BUCKLE UP, IT'S GETTING BUMPY

More rate hikes hinted as US and PH inflation exceed expectations

Financial Markets Sector
Philippine Rates Outlook
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- Markets are in a tug-of-war between *fear the Fed* and *fear of missing out* mindsets as strong US economic data and inflation hint at higher US rates.
- Philippine inflation is proving sticky, and the BSP breaks away from the Fed by hiking its policy interest rate by 50 basis points, with hints of more rate hikes to come.
- Despite BSP's hawkish rhetoric, the strong US dollar story prevails as the USD/PHP exchange rate returns above 55.00. However, pressures on the peso are still expected to moderate, and we reaffirm our year-end forecast of 55.10.
- We see value in short-term peso investments and alternatives, particularly the 3-month Asset Swap on US treasury bills, for investors with short-term requirements looking to ride future possible rate hikes as well as long-term investors who are anticipating the peak in yields.

Is FOMO fading?

The period of late 2021 through 2022 was characterized by global market risk-off sentiment as investors sold off emerging market assets during one of the US Federal Reserve's most aggressive tightening cycles to address rising inflation. The Philippines was not immune to this, and it dealt with similar declines in government securities and equity markets, with the 10-year bond yielding 7.7% and the Philippine Stock Exchange Index (PSEi) falling to the 5,700-level. A record high of 59.00 in USD/PHP was also tested as investor flight to quality exacerbated the already growing demand for dollars as the economy recovered from the pandemic *(Chart 1)*.

Surprisingly, risk assets rebounded in January, despite signs that US inflation and the labor market were still hot. Markets were optimistic when the Non-Farm Payroll (NFP) report showed that the average hourly earnings grew by only +0.3% month-on-month in December vs. +0.4% estimates. It was a sign that employers would eventually have difficulty maintaining the strong labor market. Data also came out showing that US services inflation also started to cool down in late 2022 but other consumer price index (CPI) items such as rental costs continued to remain sticky. Although the Fed hiked by 25 basis points (bps) to 4.50%-4.75% on February 1, markets were quick to react on inconsistencies in Fed Chair Jerome Powell's statements that financial conditions have already tightened and that the Fed would adjust policy should inflation fall faster than forecasted. Fed funds futures were already pricing in potential rate cuts, despite the Fed signaling that there are no plans to reverse monetary policy within the year. Government securities rallied, with 10-year bonds yielding more than 100 bps lower from their 2022 peaks. The PSEi briefly returned above 7,000 and the USD/PHP hit a year-to-date low of 53.68.

However, the fear of missing out (FOMO) mindset quickly subsided in February. The NFP report announced that a whopping 517,000 new jobs were added in January vs. 188,000 estimates. The unemployment rate decreased from 3.5% to 3.4%; the lowest level since 1969. January inflation also disappointed by coming out at +6.4% year-on-year vs. +6.2% estimates *(Chart 2)*. Although the US CPI has been decreasing for seven consecutive months, the still relatively high figure convinced the markets that the Fed still has room to hike rates in order to meet its 2% inflation target. Terminal rate expectations were raised above 5% once again.

In the Philippines, January CPI did not peak as anticipated and instead came out at +8.7% year-on-year vs. +7.6%, mainly driven by electricity, fuel, and agricultural products *(Chart 3)*. Second-round effects spilled over into housing and rent to reflect elevated energy prices, and in restaurant and accommodation services factoring in both supply issues in food and surging consumer demand. The Bangko Sentral ng Pilipinas (BSP) broke away from the Fed and instead hiked its policy interest rate by 50 bps to 6%. Despite the BSP's hawkish rhetoric, USD/PHP did not immediately sell off and the strong US dollar story kept the exchange rate well-supported at the 55-level. While there may be a reversal in global risk assets, we believe that pressures on the peso will moderate in line with government attempts to ease budget and current account deficits. We still see USD/PHP possibly trading higher on corporate demand in 2Q-3Q before ending the year at 55.10 on 4Q seasonality.

Chart 1. 10Y PHP, PHPUSD, and PSEI vs DXY Dec 2021-Feb 2023

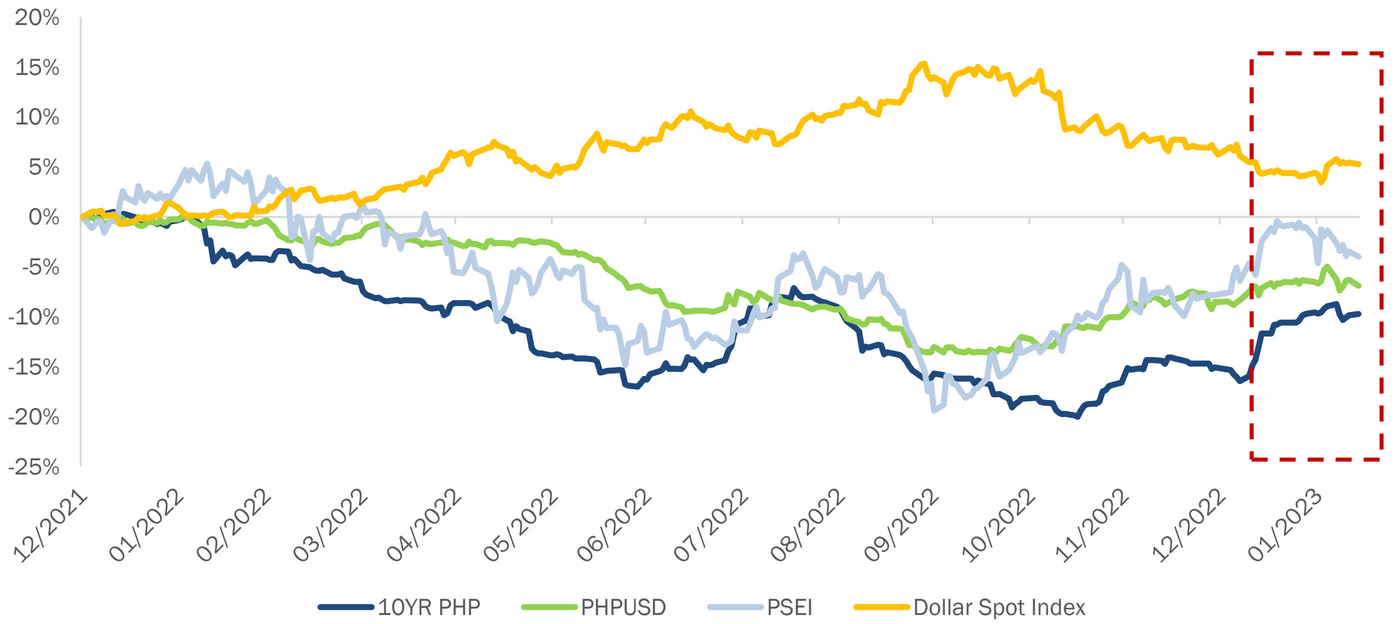


Chart 2. US Consumer Price Index vs Fed Funds Rate

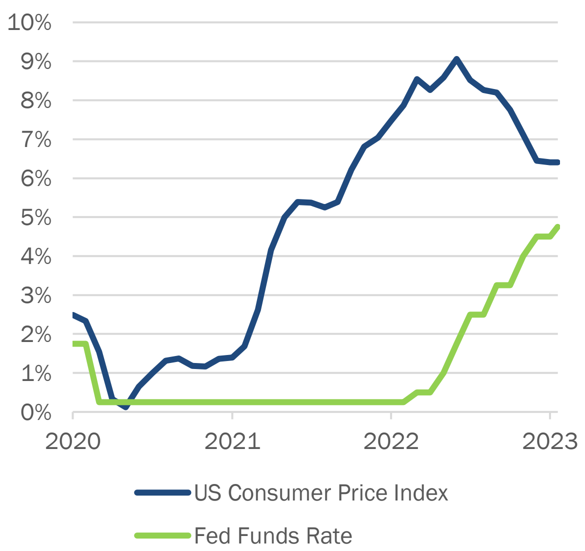
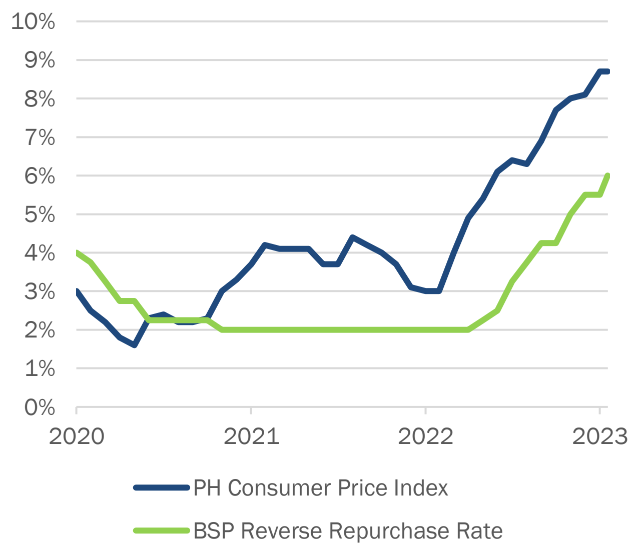


Chart 3. PH Consumer Price Index vs BSP Reverse Repurchase Rate



More rate hikes to come

Since the beginning of the year, Fed officials have said that they personally believe that the US terminal rate needs to remain at least 5.00%-5.25% in order to bring inflation down to 2%. With the Fed Funds Rate currently in the 4.50%-4.75% range, this could entail either two more 25-bp hikes in March and May or a single 50-bp hike in March, especially considering the higher-than-expected January CPI. However, even though markets have raised their terminal rate forecasts from January, Fed Funds Futures show that markets are still pricing in rate cuts by late 2023 *(Chart 4)*. This is likely in response to a possible US recession should high inflation and interest rates and a global economic slowdown adversely affect consumer demand, corporate earnings, and employment. The spread between the 2-year and 10-year US treasury yields is also at its most negative in the last 40 years, as investors sell off short-term US debt and rush to the relative security of long-term bonds. The spread is frequently used as a recession indicator and tends to be negative just before one occurs *(Chart 5).*

Chart 4. Implied Rate based on Fed Funds Futures

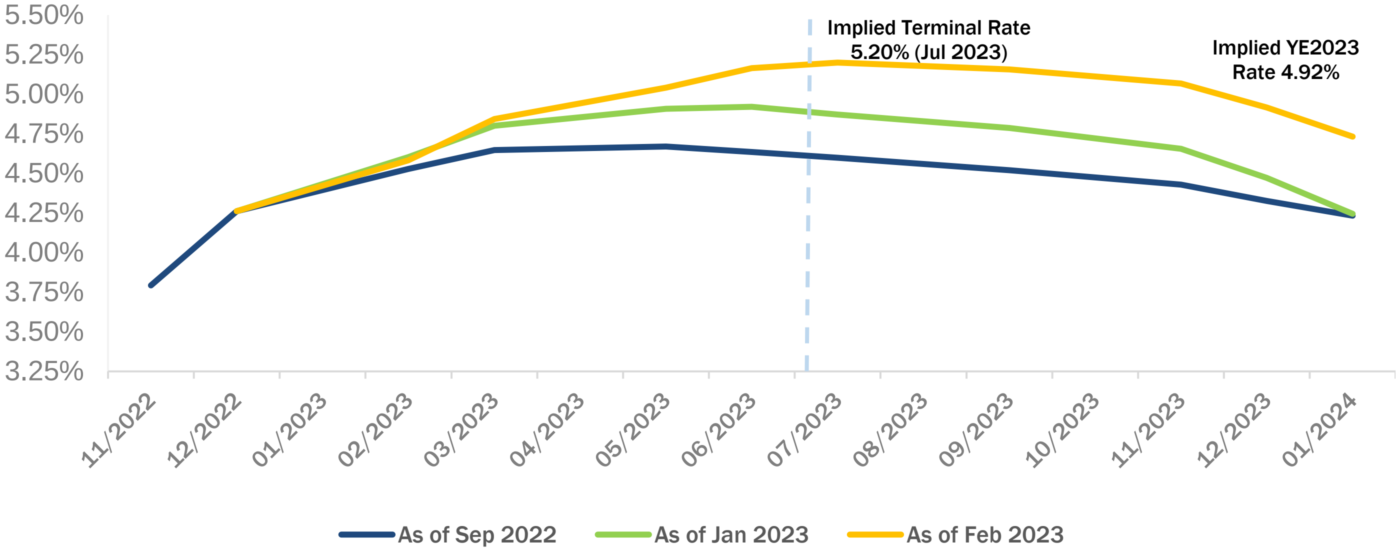
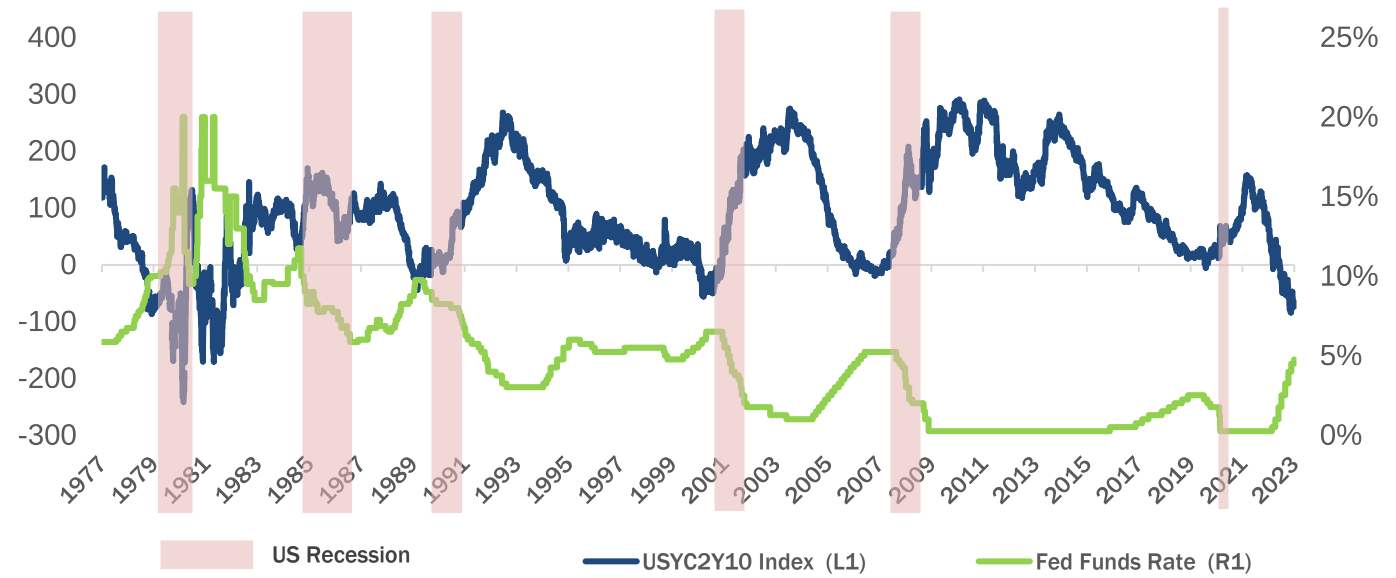


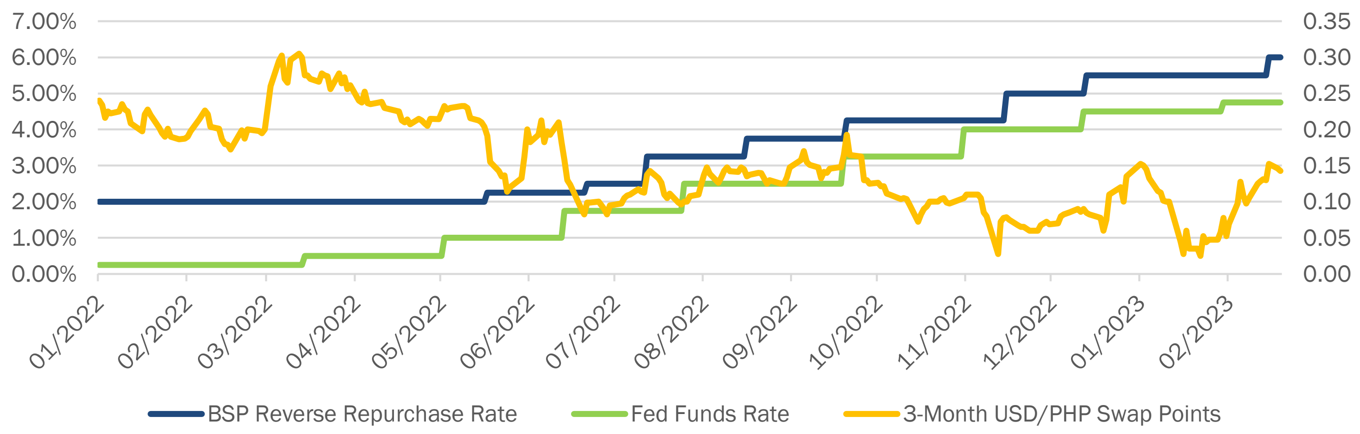
Chart 5. US Yield Curve 2s10s Spread vs Fed Funds Rate



In the local space, the BSP has also hinted at an additional rate hike in March. This will depend greatly on February inflation results. The BSP revised its 2023 average inflation forecast higher, from 4.5% to 6.1%, with other private sector economists following suit. We forecast that the BSP could already pause at the current 6% or hike 25-50 bps more and then cut by the same increment by year end, resulting in the same 6%. Unlike the US treasury yield curve, the Philippine government securities yield curve has remained upward sloping. Since the end of January, it has shifted higher by an average of 25 bps across the curve, with the issuance of a new 5.5-year Retail Treasury Bill (RTB) with a 6.125% coupon. But with the market expecting more BSP rate hikes to come, long-term peso bonds might sell off in favor of short-term bills as investors wait for the new peak.

The latest BSP rate hike also brought the USD/PHP interest rate differential (IRD) back to 125 bps. It was a level last seen in September 2022 before the Fed caught up and the BSP was forced to match hike-for-hike. USD/PHP swap points have bounced back on the wider IRD and rising USD/PHP, as dollar buyers rush to hedge future payables *(Chart 6)*.

Chart 6. US and PH Policy Rates vs 3-Month USD/PHP Swap Points



Trade idea for investors

Invest in 3-month asset swaps on US treasury bills at 4.600-4.800%

Because of rising short-term yields and USD/PHP swap points, we see opportunities for investors to potentially maximize short-term returns by entering into structured investments. This can be an appropriate strategy for investors with short-term investment requirements looking to diversify beyond time deposits and treasury bills, as well as long-term investors waiting for policy interest rates and bond yields to peak.

An asset swap (ASW) is a structured investment wherein a client buys a foreign currency-denominated security (US treasury bill) and simultaneously enters into a derivative, in this case, a forward, to transform the cash flows from foreign currency into peso. The combination of transactions creates a synthetic peso asset. The client earns interest income on the underlying security and also realizes the foreign exchange gain from buying at a lower USD/PHP spot rate and selling at a higher USD/PHP forward rate.

A higher Fed Funds Rate has allowed for new US treasury bills to be issued at higher yields. This combined with elevated USD/PHP swap points potentially enhances the return when dealt as ASW. The indicative yield has increased by 60-70 bps since the end of January. Compare this with a peso treasury bill maturing on May 24, 2023 but is yielding 4.37% gross.

Indicative pricing as of February 21, 2023. Subject to client suitability and available volume.

Category	Security	Indicative Yield	Tenor (Days)	Maturity
US T-Bill ASW	B 05/25/2023	4.757% per annum in PHP	92	25 May 2023

Clients who want US dollar exposure may also participate by simply investing in the 3-month US treasury bill without entering into an ASW. They may invest their own excess US dollar funds or purchase dollars against PHP, following BSP regulations on non-trade capital account transactions for the purpose of outward investment.

Indicative pricing as of February 21, 2023. Subject to client suitability and available volume.

Category	Security	Indicative Yield	Tenor (Days)	Maturity
US T-Bill only	B 05/25/2023	4.476% per annum in USD	92	25 May 2023

ASW allows a client to invest in foreign currency bonds and address foreign currency mismatches between assets and liabilities. It also allows for a diversification of one's investment portfolio.

The return on investment may not be realized if the transaction is terminated prior to maturity. The market value of the bond may be less compared to when the client entered the transaction. In that case, the market value of the derivative may be negative. The client takes on the credit risk of the issuer of the underlying bond and Metrobank as the counterparty for the derivative. The transaction may be illiquid.

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