ELEVATOR UP, STAIRWAY DOWN

- The BSP pauses policy interest rates for the third consecutive meeting as both inflation and economic growth slow down considerably, but revises full-year 2023 and 2024 inflation forecasts higher due to increasing global oil and rice prices.

- Metrobank Research has revised its year-end policy rate forecast from 6.00% to 6.25% on higher inflation expectations. No further tightening is expected on account of the lower Q2 GDP growth rate but there will likely be gradual easing over the next two years.

- Given the potential for a higher for longer rates environment, we continue to remain tactical on 5 to 20-year peso government securities as yields may fall much later than originally anticipated.

Financial Markets Sector
Philippine Rates Outlook
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Restrictive monetary policy

The higher interest rate environment hasn't just brought down inflation. It's taking the Philippine economy with it. Coming from a Q1 2023 gross domestic product (GDP) growth rate of 6.4% year-on-year (Y/Y), median projections for Q2 were set lower at 6.1%. However, economists and financial markets analysts were alarmed when the actual figure printed at a considerably lower 4.3% instead.

The slowdown has been primarily attributed to a decline in government spending (-7.1% Y/Y) which did not meet its spending target for the first half of the year. Only PHP 4.73 trillion out of the PHP 5.27 trillion first semester budget has been released to various government agencies.

Meanwhile, investment spending also decreased by 0.04% Y/Y, likely as a result of higher borrowing costs discouraging businesses from expansionary activities. This is also evident in imports growing by only 0.4% Y/Y compared with +14.5% in the year ending Q2 2022. Consumer spending, which drives the Philippine economy and usually accounts for 60% of GDP, moderately grew by 5.5%, implying that everyone might have overestimated the "revenge spending" narrative. Consumers are likely being more selective on discretionary spending due to elevated inflation.

Chart 1. PH GDP Y/Y Growth in %

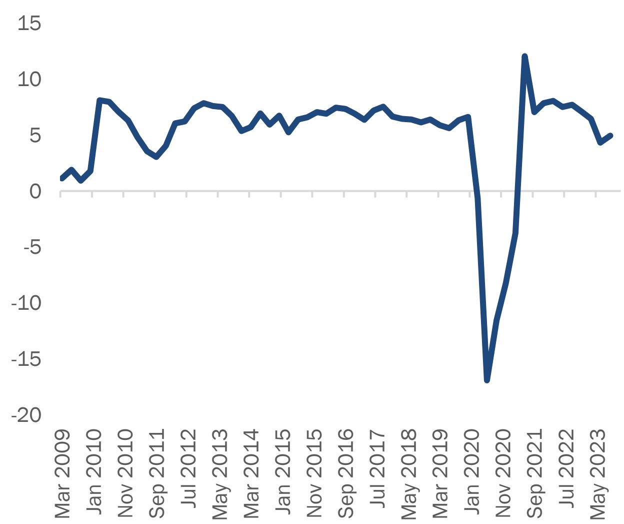
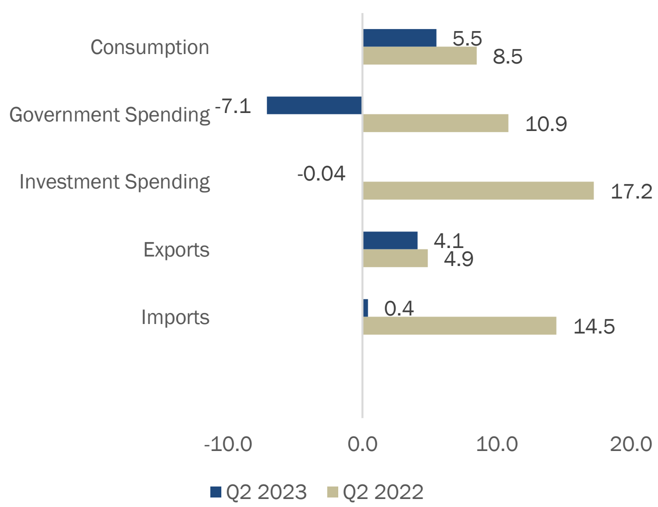


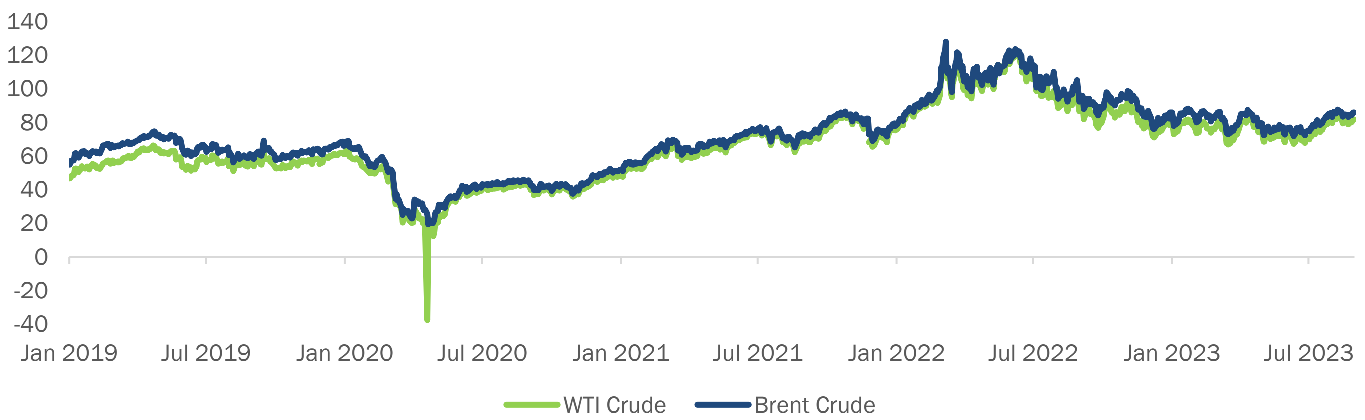
Chart 2. Real GDP by Expenditure Shares (Y/Y Growth in %)



From struggling with a peak figure of 8.7% Y/Y last January 2023, the Consumer Price Index (CPI) printed at 4.7% in July, thanks to improving supply chains as well as lower commodity prices early in the year. Core inflation with excludes volatile energy and food prices remains sticky at 6.7% due to second-round effects i.e., businesses keeping the prices of goods and services high due to elevated inflation expectations. But it is also expected to come down as domestic demand falls and businesses are persuaded to cut prices. Headline inflation is expected to enter the Bangko Sentral ng Pilipinas' preferred range of 2% to 4% by the end of the year.

However, recent external shocks may threaten the return to target inflation. Oil, which accounts for 8% of the CPI, has been on the rise as the Organization of Petroleum Exporting Countries (OPEC) cuts the production of oil by 4.66 million barrels per day in order to support prices. West Texas Intermediate (WTI) and Brent crude are priced at USD 81.63 and USD 85.86 per barrel respectively as of this writing. The BSP has simulated that if average oil prices reach USD 95.00 and USD 105.00 per barrel in 2024 and 2025 respectively, inflation will likely print above 4% once more.

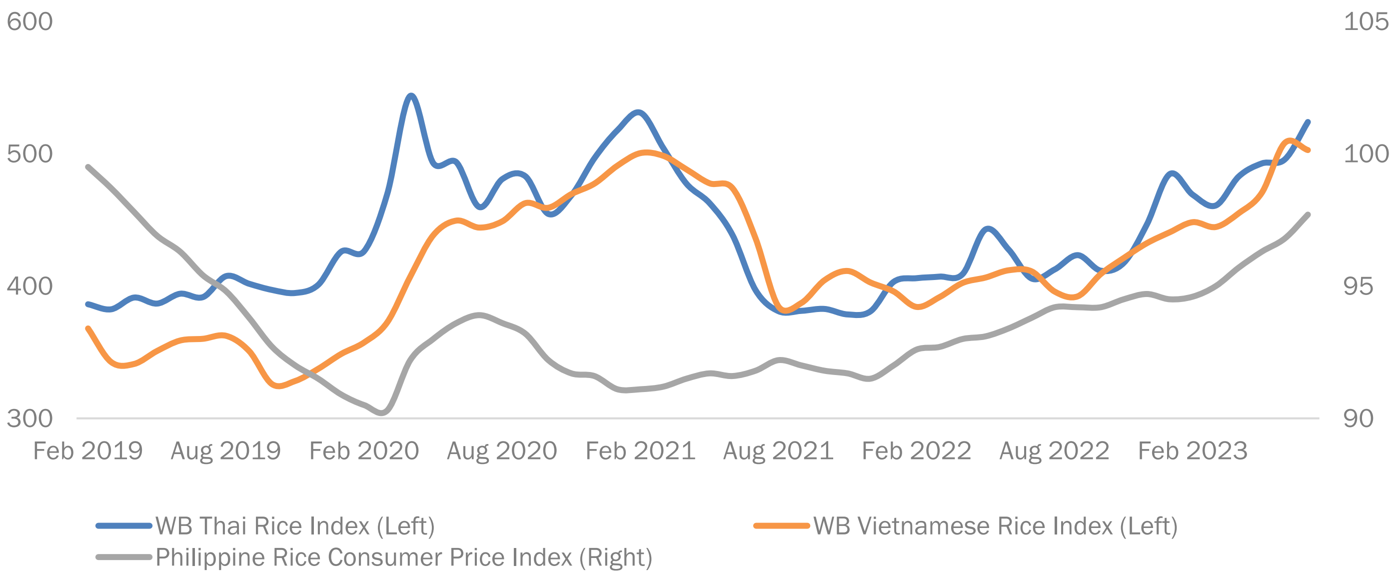
Chart 3. WTI and Brent Crude (USD/Barrel)



Food, which accounts for 38% of the CPI, is also seeing a resurgence after India banned the export of rice, for its own food security. The Philippines produces 81.5% of its rice requirement locally while 18.5% is imported. India is not among the top 3 countries that the Philippines imports rice from. Those would be Vietnam (2.5 million tons), Myanmar (0.2 million tons), and Thailand (0.2 million tons).

But the India ban threatens to squeeze rice supply and force other importing nations to compete for a much smaller supply pool. Extreme weather caused by El Niño may potentially damage rice fields here and abroad. Thailand has already announced that it will restrict rice planting to a single crop amid widespread drought conditions, which doesn't just affect global rice supply but may also spillover to sugar supply.

Chart 4. Rice Price Index (USD/MT)



The BSP has since then revised its average inflation forecasts higher from 5.4% to 5.6% in 2023 and from 2.9% to 3.3% in 2024 in anticipation of these emerging supply side risks. Following the higher than expected August headline inflation print, we anticipate an upward revision in the central bank's inflation estimate.

Metrobank Research continues to see inflation further decelerating in the coming months but at more elevated levels, given the risks posed by higher global rice prices and weaker peso particularly this Q3 import season, impact of weather disturbances on food production, and rising fuel prices. Given this recent development, we revise our full-year average inflation estimate to 6.0% (from 5.6%) for 2023, but maintain our 4.6% forecast for 2024.

While price pressures have significantly tempered for 2023, as indicated by the easing core inflation, we are also wary of upside pressures from food inflation particularly rice may prompt a new round of secondary effects.

No room for cuts in 2023

The BSP finds itself in a monetary conundrum as it balances price stability and the national government's agenda for economic growth. Higher interest rates are finally working through the economy, primarily in benign investment spending which, if left alone, could result in unemployment and further slowdowns in consumer spending. But the central bank cannot cut yet due to potential supply shocks in oil and food as well as the pace of other global central banks. The US Federal Reserve is still struggling with sticky core inflation, mostly due to elevated shelter costs, but with US Q2 2023 GDP growing by 2.1%, the country might still be able to stomach additional tightening.

Although BSP officials have previously said that they are not totally dependent on the actions of the Fed, it is highly unlikely that the BSP will be the first to cut. With the overnight interest rate differential (IRD) between the US dollar and Philippine peso at 75 basis points (bps), the BSP runs the risk of a possible USD/PHP rally, especially after the currency pair almost retested 57.00 in the middle of August. The overnight IRD is not the only factor that influences the direction of the USD/PHP. The IRD between 10-year PHP government securities and US treasury bonds has remained close to its average of 255 bps, which provides a considerable premium for long-term investors. Current Philippine gross international reserves (GIR) remains healthy at USD 99.7 billion, albeit lower than the USD 102 billion earlier in the year after suspected open market operations in the FX market. But with global investors anticipating every economic data point to predict the Fed's next move, any negative news may cause an immediate sell-off in emerging markets assets and currencies like the PHP.

Chart 5. Historical PH-US Overnight IRD

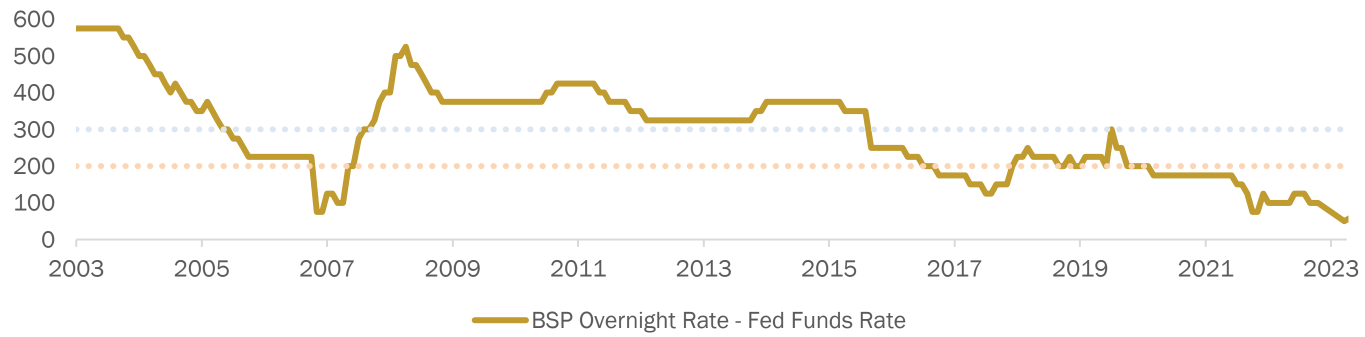
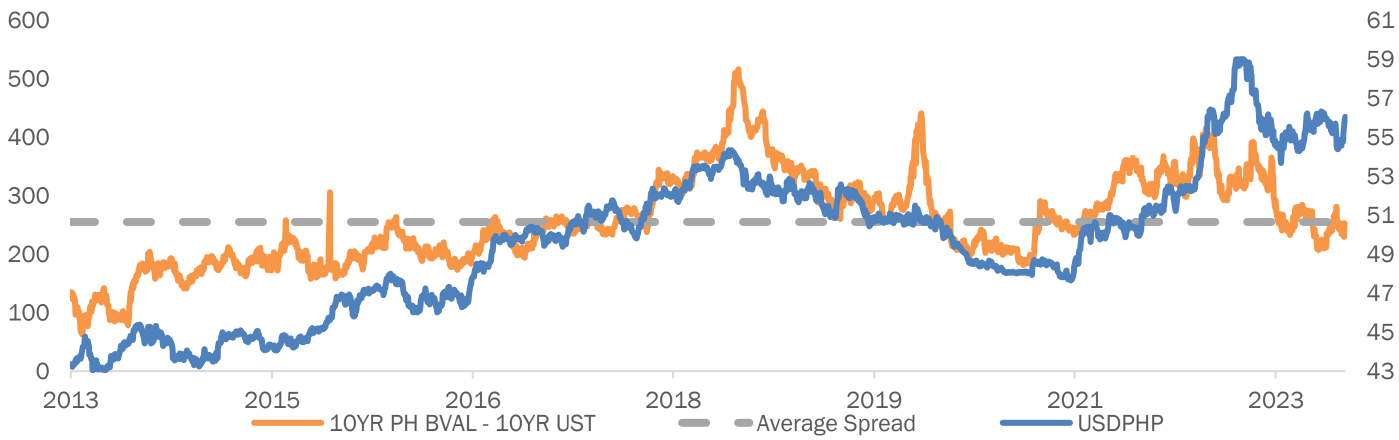
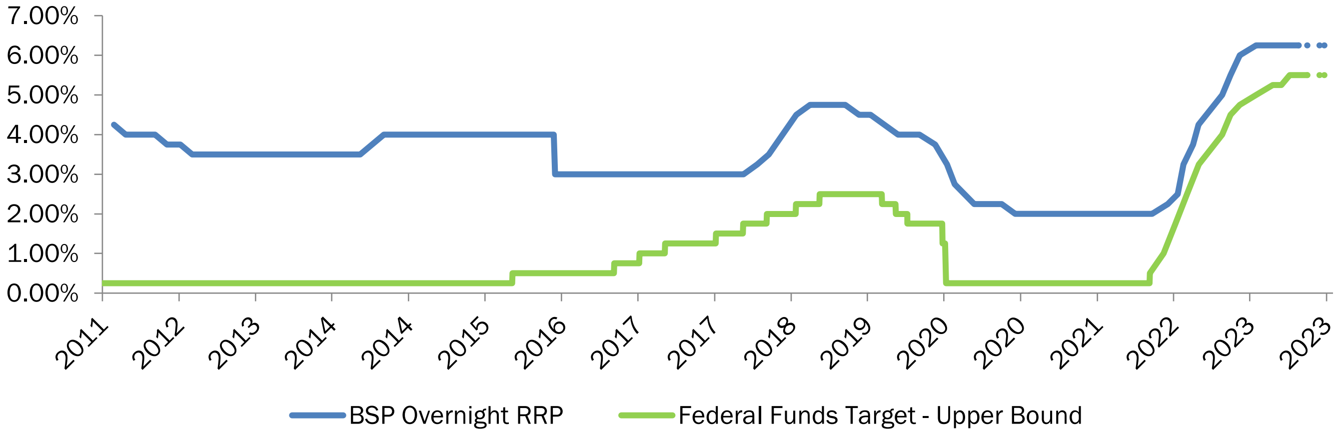


Chart 6. Historical PH-US 10-year IRD vs. USD/PHP



Metrobank Research initially projected that the BSP would cut its policy rate from 6.25% to 6.00% by December 2023, due to inflation easing faster than expected as well as to support GDP growth. But given additional supply side risks and renewed pressures on the local currency, we expect BSP to pause at 6.25% for the rest of the year. The central bank will start gradually cutting rates next year, but only after the Fed cuts first. BSP rate cuts are estimated at 25 bps every quarter over the next two years, putting the forecasted reverse repurchase rates at 5.25% and 4.25% for 2024 and 2025, respectively.

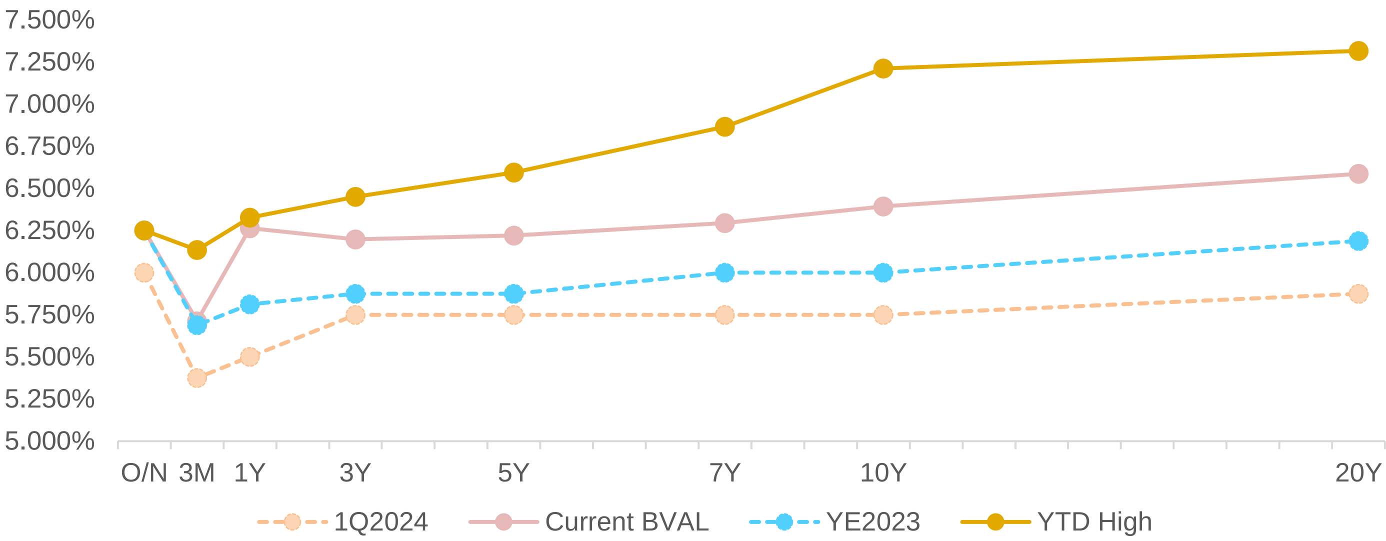
Chart 7. BSP vs. Federal Reserve Rate Path



It's still a bond year

In our view, the recent buying momentum seen in the peso GS space will persist through year-end. Our estimate of benchmark rates indicates that bonds in the belly are likely to end the year lower by as much as 35 bps from current levels while the long-ends may have room to rally by as much as 30 bps by year-end (Chart 8). With over 97% of the government's gross domestic borrowing program already covered as of end-August, we think that bond supply risk will also be subdued through end-2023.

Chart 8. PHP BVAL Forecasts



Despite heightened inflation expectations coming from the disappointing August headline inflation, the sell-off that ensued was subdued, with most peso GS trading higher by only as much as 5 bps following the report. We take this as an indication that market participants remain keen to lock-in elevated longer-term yields. Opportunistic buying demand has tempered the short-lived sell-off that followed, and we expect this support to strengthen further in the coming weeks, from reinvestments and positioning ahead of the FXTN 3-25 maturity on September 10, 2023 that will free up PHP 144 billion of liquidity.

As such, we continue to view any sell-off in the near term as buying opportunities, in anticipation of the downtrend in peso yields in the medium term.

We advise investors to load up on duration, favoring bonds beyond 10 years in tenor for their sizeable term premium pick-up and lower bond supply risk, at the following target entry levels (Table 1).

Table 1. Suggested Buy Levels

Tenor Bucket (Years)	Target Entry Levels
11-13	6.350% - 6.450%
15	6.500% - 6.600%
20	6.575% - 6.725%

Elsewhere in the curve, short-dated bonds and peso T-bills now yield higher or flattish relative to 7- to 10-year bonds, given the tenor bucket's recent outperformance. For example, RTB 3-11 and RTB 5-12 (0.5Y) at 6.08% shows significant pick-up over 6-month T-bills at 5.85%. Likewise, 1-year T-bills currently provide better value at 6.20%. vs FXTN 7-62 (2.5Y) at 6.12%.

Hold-to-maturity investors may therefore find short-dated bills and bonds attractive for carry. Tactical investors on the other hand, may take advantage of the current rally to lock-in gains from 2- to 10-year bonds.

Overall, we prefer 11- to 20-year bonds at current elevated levels to maximize cash flows and gains when interest rates fall, but also see tactical opportunities for the belly bonds given a market that continues to be awash with liquidity.

Table 2. Trade Plan

Security	Yield	Trade	Maturity	Remaining Tenor (Years)
FXTN 7-62	6.120%	SELL	14 Feb 2026	2.45
RTB 5-16	6.120%	SELL	07 Mar 2028	4.51
RTB 5-17	6.120%	SELL	22 Aug 2028	4.97
RTB 3-11	6.080%	BUY	09 Mar 2024	0.51
RTB 5-12	6.080%	BUY	12 Mar 2024	0.52
1YR TBILLS	6.200%	BUY	28 Aug 2024	1.00
FXTN 25-6	6.450%	TACTICAL BUY	05 Nov 2034	11.18
FXTN 25-7	6.450%	TACTICAL BUY	30 Sep 2035	12.08
FXTN 13-1	6.500%	TACTICAL BUY	20 Apr 2036	12.64
FXTN 20-22	6.600%	TACTICAL BUY	22 Feb 2038	14.48
FXTN 15-1	6.600%	TACTICAL BUY	13 Ju 2038	14.87
FXTN 20-25	6.700%	TACTICAL BUY	24 Nov 2042	19.24

Source: Metrobank GSTD

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