

# Philippines Macro View

## Investment Grade Rating at Last

- **Fitch first to upgrade the country to investment grade** — Coming from a stable outlook, Fitch surprised with an upgrade of LT foreign currency and LT local currency IDR to investment grade (IG) with a stable outlook on both.
- **Market implications** — Fitch's surprise upgrade to investment grade credit rating supports the strong local financial market rallies that have implicitly priced in an IG sometime this year. Peso corrected to 40.86 in the afternoon session after the Fitch news broke out, from today's open of 41.05. The IG removes a key investment obstacle for some offshore funds that may be mandated to invest only in IG paper. Today's event raises expectations of a stronger portfolio flow environment.
- **Easier to 'sell' the local economy and markets** — On the real economy side, an investment grade should make it easier to 'market' the economy to real investors. Attracting private proponents including private funding to PPP and other infrastructure projects would not constitute a major obstacle with the investment grade rating. Cost of investing including investment insurance coverage can ease, providing additional spark for investment-driven growth. We believe S&P (with positive outlook) may also upgrade soon.
- **Flipside of the rating upgrade** — The flipside of the IG rating is we may see a stronger portfolio environment that aggravates excess liquidity risk. This may be the reason why BSP has been moving urgently to put in place a monetary policy framework and correcting existing policy settings that can manage excess liquidity risk that may come with the upgrade. Linking future BSP actions on the SDA likely driven or motivated by portfolio implications of the IG action bodes well the local bond market, although admittedly the long end has rallied furiously in recent sessions due to previous SDA cuts, strong liquidity and the fiscal story.
- **Accessibility and not ratings** — Our regional economist notes that the IG rating doesn't have much impact on index inclusion of local bonds – for example, the widely tracked JPM LCY bond index, which is really a function of accessibility and not rating. The ratings game will make a bigger difference on the Philippines hard currency debt (ROP\$), although valuations prior to the upgrade were already tight (thanks to local liquidity) and may have limited room to improve.
- **Key Fitch highlights** — 1) Strong governance agenda supported a “general government debt dynamics more resilient to shocks.” 2) Resilient remittance flows partially ease the disadvantage of low per capita incomes. 3) Politically difficult “sin” tax reforms reflect Aquino's reformist resolve. For a positive rating outlook, Fitch cited “an uplift in the investment rate that enhances growth prospects without the emergence of macroeconomic imbalances.” We believe this makes reference to potential investment-driven growth on the back of PPP.

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# Investment Grade Rating

## Fitch upgrades country ratings to investment grade

In a surprise move, Fitch Ratings upgraded the Philippine sovereign credit rating to investment grade despite a stable ratings outlook in 1Q13. Fitch upgraded the Philippines' Long-Term Foreign-Currency Issuer Default Rating (IDR) to 'BBB-' from 'BB+'. The Long-Term Local-Currency IDR has been upgraded to 'BBB' from 'BBB-'. The Outlooks on both ratings are Stable.

## Market implications

Fitch's surprise upgrade to investment credit rating supports the strong rallies of local financial markets since late last year that implicitly priced in a credit rating upgrade sometime this year. Recent corrections of the equity, peso and fixed-income markets owing to external event risk should be given a strong lift by Fitch's surprise upgrade. Peso has already corrected to 40.86 in the afternoon session after the Fitch news broke out after opening today's session at 41.05.

The credit rating upgrade also removes a key investment obstacle for some offshore funds that may be mandated to invest only in investment grade paper. With the investment grade and expectations of a stronger portfolio flow environment, Philippine equity and debt paper should be given a strong lift, in our view.

On the real economy side, an investment grade should make it easier to 'market' the economy to real investors. Attracting private proponents including private funding to PPP and other infrastructure projects would not constitute a major obstacle with the investment grade, we believe. The cost of investing in the country including investment insurance coverage can ease off with the higher ratings. The investment grade rating can provide additional spark to investment-driven growth other than fast-tracking the government's PPP. We believe S&P (with positive outlook) may also upgrade soon. We believe two out of three ratings upgrade would represent a strong argument to investors that the country deserves an IG rating.

The flipside of the country rating upgrade if we see a stronger portfolio environment is the excess liquidity risk that BSP faces. This may be the reason why BSP has been moving urgently to put in place a monetary policy framework and correcting existing policy settings that hopefully can address/manage excess liquidity risk that may come with the upgrade. This risk comes in addition to existing issues of addressing BSP balance sheet pressures from 'bottled up' strong liquidity risk reflected in the SDA now at Php1.9tr. Hence the upgrade can strengthen liquidity prospects and with it the peso outlook, supporting likelihood of SDA rate easing to the 1-2% range that directly eases financial pressures. Linking future BSP actions on the SDA likely driven or motivated by portfolio implications of the credit upgrade bodes well the local bond market, although admittedly the long end has rallied furiously in recent sessions due to previous SDA cuts, strong liquidity and the fiscal story.

Our regional economist also notes that the investment grade rating doesn't have much impact on index inclusion of PHP bonds – for example, the widely tracked JPM GBI EM index (LCY bond index), which is really a function of accessibility and not rating. Prior to today's upgrade, the Philippines' GPN (Euroclearable global peso notes) had been included in the index, but not the local bonds onshore. The ratings game will make a bigger difference on the Philippines hard currency debt (ROP\$s). If Philippines secure 2 out of 3 rating agencies to give it an investment grade, it can be included in investment grade hard currency bond indices such as the Barclays index. Regardless, the Philippines 10-year dollar paper is already yielding below 3% (thanks to strong local support) despite the fact that it's not in the Barclays index. So valuations for the Philippine sovereign debt may not necessarily benefit from the upgrade since as it stands, there's limited space to tighten further. Some sovereign

wealth funds and central banks may finally decide to look into Philippine debt paper (local and dollar-denominated debts) with the upgrade, but there's the issue of withholding tax and accessibility.

## Key points to highlight in Fitch's rating upgrade

In our view, these are the major reasons behind the Fitch upgrade along with our comments:

- **1) Fitch:** Improvements in fiscal management begun under President Arroyo have made general government debt dynamics more resilient to shocks.
  - **Comment:** Strong governance measures applied to both budget expenditures and revenues (no new taxes up until this year) seemed sufficient in easing fiscal balance sheet pressures over the past two years and nine months (Pres. Aquino took over in July 2010) while enhancing fiscal contribution to growth prospects.
- **2) Fitch:** The Philippines' average income is low (US\$2,600 versus 'BBB' range median of US\$10,300 in 2012), although this measure does not account directly for the significant support to living standards from remittance inflows.
  - **Comment:** Remittances regarded as more important to consumption and living standards than prevailing low per-capita income due to income distribution issues. These remittances have withstood external shocks while service exports continue in labor/service deficient markets. Hence resilience of the remittances may partially mitigate the disadvantage of small per-capita income.
- **3) Fitch:** The recent introduction of a "sin tax", against stiff political opposition, will likely lead to some increment in revenues and underlines the administration's commitment to strengthening the revenue base.
  - **Comment:** New sin taxes (effective January 2013) regarded as strong display of fiscal policy resolve from the Aquino administration that should uplift the government's cash flows. This new tax measure complements the collection efficiency gains from Aquino's governance measures that can help raise the tax-to-GDP ratio past 13% this year while ensure funding for poverty alleviation and health projects.

Other highlights of the upgrade point to a sovereign external balance sheet considered 'strong relative to 'A' range peers, let alone 'BB' and 'BBB' category medians' due to a persistent current account surplus (CAS), underpinned by remittance inflows. The strong external accounts however have been pointed out in the previous upgrade leading to this event. Fitch estimates a net external creditor position worth 12% of GDP by end-2012, up from 6% at end-2010. Fitch expects a rising import bill due to strong domestic demand to narrow the current account surplus and stabilize the net external creditor position through to 2014.

The Philippine economy stood out in 2012 with growth of 6.6% in a weak global economic backdrop largely due to strong domestic demand. Fitch expects GDP growth of 5.5% in 2013. As such, Philippine growth was stronger and less volatile growth than its 'BBB' peers over the past five years.

The general government (GG) debt/GDP ratio is in line with the 'BBB' median while lengthening the average maturity of GG debt to 10.7 years by end-2012 from 6.6 years at end-2008. The foreign currency share of GG debt has fallen to 47% from 53% over the same period. The strong growth environment cannot do without a conducive and prudent policy-making framework proven by Bangko Sentral ng

Pilipinas (BSP) inflation management track record and proactive use of macro-prudential measures recently to address financial market stability risk. As a result inflation has been in line with 'BBB' peers on average over the past five years. Strong governance agenda that has been the hallmark of the Aquino administration has yet to translate into estimates (using World Bank measures) in line with 'BBB' range norms but are not inconsistent with a 'BBB-' rating.

### **What can affect ratings: Upside and downside risks**

Fitch said factors that could lead to a positive rating action in the future include:

- “An uplift in the investment rate that enhances growth prospects without the emergence of macroeconomic imbalances.”
  - We believe this has strong reference to fast-tracking PPP and its implementation that can provide a strong spark to investment-driven growth even past the lifetime of the Aquino administration (next presidential elections on May 2016).
- “Broadening of the fiscal revenue base, as well as further improvements in the structure of the Philippine sovereign debt stock.”
  - This may come from more tax and policy reforms.

Key downgrade factors may come from:

- “A reversal of reform measures and deterioration in governance standards.”
- “Sustained fiscal slippage, leading to a higher fiscal debt burden.”
- “Deterioration in monetary policy management that allows the economy to overheat.”
- “Instability in the banking sector, leading to a crystallisation of contingent liabilities on the sovereign balance sheet.”

Among the key assumptions behind the recent rating upgrade, Fitch estimates trend GDP growth for the Philippines in a range of 5-5.5%. In our 2013-14 macro forecasts, we expect growth of at least 6% that contributes to sustaining the prevailing ratings at the very least.

## Appendix A-1

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