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Central banks start to sound dovish ahead of a possible economic slowdown

- The Bangko Sentral ng Pilipinas hiked policy rates by 25 basis points to 6.25%, citing easing inflation in February and a softer global growth outlook. We believe the BSP will pause here and then cut rates down to 6.00% in December.

- USD/PHP once again trades below 55.00 as the top performing Asian currency year-to-date, but we question the sustainability of its outperformance. We reaffirm our year-end forecast of 55.10 as economic fundamentals result in greater domestic demand for USD.

- For peso investors, we see value in locking in 10 to 20-year government securities before the market chases after the peak in yields. We also see the lower USD/PHP as an opportunity to enter USD-denominated bonds, but we prefer staying in sovereign bonds due to the impact of Silicon Valley Bank and Credit Suisse on corporate credits.

Financial Markets Sector
Philippine Rates Outlook
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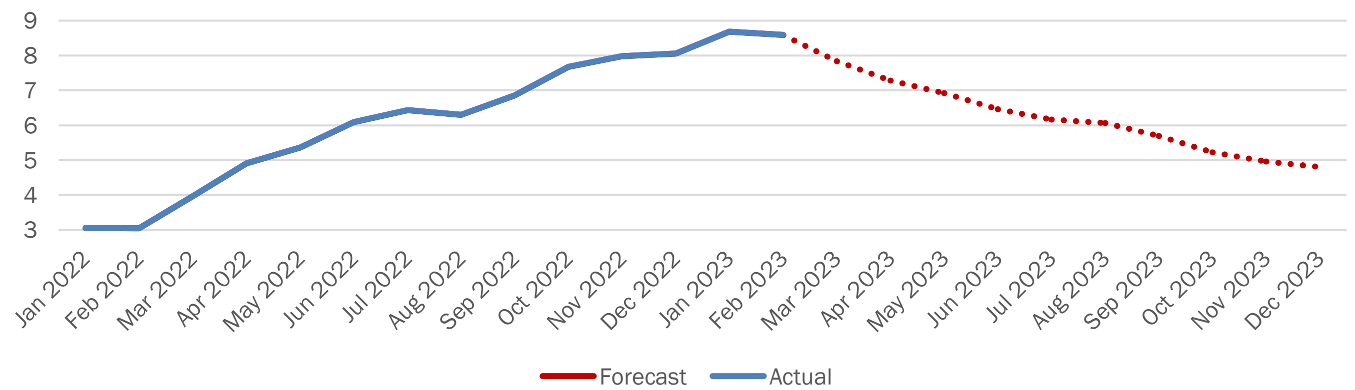
Nearing the peak of peso interest rates

The Bangko Sentral ng Pilipinas (BSP) went for a dovish hike and raised its policy rate by 25 basis points (bps) to 6.25% last March 23. BSP Governor Felipe Medalla previously mentioned that the central bank would consider another 50 bps hike should February inflation hit 9% or higher. Instead, the February Consumer Price Index (CPI) came out softer at 8.6% year-on-year versus 8.9% forecast. Though only inching down from the January's surprise 8.7% inflation growth rate, the lower figure was welcome news and gave off the impression that inflation may have already peaked. Lower transport-related costs brought about by a decline in global oil prices helped the headline inflation decelerate. However, markets are still cautious of the core inflation figure, which excludes volatile commodities such as food and energy. This figure has not yet peaked, instead growing from 7.4% year-on-year in January to 7.8% in February, due to second round effects amid higher inflation expectations. The BSP recently revised its average inflation forecasts from 6.1% to 6% in 2023 and 3.1% to 2.9% in 2024, citing easing inflation pressures and a softer global growth outlook.

Metrobank Research believes that inflation has indeed peaked last January 2023 and will continue to trend downward for the remainder of the year, barring any new supply and price shocks. Base effects will also set in as prices already saw a rapid increase starting in 2Q 2022 and additional increases in 2Q 2023 onwards are likely marginal at best and should translate to a lower headline inflation growth rate. Our research team expects the average full year inflation rate to be between 6% to 7% but the descent to meet that average looks identical to the rise in prices seen in 2022.

Chart 1. Philippine Consumer Price Index (CPI) – Metrobank Research Forecast (%)

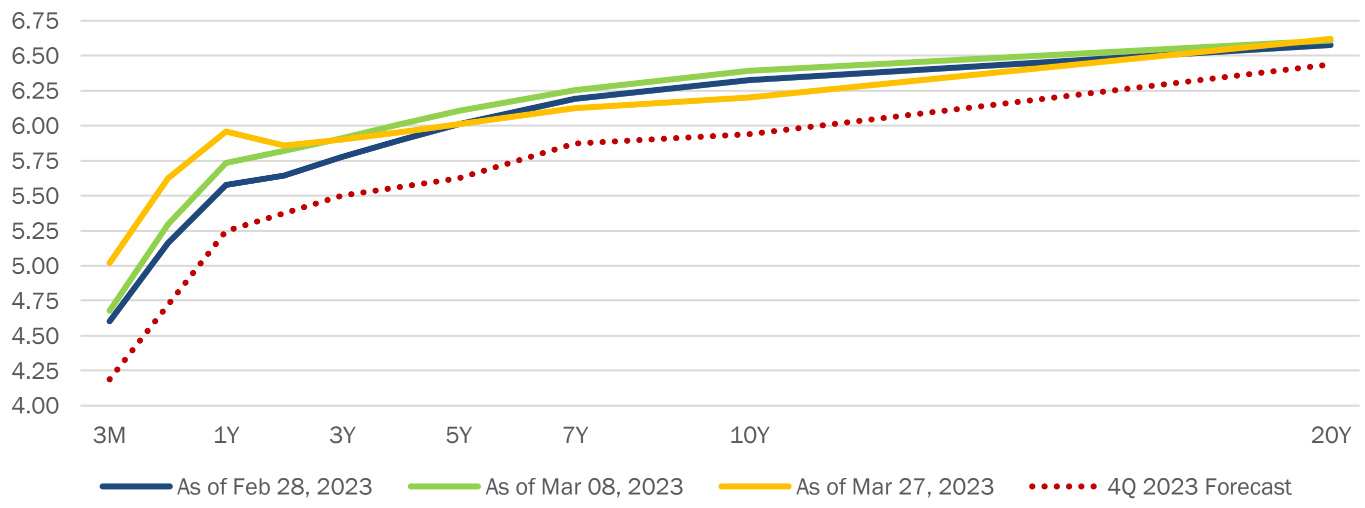


Diving deeper on a quarterly basis, our research team's average inflation forecast for 1Q 2023 is at least 8%. The higher figure makes sense when considering that 1Q 2022 average CPI was still 3.4%, well within the BSP's preferred 2% to 4% range. For 2Q 2023, we expect a lower average forecast of 6.9%, coming from an already elevated 2Q 2022 average CPI of 5.5%. When comparing our forecasts for 1Q 2023 and 2Q 2023, this is a quarter-on-quarter decrease of almost 100 bps. While inflation is expected to decrease by this much in the span of three months, interest rates will continue to remain elevated in order to reduce excess demand in the economy. However, we believe that the combination of elevated interest rates and falling inflation supports our view that a new easing cycle could come as early as the end of this year.

Finance Secretary Benjamin Diokno, who sits on the BSP Monetary Board, also commented that the BSP may consider pausing its tightening cycle in May, stating that the full impact of the central bank's rate hikes still has to be absorbed by the economy. We hold the view that the BSP will pause at 6.25% or possibly even hike to 6.50% in May, but we ultimately expect a rate cut back down to 6.00% later in December, in order to signal the beginning of an easing cycle in 2024.

Looking at Peso Government Securities, the yield curve flattened further from how before Silicon Valley Bank's (SVB) collapse and the BSP rate hike *(Chart 2)*. The 3-month to 1-year yields adjusted higher by 22-34 bps, with the 1-3 year part of the curve inverting by 6 bps. Tenors longer than 5 years shifted lower by 10-20 bps as investors started to buy long-term bonds in bulk, expecting March to be the BSP's last rate hike for this tightening cycle.

Chart 2. PHP Government Securities / Bloomberg Valuation Service (BVAL) Yield Curve (%)

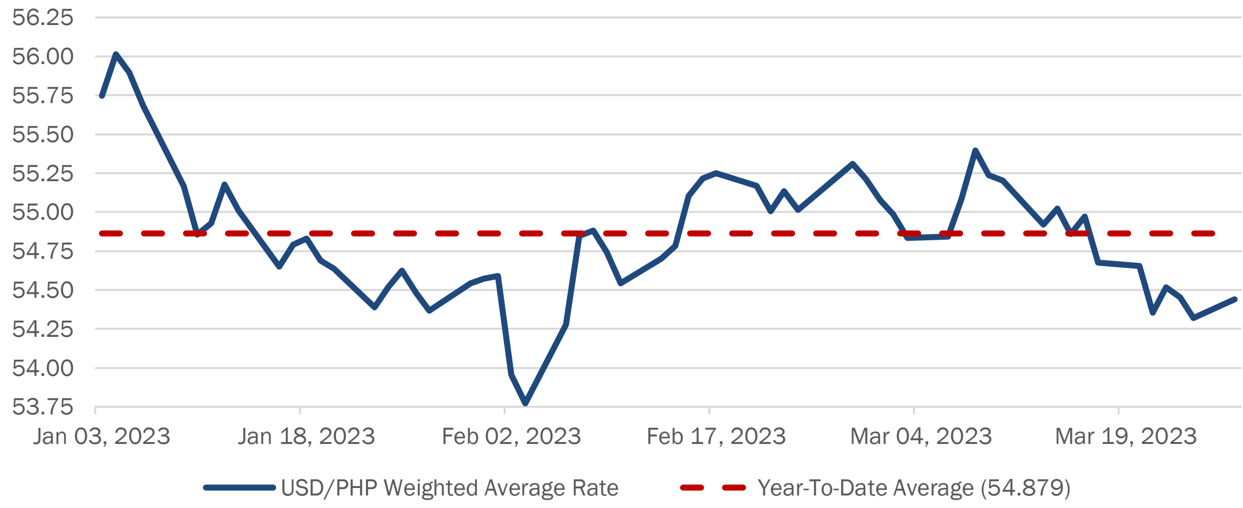


With the Bureau of Treasury (BTr) about 40% done with its domestic funding requirement, we expect the yield curve to continue its descent, due to lower bond supply in the second half of the year and increasing demand for long-term bonds before the start of the BSP's next easing cycle. Our 4Q 2023 forecasts sees the belly to the back end of the curve shifting downward by 20 to 40 bps. A new easing cycle will only continue to drive up demand for long-term bonds so we prefer to be overweight duration at these levels.

Bullish peso bets delay the inevitable

The strong US dollar was back in full swing with the USD/PHP once again testing highs of 55.30s in early March *(Chart 3)*. The softer February CPI figure and impression that inflation may have already peaked would have also added to expectations of further peso weakness *(Chart 4)*. The trajectory was consistent with our FX traders' personal views of 55.50 by end of 1Q 2023. However, the collapse of SVB resulted in a sell off in the US dollar against its global peers. Surprisingly, the peso continued to appreciate further below 54.50 even as global markets were in risk-off mode after UBS' takeover of Credit Suisse.

Chart 3. USD/PHP Weighted Average Rate Year-To-Date



The Philippine peso is currently the top performing currency in Asia, gaining close to 2% against the US dollar year-to-date *(Chart 5)*, but we question the sustainability of its outperformance. We believe that market players may be exceptionally bullish on the peso, believing that the US regional banking crisis and sudden dovishness of the Fed will continue to keep the dollar weak. However, we are wary of an imminent correction driven by the Philippines' own economic fundamentals.

Chart 4. PH CPI vs. BSP Reverse Repurchase Rate (%)

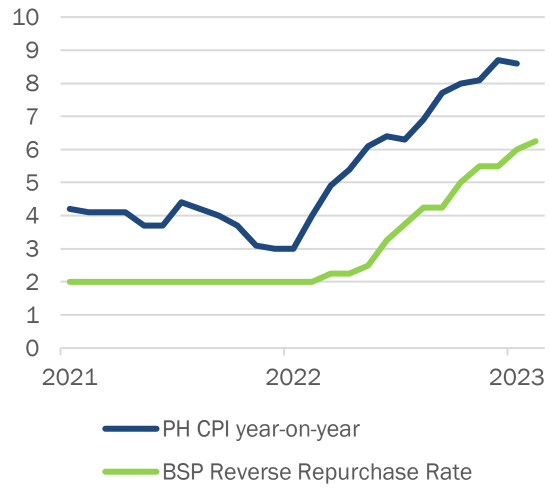
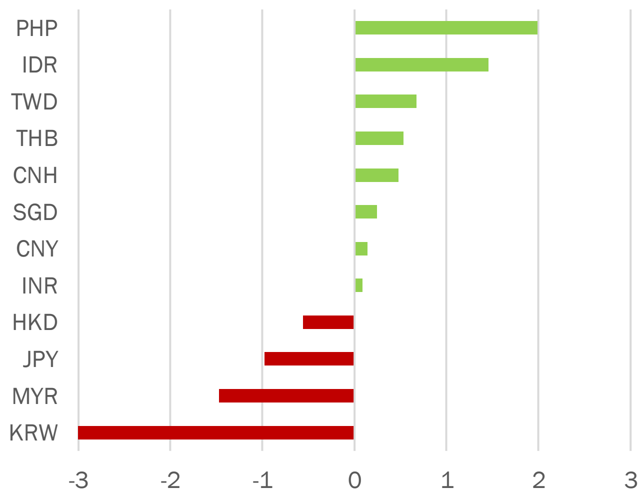
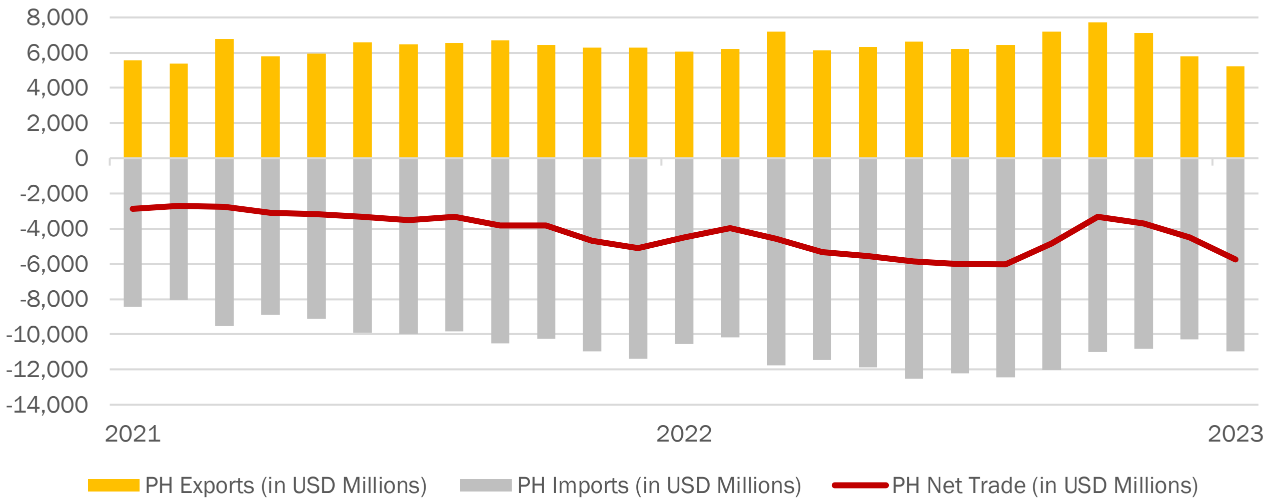


Chart 5. Asian Currencies Year-To-Date Returns against USD (%)



Domestic dollar demand is slowly growing, resulting in bouts of short squeezes in the USD/PHP market. January imports increased to USD 10.97 billion from USD 10.3 billion in December 2022 and the 1-year average of USD 10.6 billion. Meanwhile, January exports decreased significantly to USD 5.23 billion from USD 5.8 billion the previous month and the 1-year average of USD 6.36 billion. This 13.5% year-on-year decline in exports was driven by lower demand for automotive electronics (-79%), office equipment (-64%), and consumer electronics (-23%) in China, the US, and Hong Kong,. These three destinations account for more than half of Philippine export volumes and may also be an indicator for a slowdown in global demand. The result is a wider January trade deficit of USD 5.74 billion versus the December 2022 trade deficit of USD 4.5 billion and 1-year average of USD 4.25 billion *(Chart 6)*. We expect the net trade drag to weigh heavily on the peso, which could retrace back to 56-levels by 2Q-3Q and then gradually fall back to 55.10 by 4Q. If the global economy is truly headed for a slowdown, then the decrease for Philippine exports will continue while the country must keep importing fuel as well as materials for the government's infrastructure projects. The only consolation is that commodity prices should also ease in the middle of a global slowdown, which benefits Philippine importers.

Chart 6. PH Exports vs. Imports vs. Net Trade



Trade ideas for investors

Invest in 10-20Y Government Securities at 6.250-6.650%

With Philippine inflation slowing and the BSP likely pausing its policy interest rate at this level, we believe that this is the time to start adding duration, particularly 10 to 20-year government securities. Yields on long-term bonds have already started to shift lower as market players chase after peak rates. Even though a rate cut could still be several months away, we expect that lower bond supply due to plans to reduce future borrowings will only drive up the demand for bonds, causing yields to fall further down.

Top picks indicative pricing as of 31 Mar 2023. Subject to client suitability and available volume.

Category	Bond	Indicative Yield-To-Maturity (YTM)	Tenor (Years)	Maturity Date
Peso Government Security	FXTN 10-68	6.150%	9.23	23 Jun 2032
Peso Government Security	FXTN 10-69	6.150%	9.46	15 Sep 2032
Peso Government Security	FXTN 25-6	6.260%	11.60	05 Nov 2034
Peso Government Security	FXTN 25-7	6.280%	12.50	30 Sep 2035
Peso Government Security	FXTN 20-25	6.580%	19.66	24 Nov 2042

Invest in 10Y Investment Grade Sovereign Bonds at 4.750-5.000%

For investors who want to diversify their portfolio and gain exposure to US dollar-denominated bonds, we see the lower USD/PHP as an opportunity to pick up dollars before an possible retracement higher due to growing domestic dollar demand and a widening Philippine trade deficit. However, we prefer investment grade sovereign bonds over corporate credits, which will likely continue to be affected by the crisis surrounding SVB and Credit Suisse. Corporate credits might also be the first to underperform in a potential global economic slowdown. Bonds such as the newly issued 10-year Republic of the Philippines (ROP) and Kingdom of Saudi Arabia (KSA) represent good levels to lock in for longer term while potentially being a source of capital gains should US treasury yields go lower in the medium to long term. KSA are a better relative value as they have similar yields to ROPs but have a higher credit rating.

Top picks indicative pricing as of 31 Mar 2023. Subject to client suitability and available volume.

Category	Bond	Indicative Yield-To-Maturity (YTM)	Tenor (Years)	Maturity Date
Sovereign	ROP 33NEW	4.736%	10.30	17 Jul 2033
Sovereign	KSA 33NEW	4.673%	10.30	18 Jul 2033

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