exhibits 1 to 4 for more details*) Note that equity markets moved higher despite the rate hikes as economic conditions improved leading to stronger corporate earnings. After all, any move by the Fed that would lead to higher interest rates is an indication of its confidence that economic conditions are improving.

Exhibit 1: S&P 500 from 1993 to 1995



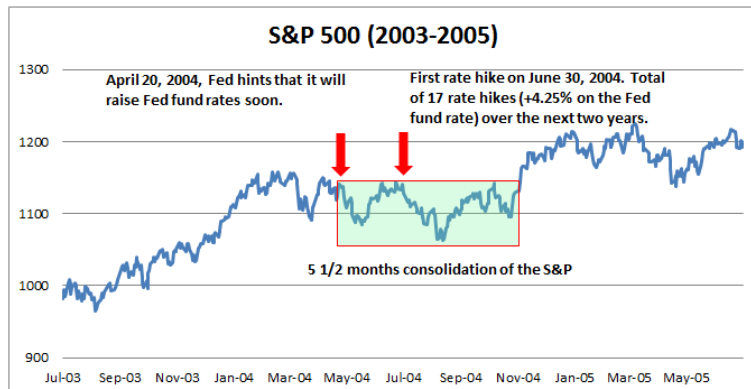
Source: Bloomberg

Exhibit 2: S&P 500 from 1993 to 2001



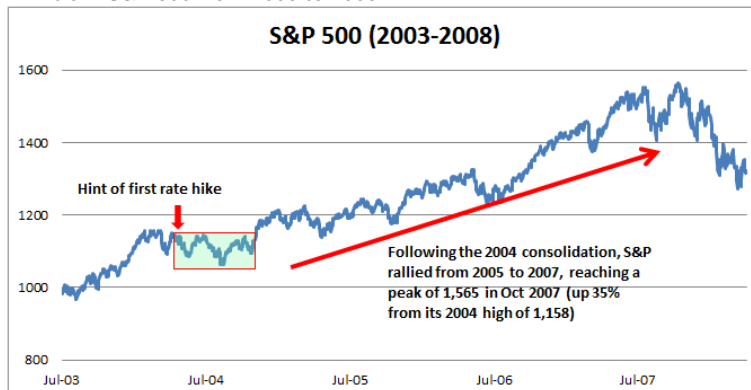
Source: Bloomberg

Exhibit 3: S&P 500 from 2003 to 2005



Source: Bloomberg

Exhibit 4: S&P 500 from 2003 to 2008



Source: Bloomberg

Moreover, bull market usually ends with excesses or bubbles. With local banks currently still awash with cash as evidenced by the very low loans to deposit (including SDA) ratio of only 53.9%, it's hard to imagine that there is a bubble in the Philippine market. The best is yet to come!

3. Volatility will remain in the short term. Despite our positive view, we recognize that volatility will remain. While markets reacted positively as Ben Bernanke surprised investors by not tapering the Fed's bond buying program last September, tapering is still expected to take place sooner rather than later. Meanwhile, the US government's failure to pass a spending bill last October 1, and the possibility that it might not be able to raise the debt ceiling by October 17 could have negative consequences on the US economy and the stock market as these two developments could lead to a shutdown of all government services.

4. However, the worst is probably over. In August, when the market suffered its worst performance for the year, we had a discussion among ourselves at COL. Our goal was to identify the greatest risk facing investors in the Philippine market. From the said discussion, we agreed that the greatest risk was the uncertainty on the level at which the US' 10-year T-bond rate would stabilize as a result of the Fed's exit from its ultra-accommodative monetary policy. From a low of 1.6% before concerns of the Fed tapering materialized, the US 10-year T-bond rate jumped to a high of 3.0% before falling back to its current level of 2.6%. At the peak, the US 10-year T-bond rate was dangerously close to the Philippines' peso denominated 10-year T-bond rate of 3.5%.

Rising US 10-year T-bond rate is a major risk since it increases the likelihood that the Philippines' peso denominated 10-year T-bond rate would also increase. It also increases the likelihood that the peso would weaken as more investors switch to the US dollar paper (investors might find the US paper more attractive given the tightening spread between the US and the Philippine paper). Note that higher interest rates and currency weakness are both undesirable outcomes for equity investors.

In light of the said risk, we did a scenario analysis where we assumed that the US 10-year bond rate would stabilize at 3.5% (at par with its average during the past 10 years), while the Philippines' 10-year T-bond rate would climb to 5.5% in response. Based on our analysis, even with the very bearish scenario, our end June 2014 target for the PSEi would be 6,450, almost at par with the market's current level. This would imply that the risk of rates rising significantly is already priced in by the market.

This view is also supported by the improving technical picture of the index. Note that the PSEi recently broke above the critical 6,400 level in response to the Fed's surprise move – the first indication that the downtrend has been broken. According to our Chief Technical Analyst Juanis Barredo, as long as the PSEi stays above 6,000, it is safe to say that the market has exited the correction phase and is now in a consolidation phase. (See exhibit 5. Please read "Tech Spotlight" dated October 3, 2013 for more details)

Exhibit 5: PSEi Breaks Above Downtrend



Source: Stockcharts.com, COL

Period of accumulation

For retail investors that are still waiting on the sidelines, I cannot emphasize enough that **now is the best time to start entering the market** given our view that the worst is over and that the bull market is still intact. I think our chairman Mr. Edward Lee described this period perfectly when he said that this is “a period of accumulation.” While the market could stay here and remain volatile for a while, now would be the perfect time to start accumulating stocks to position for the next wave up in this bull market!

Admittedly, the volatility of the market can make the process of buying stocks very emotionally stressful. After all, the “cheap” stock you bought last week could become cheaper (albeit temporarily) because of volatility! To remove the emotion out of trading, adopt a peso cost averaging approach – slowly buying a fixed amount of stocks over time. This has been responsible for the success of a lot of COL investors today. You can also use our “good till cancelled” or GTC order feature. This feature allows you to potentially execute your buy order at a cheaper price. The order will only expire if it does not get executed in 60 days.

For example, assuming that you would like to buy shares of PGOLD but the stock has gone up by 5% during the past week making it more vulnerable to a correction, you could enter a GTC order to buy PGOLD Php2.00 below its current market price. That way, you don’t have to be monitoring the stock to buy it if and when it corrects to the price you want. Moreover, it takes away the “hesitation” that investors are generally vulnerable to when markets are being sold off.

No change in COLing the Shots portfolio

We are maintaining all the members of our COLing the Shots portfolio. While some stocks are trading at prices that are lower compared to their level two months ago, we are of the view that they are only undergoing a healthy correction.

Going over our COLing the Shots model portfolio, you will probably notice that our fair value estimates increased compared to what was published around two months ago. The increase was largely a result of the rollover of our estimates to end 2014. After all, it will already be 2014 in three months! The only stock that suffered from a reduction in fair value estimate was EEI. From Php16.50, we reduced our fair value estimate to Php13.00 after EEI reported disappointing first half earnings results as it was unable to replenish foreign contracts that were completed. Nevertheless, we are maintaining the stock in our portfolio. During our visit with EEI’s management last month, we learned that EEI’s backlog jumped to Php28 Bil from only Php21 Bil. This should imply that earnings will recover in the next 18 months after weakening temporarily early this year. Moreover, the stock is also now very cheap, trading at only 9.1X 2014E P/E.

Exhibit 6: COLing the Shots Model Portfolio

	Current Price	FV	Buy Date	Buy Price	Current Return	Buy Below Price
EEI	9.53	13	30-Mar-12	6.07	57.00%	11.3
PGOLD	42.8	51	11-Jun-12	24.6	74.00%	44.35
AGI	24	30.6	11-Jan-13	17.2	39.50%	26.6
MEG	3.32	4.78	11-Jan-13	3.11	6.80%	4.16
TEL	3,028.00	3,560.00	11-Jan-13	2,636.00	14.90%	3,095.00
DNL	6.5	10.5	14-Feb-13	6	8.30%	9.13
RLC	21.2	30	5-Aug-13	22.7	-6.60%	26.1
AC	602	753	5-Aug-13	600	0.30%	655

Source: COL estimates

Investment Rating Definitions

BUY	HOLD	SELL
<p>Stocks that have a BUY rating have attractive fundamentals and valuations, based on our analysis. We expect the share price to outperform the market in the next six to twelve months.</p>	<p>Stocks that have a HOLD rating have either 1.) attractive fundamentals but expensive valuations; 2.) attractive valuations but near term earnings outlook might be poor or vulnerable to numerous risks. Given the said factors, the share price of the stock may perform merely inline or underperform the market in the next six to twelve months.</p>	<p>We dislike both the valuations and fundamentals of stocks with a SELL rating. We expect the share price to underperform in the next six to twelve months.</p>

Important Disclaimers

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