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THE RADAR

RIDING THE RALLY

Financial Markets Sector
Philippine Rates Outlook
December 2023

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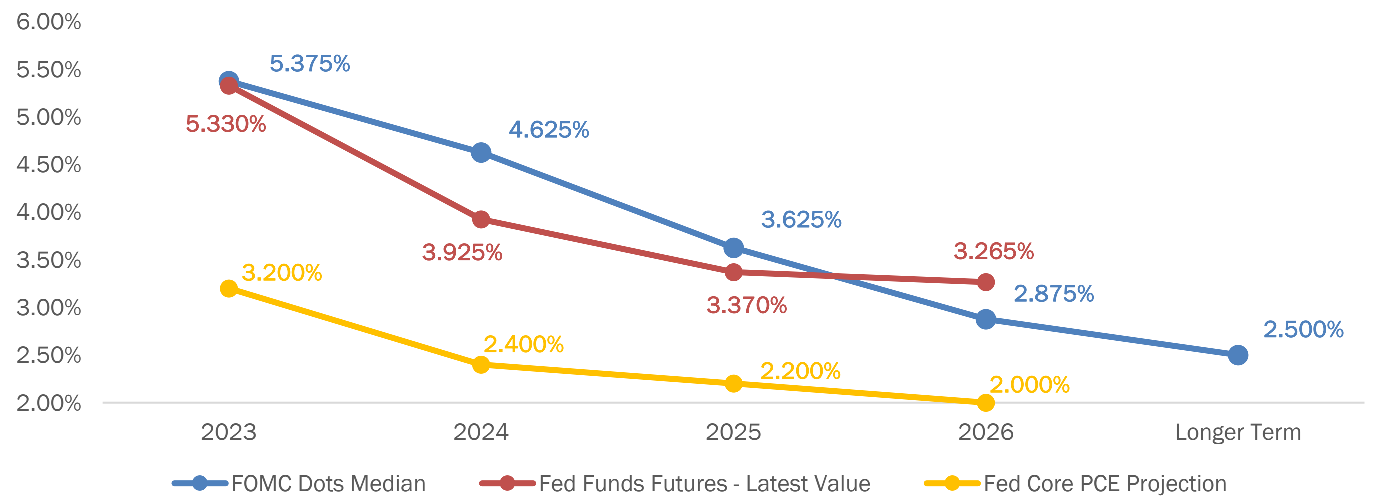
- The US Federal Reserve paused policy rates as expected at its December meeting and revised median yearend rate projections for 2024 and 2025 lower than previously forecasted. The BSP followed suit but retained its hawkish stance.
- The peso government securities (GS) yield curve has flattened further, with the belly to the back-end falling by more than 100 basis points from the year-to-date highs that followed the BSP's off-cycle hike in late October.
- Following the recent rally in global and local bond markets, we see an opportunity for trading clients to shift to our top short-term peso bond picks and investment alternatives while waiting for the auctions of longer-dated bonds in Q1 2024.

Same decision, different messages

At the end of its December 13 meeting, the US Federal Reserve held its policy rates for the third consecutive meeting, leaving the fed funds rate within a range of 5.25%-5.50%. This is effectively 25 basis points lower than its previous yearend median forecast of 5.625%. The pause comes amid multiple consecutive months of easing inflation, with the consumer price index (CPI) growing in line with expectations at 3.1% year-on-year in November, albeit due to easing global oil prices. When excluding volatile oil and food prices, the core personal consumption expenditure (PCE) index grew by 3.5% year-on-year in October while the November figure released last December 22 decelerated to 3.2%, as services and shelter costs show smaller gains. The lower inflation figures justified the release of new yearend median rate projections, from 5.125% to 4.625% in 2024 and from 3.875% to 3.625% in 2025. The projection for 2026 remains unchanged at 2.875%.

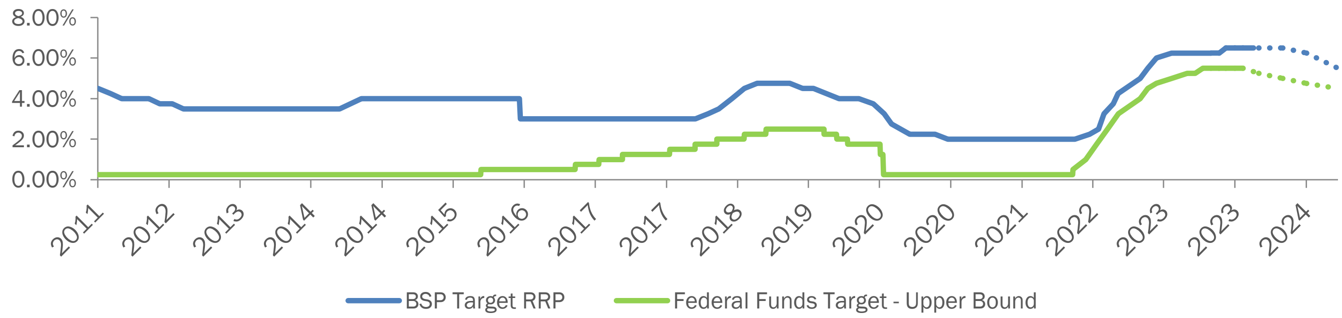
Chart 1. Fed Dot Plot as of 13 Dec 2023



Markets quickly digested the dovish message, with the US dollar selling off while the 10-year US treasury yield rallied to below 4% despite reaching almost 5% in October. Several Fed officials such as New York Fed President John Williams and Chicago Fed President Austan Goolsbee attempted to downplay the hints of monetary easing, reiterating that it is too early to discuss interest rate cuts while inflation remains above 2%. Despite the Fed's revised projections for three 25-basis point (bp) cuts in 2024, the markets have aggressively priced in four to five cuts in preparation for a potential economic slowdown or recession. The markets expect the first cut to happen as early March 2024.

In the local space, the Bangko Sentral ng Pilipinas (BSP) also held its target reverse repurchase rate (RRP) at 6.50%. Unlike the Fed, BSP Gov. Eli Remolona, Jr. maintained his hawkish stance and reiterated potential upside pressures to the central bank's inflation outlook. The BSP expects inflation to temporarily accelerate above its 2%-4% target in Q2 2024 due to the impact of El Niño and wage adjustments, before returning to the target range by Q3 2024. Despite this view, the BSP is prepared to tighten monetary policy as necessary, especially if higher oil prices, transportation costs, and electricity rates result in second-round effects and threaten to raise inflation expectations anew. Gov. Remolona also mentioned that inflation must remain within the 2%-4% target for a sustainable period of time before any rate cuts may be considered. With the Philippines' CPI seeing back-to-back lower-than-expected inflation figures of 4.9% and 4.1% in October and November, respectively, Metrobank Research believes that the BSP can afford four 25-bp cuts in 2024, to bring the target RRP by 5.50% by yearend. The first cut will likely happen in June 2024, a few months after the Fed's own cut.

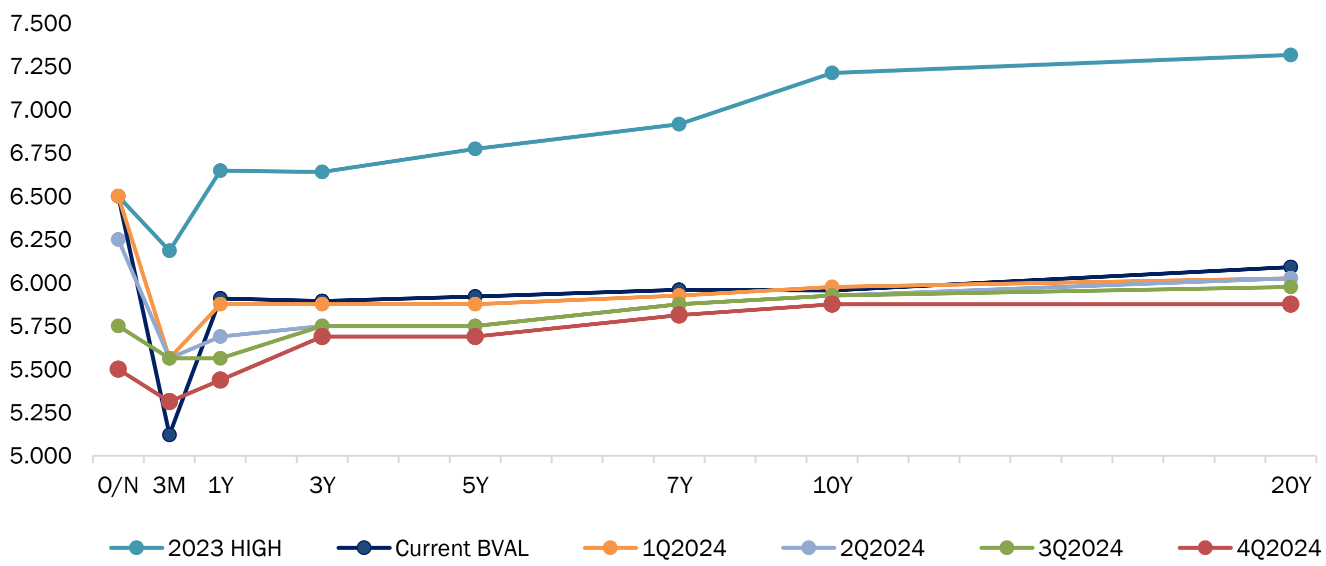
Chart 2. Central Bank Policy Rate Path



Flattening of the curve

Yields in the peso government securities (GS) market hit new year-to-date highs in late October after tracking rising US treasury yields and experiencing a sell-off following the BSP's off-cycle hike. 10- to 20-year bonds were well above 7% gross for the first time since the beginning of 2023. Demand for long-dated bonds has increased since as investors opportunistically locked in record-high yields. Even with the BSP maintaining its hawkish stance at its December meeting, local markets are convinced that easing will come in 2024 as inflation decelerates accordingly. This has severely flattened the GS yield curve, with 10- to 20-year bonds now barely trading at around 6% gross.

Chart 3. PHP Bloomberg Valuation (BVAL) yield curve and forecasts as of 28 Dec 2023



Sell-offs in the GS market may still occur, especially if institutional investors decide to take profit on existing holdings and/or the BSP signals the need for further tightening. However, any retracement higher in yields may immediately be bought into as markets expect interest rates to fall over the long-term. As of this writing, our fixed income traders expect the GS yield curve to flatten further and trade well below 6% gross by yearend 2024.

Trade ideas for investors

Take profit on 7- to 20-year GS and reinvest in short-term securities / funds

In our October 2023 Radar report entitled *An Opportunity to Add Duration*, we flagged an opportunity to buy long-term peso GS with tenors of 7-20 years as the local market tracked the sell-off in global yields and the off-cycle hike of the BSP. Our trade recommendation came out around the time when US 10-year yields were just below 5% and long-term peso yields had reached 7% gross. Trading clients who were able to execute this recommendation may consider taking profit on the gains thus far by selling the following bonds at current levels.

Indicative pricing as of 29 Dec 2023. Subject to client suitability and available volume.

Security	Maturity Date	Remaining Tenor (Yrs)	Coupon (Gross of 20% WHT)	Bid Price	Bid Yield
FXTN 10-64	10 Jan 2029	5.04	6.875%	103.559	5.870%
FXTN 7-70	27 Jul 2030	6.58	6.375%	102.212	5.880%
FXTN 10-71	17 Aug 2033	9.64	6.625%	104.628	5.870%
FXTN 25-6	05 Nov 2034	10.86	9.250%	122.530	5.900%
FXTN 25-7	30 Sep 2035	11.76	8.000%	115.005	5.900%
FXTN 15-1	13 Jul 2038	14.55	7.000%	109.000	5.920%
FXTN 20-25	24 Nov 2042	18.94	8.125%	120.397	6.050%

For example, an investor client who bought FXTN 10-71 in early November would realize the following trading gains:

Security	Settlement Date	Client Direction	Face Value	Yield to Maturity	Price	Total (Cashout)/ Proceeds
FXTN 10-71	06 Nov 2023	BUY	PHP 10,000,000.00	7.000%	97.755	PHP (9,904,570.03)
FXTN 10-71	29 Dec 2023	SELL	PHP 10,000,000.00	5.870%	104.631	PHP 10,644,724.98
					Trading Gains	**PHP 740,154.95 (+50.76% per annum)**

Given the BSP's hawkish stance, we have seen short-term peso yields move higher to levels close to that of long-dated peso GS, with the exception of the 3-month treasury bill, which continues to see strong demand from offshore institutional investors. Thus, we see good value in reinvesting the sales proceeds first in retail treasury bonds (RTB) with less than a year to maturity.

Indicative pricing as of 29 Dec 2023. Subject to client suitability and available volume.

Security	Maturity Date	Remaining Tenor (Yrs)	Coupon (Gross of 20% WHT)	Offer Price	Offer Yield
RTB 3-11	09 Mar 2024	0.19	2.375%	99.482	5.880%
RTB 5-12	12 Mar 2024	0.20	6.250%	100.055	5.880%

Investors may also consider Metrobank Trust Banking Group's Unit Investment Trust Funds (UITF) such as the Metro Money Market Fund and Metro Short Term Fund, which pool and invest their funds in a variety of short-dated underlying securities.

Key information and investment disclosure statement (KIIDS) as of 30 Nov 2023. Subject to client suitability.

Fund Information	Metro Money Market Fund	Metro Short Term Fund
Investor Risk Profile	Conservative	Moderate
Investment Horizon	At least 30 days	At least 6 months
Fund Assets	PHP-denominated high-yielding time deposits and short-term government securities	PHP-denominated money market instruments and fixed income securities with a maximum duration of 1 year
Composition	GS < 1Y (80%), TD (20%)	GS < 1Y (50%), Corp Bonds < 3Y (39%), TD (11%)
Minimum Holding Period	7 calendar days	
Early Redemption Charge	50% of income on redeemed amount	
Dealing Day and Cut-off	Any banking day, up to 12:00 PM	
Redemption Settlement Date	Same as date of redemption	
Trust Fee	0.60% per annum based on Net Asset Value	
Benchmark	Average rate of the most recent 91-day Philippine Treasury Bill auction, net of taxes	75% average rate of the most recent 91-day Philippine Treasury Bill auction, net of taxes, and 25% Markit iBoxx ALBI Philippines Money Market
1-year Fund Return	4.385%	4.452%
1-year Benchmark Return	4.343%	4.389%

Reposition in 7- to 20-year GS via Q1 2024 primary auctions

With the GS yield curve much flatter, long-dated bonds currently have little to no premium over shorter-dated bonds. From here, investors can wait for better levels to reinstate positions and add duration once more.

The BTr has just released its borrowing schedule for Q1 2024, with a focus on 7- and 10-year bonds as well as one 20-year bond in February. Investors may opportunistically scale-in through these auctions. Given the BTr's PHP 1.8 trillion borrowing program for 2024, our fixed income traders expect that the BTr may be pressured to accept bids aggressively in order to raise the necessary amount of funding.

Auction Date	Issue Date	Tenor (Yrs)	Volume of Offering
03 Jan 2024	04 Jan 2024	3	PHP 30,000,000,000.00
09 Jan 2024	11 Jan 2024	5	PHP 30,000,000,000.00
16 Jan 2024	18 Jan 2024	7	PHP 30,000,000,000.00
23 Jan 2024	25 Jan 2024	10	PHP 30,000,000,000.00
30 Jan 2024	01 Feb 2024	3	PHP 30,000,000,000.00
06 Feb 2024	08 Feb 2024	5	PHP 30,000,000,000.00
13 Feb 2024	15 Feb 2024	7	PHP 30,000,000,000.00
20 Feb 2024	22 Feb 2024	10	PHP 30,000,000,000.00
27 Feb 2024	29 Feb 2024	20	PHP 30,000,000,000.00
05 Mar 2024	07 Mar 2024	3	PHP 30,000,000,000.00
12 Mar 2024	14 Mar 2024	5	PHP 30,000,000,000.00
19 Mar 2024	21 Mar 2024	7	PHP 30,000,000,000.00
26 Mar 2024	28 Mar 2024	10	PHP 30,000,000,000.00

Our overall view remains to be falling GS yields as the economic environment heads into a cycle of monetary easing in the years to come. We still prefer to be overweight duration via 7- to 20-year bonds through participating in BTr auctions and being opportunistic in the secondary market in the event of market sell-offs.

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