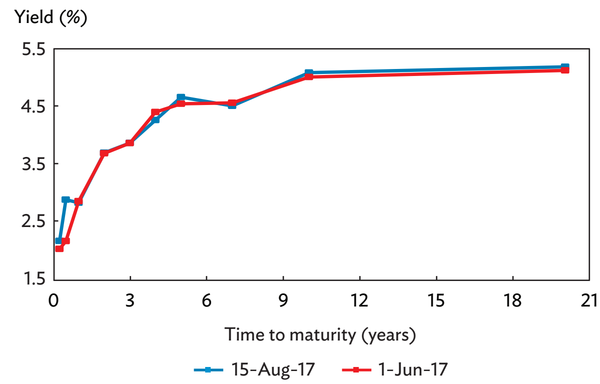
Philippines

Yield Movements

Between 1 June and 15 August, local currency (LCY) government bond yields in the Philippines rose for most tenors, particularly the 3-month, 6-month, 2-year, 5-year, 10-year, and 20-year maturities (**Figure 1**). The largest yield increase was seen for 6-month government bonds at 71 basis points (bps), while the smallest increase was 1 bp for the 2-year tenor. Yields fell for 1-year, 4-year, and 7-year government bonds, with 4-year maturities experiencing the largest drop of 14 bps. The yield for the 3-year tenor was practically unchanged. During the review period, the yield spread between the 2-year and 10-year maturities widened 7 bps from 132 bps to 139 bps.

Figure 1: Philippines' Benchmark Yield Curve—Local Currency Government Bonds



Source: Based on data from Bloomberg LP.

The advance in yields for most tenors reflected the market's reaction to the United States (US) Federal Reserve's plan that it would soon start the process of balance sheet normalization, whereby it will reduce its holdings of US Treasury bonds and mortgage-backed securities, as well as on account of upbeat economic data reports. Softer US consumer price inflation, however, may have capped a further rise in yields as the Federal Reserve's decision on another rate hike, which greatly affects yield movements, may be delayed as prices are not accelerating as expected. The European Central Bank's statement on adjusting the parameters of its policy instruments may also have contributed to the rise in yields. On the domestic front, the Government of the Philippines incurred a budget deficit of PHP154.5 billion in the first half of 2017, 28.0% higher than in the same period a year earlier. Revenue projections from the tax reform package were reduced as some revenue-generating measures were watered down by the Philippine Congress. With more spending in the pipeline, the government may need to borrow more to fund the gap, likely pulling up government bond yields.

Consumer price inflation in the Philippines climbed to 2.8% year-on-year (y-o-y) in July from a revised 2.7% y-o-y in June. Nonfood inflation increased to 2.4% y-o-y in July from 1.9% y-o-y in June, lifted by higher prices in the transport sector due to upward adjustments in railway transport fare and domestic petrol prices. Higher prices were also observed for housing rentals, utilities, education, and miscellaneous services. On the other hand, price increases for food and nonalcoholic beverages slowed to 3.3% y-o-y in July from 3.5% y-o-y in the previous month. March and April posted the highest inflation rates of the year through July at 3.4% y-o-y in each month. Average inflation for the first 7 months of 2017 was 3.1%, well within the government's target range of 2.0%–4.0% for 2017. Core inflation, which excludes selected volatile food and energy items, decelerated to its slowest pace since January at 2.1% y-o-y in July.

The Bangko Sentral ng Pilipinas (BSP) maintained its overnight reverse repurchase rate at 3.00% and the interest rates on its overnight lending and deposit facilities at 3.50% and 2.50%, respectively, during its monetary policy meeting on 10 August. Despite inflation remaining relatively high in recent months, the BSP stated that inflation continues to be manageable. According to the central bank's latest baseline forecasts, average inflation will remain within the target range of 2.0%–4.0% in 2017. Inflationary pressures arising from the impact of the proposed tax reform program are expected to be lessened by social safety nets. The central bank's decision to keep the policy rate unchanged allows it to properly assess global developments, such as the normalization of US monetary policy, and to calibrate its policy tools accordingly.

The Philippine peso continued to underperform against the US dollar. On 15 August, the Philippine peso traded at PHP51.41 to the US dollar, losing 3.5% since the start of the year. It reached an 11-year low in August, making it the worst performing currency in emerging East Asia in 2017. The Philippine peso is being weighed down by the current account deficit and negative sentiments over political concerns and the security situation in the southern Philippines. The BSP, however, dismissed worries surrounding the current account deficit as the central bank said that the deficit is underlain by capital goods imports that will eventually improve the economy's productive capacity. The central bank also said that the depreciation of the peso is consistent with government efforts to spur economic growth and it is prepared to use its foreign reserves to temper the volatility of the currency.

The Philippine economy expanded 6.5% y-o-y in the second quarter (Q2) of 2017 following a period of moderation in the preceding 2 quarters. The growth was much slower than the 7.1% y-o-y growth in Q2 2016, which was driven by election-related expenditures. On the expenditure side, GDP growth was helped by government spending, which accelerated to 7.1% y-o-y in Q2 2017 from only 0.1% y-o-y in the first quarter (Q1) of 2017. Household expenditure, export, and import growth rates in Q2 2017 were broadly at par with Q1 2017, while capital formation growth decelerated. On the production side, the primary sector registered faster growth of 6.3% y-o-y in Q2 2017, indicating continued recovery from El Niño. Industrial sector growth accelerated in Q2 2017, while services sector growth slowed even as it remained to be the main driver of growth. GDP performance in Q2 2017 put the Philippines' growth momentum back on track. The economy is highly likely to reach the lower bound of the government's full-year GDP growth target of 6.5%–7.5%. The Philippines remains one of the best performing economies in emerging East Asia.

Size and Composition

The size of the Philippines' LCY bond market reached PHP5,168 billion (USD102 billion) at the end of June, up from PHP 4,943 billion at the end of March (**Table 1**). The bond market registered faster growth of 4.6% quarter-on-quarter (q-o-q) and 10.2% y-o-y in Q2 2017, compared with 1.5% q-o-q and 5.0% y-o-y in the preceding quarter. The market expansion was lifted by advances in both the LCY government and corporate bond segments.

Government bonds. Total LCY government bonds outstanding amounted to PHP4,211 billion at the end of June, posting growth of 5.0% q-o-q and 8.5% y-o-y. Strong growth rates were seen in Treasury bonds, which increased 5.1% q-o-q and 9.3% y-o-y, and in Treasury bills, which increased 11.1% q-o-q and 10.4% y-o-y. The expansion in the size of the government bond market was sustained by increased issuance, particularly the issuance of Retail Treasury Bonds (RTBs) in April. On the other hand, the outstanding bonds of government-owned or -controlled corporations continued to decline due to the maturing bonds and the absence of new issuance. As of the end of June, government bonds comprised 81.5% of the total LCY bond market.

Table 1: Size and Composition of the Local Currency Bond Market in the Philippines

	Outstanding Amount (billion)						Growth Rate (%)			
	Q2 2016		Q1 2017		Q2 2017		Q2 2016		Q2 2017	
	PHP	USD	PHP	USD	PHP	USD	q-o-q	y-o-y	q-o-q	y-o-y
Total	**4,688**	**99**	**4,943**	**98**	**5,168**	**102**	**(0.4)**	**0.9**	**4.6**	**10.2**
Government	3,880	82	4,011	80	4,211	83	(0.3)	(0.4)	5.0	8.5
Treasury Bills	288	6	286	6	318	6	3.2	4.6	11.1	10.4
Treasury Bonds	3,517	75	3,656	73	3,842	76	(0.6)	(0.7)	5.1	9.3
Others	76	2	69	1	51	1	0.0	(5.6)	(27.0)	(33.1)
Corporate	808	17	932	19	957	19	(0.6)	7.9	2.7	18.5

( ) = negative, LCY = local currency, PHP = Philippine peso, q-o-q = quarter-on-quarter, Q1 = first quarter, Q2 = second quarter, USD = United States dollar, y-o-y = year-on-year.
Notes:
1. Calculated using data from national sources.
2. Bloomberg end-of-period LCY–USD rates are used.
3. Growth rates are calculated from an LCY base and do not include currency effects.
4. "Others" comprise bonds issued by government agencies, entities, and corporations for which repayment is guaranteed by the Government of the Philippines. This includes bonds issued by Power Sector Assets and Liabilities Management (PSALM) and the National Food Authority, among others.
5. Peso Global Bonds (PHP-denominated bonds payable in US dollars) are not included.
Sources: Bloomberg LP and Bureau of the Treasury.

Total government issuance of LCY bonds amounted to PHP415 billion in Q2 2017, up from PHP268 billion in the preceding quarter. The sharp increase of 55.0% q-o-q was mainly due to the issuance of PHP181 billion worth of RTBs in April. The RTB offer was met with strong demand, prompting the Bureau of the Treasury (BTr) to increase its initial offer size of PHP30 billion to accommodate investor appetite. The 3-year security has a coupon rate of 4.25%. Excluding RTBs, the issuance of Treasury bonds fell short of the PHP90 billion quarterly target as the BTr raised only PHP64.8 billion during Q2 2017 as opposed to reaching the target in Q1 2017. Most Treasury bond auctions were partially awarded due to high rates demanded by market participants amid pronouncements by major central banks of rake hikes. Moreover, the BTr is awash with cash from its RTB sale, allowing it to reject some bids.

In contrast, auctions of Treasury bills were successful, raising PHP89.2 billion of the PHP90 billion target in Q2 2017.[18] Market participants preferred shorter-dated securities as they wait on the sidelines in anticipation of the Federal Reserve's balance sheet reduction and future rate hikes, as well as the direction of monetary policy of central banks in other advanced economies.

The Department of Finance is considering the possibility of issuing PHP30 billion worth of "patriotic bonds" for the rehabilitation of Marawi City in the southern Philippines. The department is considering a 20-year maturity for the bond issuance. However, bond traders think it is unlikely to attract buying interest from the market as investors prefer shorter-term bonds of about 3–8 years. On the other hand, an RTB-style issuance with a maturity of 5–7 years would likely garner sufficient interest. The BSP said that the market has enough liquidity to cover the issuance if pursued.

Corporate bonds. Total LCY corporate bonds outstanding grew 2.7% q-o-q and 18.5% y-o-y in Q2 2017 versus growth of 4.6% q-o-q and 14.6% y-o-y in Q1 2017. In annual terms, the growth rate of corporate bonds exceeded that of government bonds. On a quarterly basis, however, the corporate bond market lagged behind the government bond market's expansion. Corporate bonds outstanding rose to PHP957 billion in Q2 2017 from PHP932 billion in Q1 2017, comprising 18.5% of the total LCY bond market at the end of June.

Outstanding corporate bonds in the property sector surpassed that of the banking sector in Q2 2017 with totals of PHP261.5 billion and PHP256.8 billion, respectively, at the end of June (**Figure 2**). The property sector's share of the total corporate bond stock increased to 27.3% at the end of June from 24.4% at the end of June 2016, and the banking sector's share decreased to 26.8% from 28.3% in the same period.

Aggregate LCY bonds outstanding for the top 30 corporate issuers reached PHP818.1 billion at the end of June, up 3.2% from PHP793.0 at the end of March (**Table 2**). While more banks were included among the top 30 issuers in Q2 2017 than in the previous quarter, property firms led the group in cumulative bonds outstanding. Property giants Ayala Land and SM Prime had the most bonds outstanding at PHP87.3 billion and PHP73.8 billion, respectively.

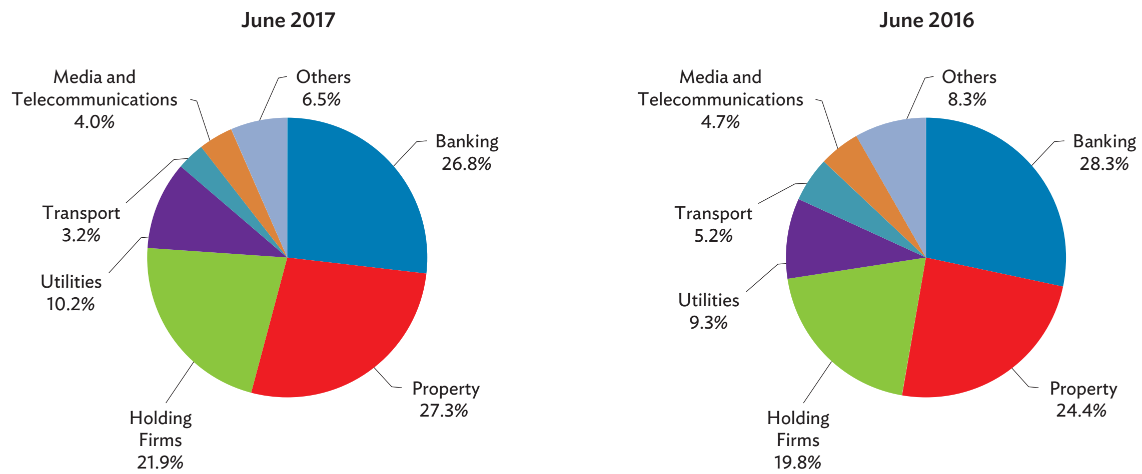
LCY bond issuance from the corporate sector increased 4.9% q-o-q to PHP54.9 billion in Q2 2017, in contrast to the 27.2% q-o-q drop in Q1 2017, which was mainly traced to high base effects. Companies are timing their entry into the market while rates are still favorable as the Federal Reserve monetary policy tightening could shift capital away from emerging markets and drive up funding costs.

Market participants see the corporate bond market remaining vibrant even if the government shifts its project financing to appropriation from public–private partnerships. Should government spending, particularly huge infrastructure projects, gain further traction, it would spur economic activity and provide more opportunities for firms to expand. Market participants see investor appetite remaining strong in the LCY corporate bond market due to ample liquidity and that the yield spread of corporate bonds over government bonds will continue to attract investors.

Bond issuance in Q2 2017 came from property firms, banks, and holding firms. Property firms led all other types of issuers during the quarter, with total issuance of PHP27 billion, followed by banks at PHP18 billion

[18] This does not include special bills.

Figure 2: Local Currency Corporate Bonds Outstanding by Sector



Source: Based on data from Bloomberg LP.

and a single holding firm with PHP10 billion. Growth in property bonds outstanding is attributed to the optimistic outlook for the property sector, which is supported by low mortgage rates, strong dollar remittances from overseas Filipinos, and the expanding business process outsourcing industry.

SM Prime, the Philippines' largest property firm, had the largest issuance during the quarter, raising PHP20 billion from the sale of a 7-year bond carrying a coupon rate of 5.17% (**Table 3**). Another property firm, Ayala Land, sold a 5-year PHP10 billion bond with a 5.19% coupon rate.

Investor Profile

The profile of investors in the LCY government bond market in Q2 2017 was little changed from a year earlier (**Figure 3**). Banks and investment houses remained the largest holder of government bonds, with a share of 40.2% of the total market at the end of June, up from 36.4% at the end of June 2016. The group's nominal holdings were up 20.1% y-o-y. Contractual savings institutions and tax-exempt institutions comprised the second-largest share at 31.3% at the end of June on an increase in nominal holdings of 10.4% y-o-y. The share of BTr-managed funds; brokers, custodians, and depositories; and government-owned or –controlled corporations and local government units decreased to 12.1%, 6.9%, and 0.5%, respectively, at the end of June from a year earlier, while other investor share increased to 8.8%.

Ratings Update

On 6 July, Japan Credit Rating Agency affirmed the Philippines' foreign currency and LCY long-term issuer ratings at BBB+ and maintained a stable outlook for both ratings. The rating agency stated that the affirmation reflected the economy's robust expansion, which is supported by strong domestic demand, a sound external position given by declining external debt and an accumulation of foreign exchange reserves, and a continued reduction of the government's debt burden. Challenges flagged by rating agency include improving the economy's infrastructure to enhance the investment environment in order to attract and sustain foreign direct investments, and restoring stability in the southern Philippines.

Table 2: Top 30 Issuers of Local Currency Corporate Bonds in the Philippines

Issuers		Outstanding Amount		State-Owned	Listed Company	Type of Industry
		LCY Bonds (PHP billion)	LCY Bonds (USD billion)			
1.	Ayala Land	87.3	1.7	No	Yes	Property
2.	SM Prime	73.8	1.5	No	Yes	Property
3.	Metrobank	55.4	1.1	No	Yes	Banking
4.	SM Investments	47.3	0.9	No	Yes	Holding Firms
5.	Ayala Corporation	40.0	0.8	No	Yes	Holding Firms
6.	BDO Unibank	37.5	0.7	No	Yes	Banking
7.	Philippine National Bank	35.1	0.7	No	Yes	Banking
8.	San Miguel Brewery	34.8	0.7	No	No	Brewery
9.	San Miguel	30.0	0.6	No	Yes	Holding Firms
10.	JG Summit Holdings	30.0	0.6	No	Yes	Holding Firms
11.	Filinvest Land	29.0	0.6	No	Yes	Property
12.	Aboitiz Equity Ventures	24.0	0.5	No	Yes	Holding Firms
13.	Meralco	23.5	0.5	No	Yes	Electricity, Energy, and Power
14.	East West Bank	23.1	0.5	No	Yes	Banking
15.	Security Bank	23.0	0.5	No	Yes	Banking
16.	GT Capital	22.0	0.4	No	Yes	Holding Firms
17.	Petron	18.6	0.4	No	Yes	Electricity, Energy, and Power
18.	Rizal Commercial Banking Corporation	18.3	0.4	No	Yes	Banking
19.	Globe Telecom	17.0	0.3	No	Yes	Telecommunications
20.	Maynilad Water Services	15.9	0.3	No	No	Water
21.	China Bank	15.9	0.3	No	Yes	Banking
22.	MCE Leisure (Philippines)	15.0	0.3	No	No	Casinos & Gaming
23.	Philippine Long Distance Telephone Company	15.0	0.3	No	Yes	Telecommunications
24.	SMC Global Power Holdings	15.0	0.3	No	No	Electricity, Energy, and Power
25.	Union Bank of the Philippines	14.0	0.3	No	Yes	Banking
26.	Megaworld	12.0	0.2	No	Yes	Property
27.	Robinsons Land	12.0	0.2	No	Yes	Property
28.	NLEX Corporation	11.9	0.2	No	No	Transport
29.	MTD Manila Expressways	11.5	0.2	No	No	Transport
30	Vista Land and Lifescapes	10.2	0.2	No	Yes	Property
Total Top 30 LCY Corporate Issuers		**818.1**	**16.2**			
Total LCY Corporate Bonds		**957.4**	**19.0**			
Top 30 as % of Total LCY Corporate Bonds		**85.4%**	**85.4%**			

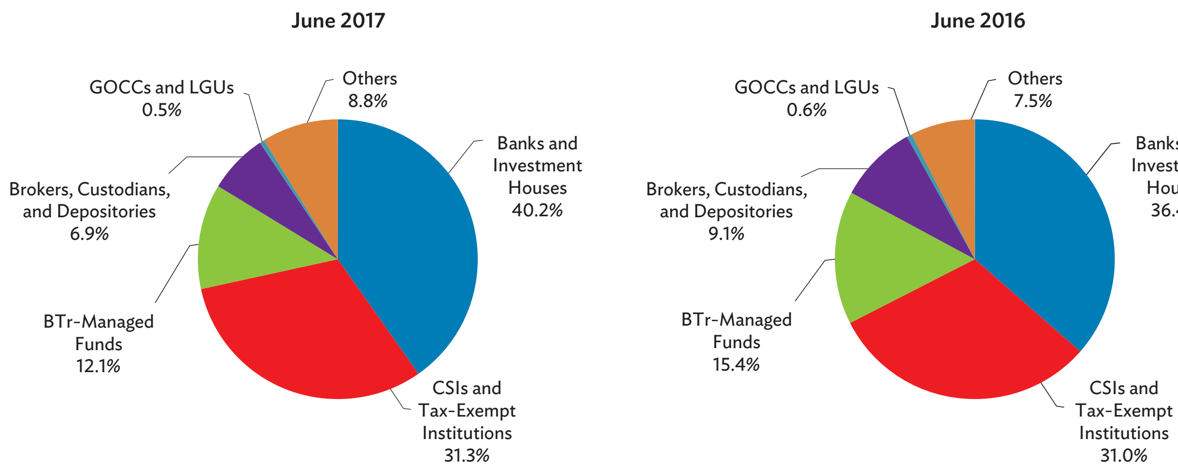
LCY = local currency, PHP = Philippine peso, USD = United States dollar.
Notes:
1. Data as of end-June 2017.
2. State-owned firms are defined as those in which the government has more than a 50% ownership stake.
Source: *AsianBondsOnline* calculations based on Bloomberg LP data.

Table 3: Notable Local Currency Corporate Bond Issuance in the Second Quarter of 2017

Corporate Issuers	Coupon Rate (%)	Issued Amount (PHP billion)
SM Prime		
7-year bond	5.17	20.00
San Miguel		
5-year bond	5.19	10.00
Ayala Land		
10-year bond	5.26	7.00
China Bank		
5-year bond	3.65	6.35

PHP = Philippine peso.
Source: Bloomberg LP.

Figure 3: Local Currency Government Bonds Investor Profile



BTr = Bureau of the Treasury, CSIs = contractual savings institutions, GOCCs = government-owned or -controlled corporations, LGUs = local government units.
Source: Bureau of the Treasury.

Policy, Institutional, and Regulatory Developments

Bangko Sentral ng Pilipinas Considers Liberalizing Foreign Exchange Rules

In July, the BSP announced new reforms aimed at further liberalizing the foreign exchange market, including easing existing rules on foreign currency exchange to make it more attractive for the public to transact through formal platforms such as banks rather than in unregulated platforms like money changers and remittance agents. Current rules are seen by the BSP as restrictive, difficult, opaque, and shallow, resulting in higher costs of doing business and an expanding black market. The proposed liberalization would make the system more risk-based and transparent.

Department of Finance Outlines the Second Package of the Comprehensive Tax Reform Program

In May, the Department of Finance said it expects to submit the second package of the comprehensive tax reform program to the Philippine Congress by the fourth quarter of 2017. The second package will plug tax holiday loopholes granted by investment promotion agencies such as the Board of Investments and the Philippine Economic Zone Authority. The current tax perks allow companies to shift expenses from projects that are subject to tax holidays in order to maximize profits. The second package is revenue neutral wherein forgone revenue from lowering the corporate income tax rate to 25% from 30% will be offset by eliminating some tax incentives.