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Financial Markets Sector
Philippine Rates Outlook
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Earl Andrew Aguirre
ea.aguirre@metrobank.com.ph

Ruben Zamora
ruben.zamora@metrobank.com.ph

Patricia Membrebe
patricia.membrebe@metrobank.com.ph

Geraldine Wambangco
geraldine.wambangco@metrobank.com.ph

- The BSP delivered an off-cycle policy rate hike, citing recent supply shocks in food and fuel causing a surge in second round effects and threatening to keep inflation elevated.
- The surprise hike did little to talk down the USD/PHP exchange rate, which has been retesting previous highs, but consistent hawkish rhetoric from the BSP could help cap the currency pair from breaching 57.00.
- We remain tactical and continue to be overweight duration following the sell-off in the peso government securities. For short-term securities, we also want to take advantage of possible heaviness in the USD/PHP by entering into bearish or range binary structured notes.

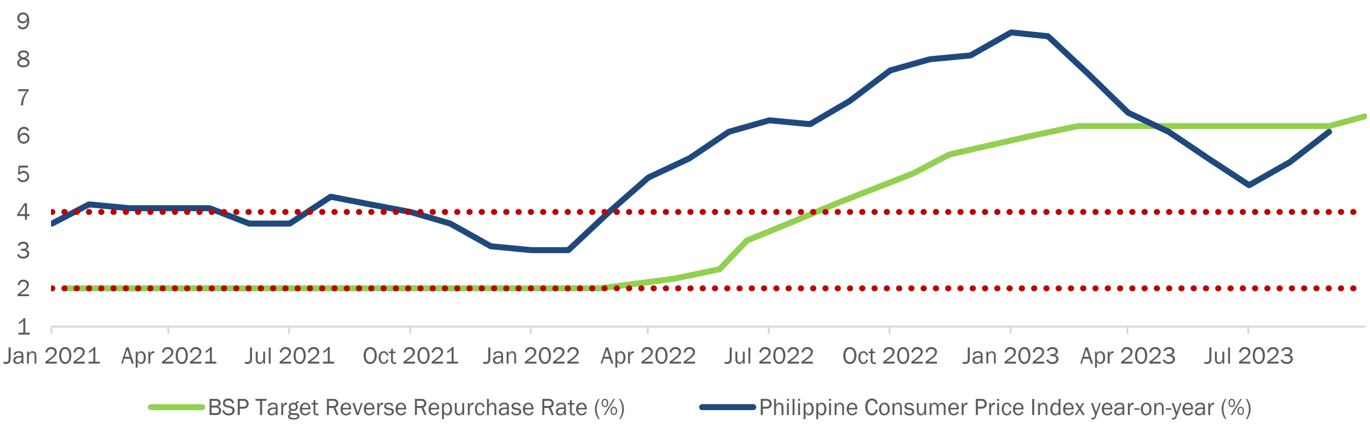
A structurally hawkish BSP

After weeks of preparing the financial markets for an off-cycle policy rate hike, the Bangko Sentral ng Pilipinas (BSP) finally announced a 25-basis point (bp) hike on October 26, 2023 to take effect the following day, bringing the Target Reverse Repurchase Rate (RRP) to 6.50%. Rates on the overnight deposit and lending facilities were also raised accordingly to 6.00% and 7.00%, respectively. This is the central bank's first policy move since March 2023 and amounts to 450 bps in cumulative rate increases since May 2022.

Recent supply-side inflation in food and fuel have caused the year-on-year consumer price index (CPI) to rebound to 5.3% and 6.1% in August and September, respectively. Rice, which accounts for roughly 10% of the entire CPI equation, saw rising global prices after India banned the export of non-basmati rice in July in order to secure its own domestic supplies ahead of expected El Niño. This drove up rice prices in Vietnam, Myanmar, and Thailand, where the Philippines actively imports from. In the case of fuel, the Organization of Petroleum Exporting Countries (OPEC) undertook voluntary production cuts to artificially support the price of oil and this was further exacerbated by the developing conflict between Israel and Hamas.

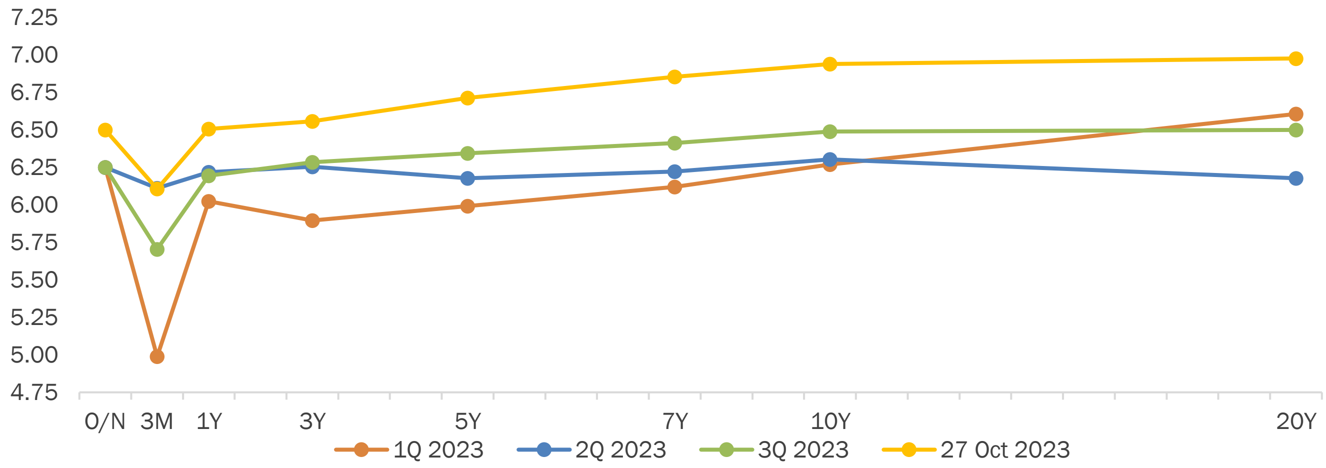
National Economic and Development Authority (NEDA) Secretary Arsenio Balisacan previously warned that additional monetary policy tightening will not have a direct impact on external supply shocks and may weigh on economic growth. However, BSP Governor Eli Remolona, Jr. is attempting to soften the impact of second round effects on the prices of goods and services, transport fares, and wages. He expects headline inflation to return to the BSP's target range of 2% to 4% by August 2024 instead of the first quarter of 2024 as previously estimated.

Chart 1. BSP Target RRP vs. PH CPI



The immediate reaction in the peso government securities (GS) market was a sell-off, with 10- to 20-year yields reaching 7% gross on the day of the announcement and settling just below it the day after. GS yields have revisited highs not seen since January 2023, when investors started to accumulate duration in anticipation of the end to monetary tightening by both the BSP and US Federal Reserve. While most of the curve has adjusted much higher since the end of September, the 3-month treasury bill yield remains depressed as offshore investors continue to park their cash in this tenor.

Chart 2. PHP GS yield curve

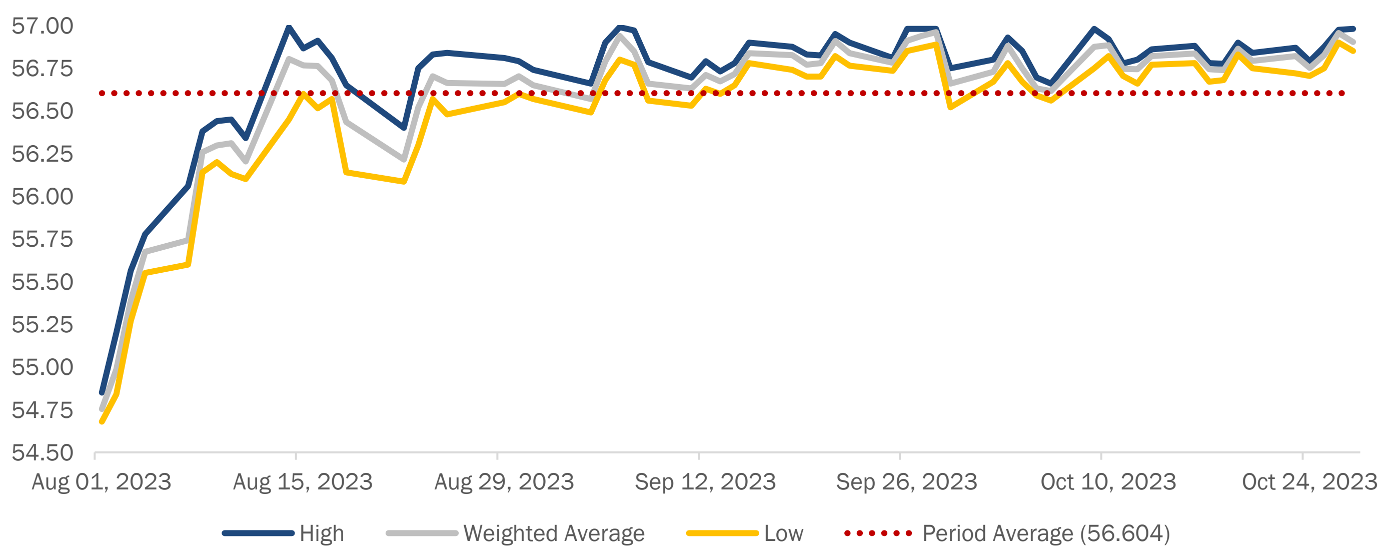


Although Governor Remolona has signaled another possible rate hike at the BSP's actual monetary board meeting on November 16, Metrobank Research believes that BSP will instead keep rates at this already restrictive level until the middle of 2024 and then pursue fewer rate cuts. We have revised our yearend 2023 and 2024 Target RRP forecasts to 6.50% and 6.00%, respectively.

Strong dollar keeps USD/PHP rangebound

Since September, the USD/PHP exchange rate has continued to trade within a range of 56.40 to 56.99. Higher US treasury yields due to increasing issuances, a widening fiscal deficit, and a stronger-than-expected US economy have contributed to broader US dollar strength in global FX markets. Local dollar supply above 56.90 has kept the currency pair tempered and caused players to liquidate long dollar positions when it felt overbought. However, on the downside, the dollar remains supported by corporate demand and opportunistic buyers. While the off-cycle hike had little impact on the USD/PHP, consistent hawkish rhetoric by Governor Remolona along with BSP open market operations will likely help keep the currency pair from breaching 57.00.

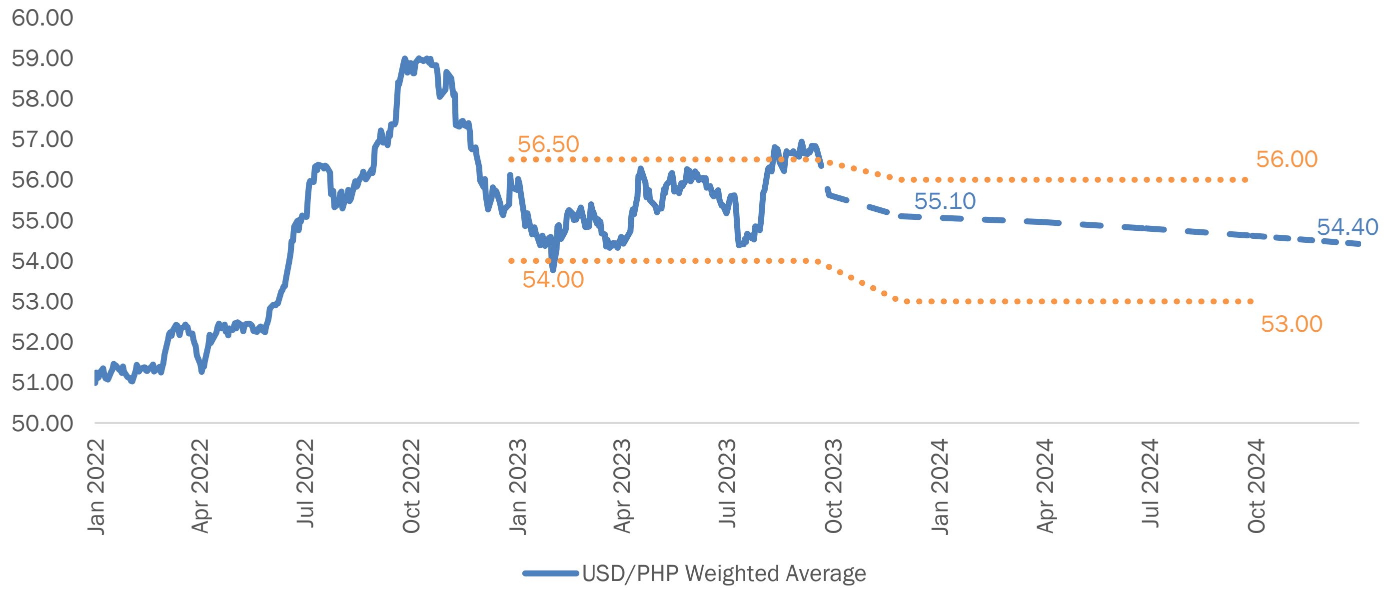
Chart 3. USD/PHP August 1, 2023 – October 27, 2023



This October, a combination of profit-taking in global FX and Overseas Filipino Workers' (OFW) remittance inflows have helped kept the USD/PHP heavy, albeit still supported at the 56.60-level. The Business Process Outsourcing (BPO) sector which earns revenues that are predominantly denominated in dollars is also expected to unload its supply to fund employee bonuses. This along with increased OFW remittances and a general lack of import activity in the fourth quarter should bring USD/PHP below the 56.00 level once more. We reiterate our view that USD/PHP will end 2023 at 55.10. However, should corporates start hedging purchases scheduled for the first quarter of 2024, similar to last year, then 56.00 will likely remain a strong support.

Our outlook for 2024 is for USD/PHP to trade within a lower range of 53.00 to 56.00 in anticipation of Fed rate cuts in the second half. With expectations of government spending catching up and seasonal imports returning in the second and third quarters, we think that the currency pair will still be able to reach highs around the 56.00 area. But fourth quarter seasonality should once again bring USD/PHP lower to 54.40 by yearend.

Chart 4. USD/PHP Weighted Average & Forecasted Ranges



Trade ideas for investors

Invest in 5-20Y Government Securities

Our investment strategy for peso GS is to remain tactical amid the higher-for-longer rates environment. We still prefer a barbell strategy of maintaining 10% to 20% cash in short-term securities while being overweight duration, particularly in 5- to 20-year bonds. For cash requirements, we prefer bonds with less than one year remaining to maturity, such as the RTB 3-11, over comparable peso treasury bills. While for long-term bonds, although the national government is expected to increase domestic borrowings to PHP 1.853 trillion next year, we think that the current PHP 1.63 trillion circulating in excess peso liquidity will limit potential upside in GS yields. Since we expect yields to also follow policy rate cuts over the next few years, we recommend investors to lock in long-term yields now, especially at 7% gross or higher.

Security	Remaining Tenor (years)	Coupon Rate (gross)	Suggested Entry Levels (gross)
RTB 3-11	0.35	2.375%	6.400% - 6.500%
RTB 5-13	1.78	2.625%	6.500% - 6.600%
FXTN 10-64	5.19	6.875%	6.750% - 7.050%
FXTN 7-70	6.73	6.375%	6.850% - 7.100%
FXTN 10-71	9.79	6.625%	6.950% - 7.200%
FXTN 25-6	11.01	9.250%	7.000% - 7.250%
FXTN 25-7	11.92	8.000%	7.000% - 7.250%
FXTN 15-1	14.70	7.000%	7.100% - 7.350%
FXTN 20-25	19.07	8.125%	7.100% - 7.350%

Invest in 3-12M Brokered Third Party Bearish and Range Binary Structured Notes

Given our views on the USD/PHP exchange rate decreasing over time, clients may also consider investing in the bank's new Brokered Third Party Binary Structured Notes linked to the USD/PHP as an alternative to short-term GS.

The **bearish binary note** may be an appropriate investment for clients who share the same view of USD/PHP going lower in the near future. The note pays a maximum coupon when the USD/PHP 11:30 AM Weighted Average Rate ("fixing rate") two (2) business day before maturity date falls below the specific strike rate. However, if the fixing rate rises above the strike rate, then the note pays a minimum coupon instead.

Indicative pricing as of November 6, 2023 at spot reference 55.81. Subject to client suitability and derivative credit facilities.

Issuer	Issuance Date	Maturity Date	Tenor (days)	Currency	View	Strike Rate	Minimum Coupon	Maximum Coupon
Goldman Sachs International	13 Nov 2023	12 Feb 2024	91	PHP	Bearish	55.81	2.710%	5.100%
	13 Nov 2023	13 May 2024	182	PHP	Bearish	55.81	2.710%	5.520%
	13 Nov 2023	9 Aug 2024	270	PHP	Bearish	55.81	2.710%	5.910%
	13 Nov 2023	12 Nov 2024	365	PHP	Bearish	55.81	2.710%	6.130%

On the other hand, the **range binary note** is more suitable for clients who believe that USD/PHP will just trade within a range of two rates over the investment horizon. The note pays a maximum coupon when the fixing rate two (2) business day before maturity date is within the chosen range. However, if the fixing rate falls outside the range, then the note pays a minimum coupon instead.

Indicative pricing as of November 6, 2023 at spot reference 55.81. Subject to client suitability and derivative credit facilities.

Issuer	Issuance Date	Maturity Date	Tenor (days)	Currency	View	Range	Minimum Coupon	Maximum Coupon
Goldman Sachs International	13 Nov 2023	12 Feb 2024	91	PHP	Inside Range	54.6938 - 56.9262	2.710%	5.080%
	13 Nov 2023	13 May 2024	182	PHP	Inside Range	54.6938 - 56.9262	2.710%	6.250%
	13 Nov 2023	9 Aug 2024	270	PHP	Inside Range	54.6938 - 56.9262	2.710%	7.350%
	13 Nov 2023	12 Nov 2024	365	PHP	Inside Range	54.6938 - 56.9262	2.710%	8.220%

These are just illustrations of how binary notes can be priced. The actual product is flexible enough that the bank is able to adjust the binary note components, depending on a client's preferences. For example, it is possible to set a higher minimum coupon but the corresponding maximum coupon will also adjust lower. Conversely, a lower the minimum coupon will result in a potentially higher maximum coupon.

Terminating structured notes prior to maturity may result in potential mark-to-market (MTM) losses depending on the prevailing foreign exchange rate at the time of the unwind. Clients are encouraged to hold their structured notes until the maturity date to avoid potential losses.

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