

Philippine Bonds: The Auction “Glitch”¹

August 27, 2020

1. **Introduction:** The Bureau of the Treasury’s (BTr) rejected all bids received for the 20-year Philippine government bond (RPGB) at the auction held on August 25, 2020. The bond put up for auction was *RPGB 3 5/8 03/21/33* (Coupon 3.625 percent; maturity March 21, 2033; hereafter “the Bond”) which has a residual maturity of 13 years. The issuance was canceled when the yield received in the bids was much higher than secondary market levels. In our view, the bidding yields were high owing to technical factors that were specific to the Bond, and is not an indication of investor sentiment toward the broader Philippine sovereign bond market.

2. **Cheap valuations:** The Bond has been “cheap” on the yield curve for the past few months with a higher yield-to-maturity (YTM) than comparable bonds with similar maturities (*RPGB 8 1/2 11/29/32* and *RPGB 9 1/4 11/05/34*) and duration (*RPGB 8 09/30/35* and *RPGB 8 1/8 12/16/35*) (Figure 1). Heading into the auction, the Bond yield was 3.23 percent as against the 2.76–3.13 percent range for the aforementioned bonds. A regression model (YTM versus modified duration²) suggests that the fair yield level was around 3.00 percent (Figure 2).

3. **Limited investor appetite:** The weighted average yield of issuance—had the auction committee awarded the Bonds—would have been 3.501 percent. The pricing would have been 50 basis points higher than our estimated fair yield level and 27 basis points higher than the secondary market yield. Although increased supply typically leads to an uptick in yields, it may not be sufficient to justify the **significantly** higher bid yields. Secondly, the bid-to-target for the auction was the third lowest seen in 2020 (Figure 3), and the issuance fell short of target on each occasion. The cheapness of the Bond even before the market positioned for the additional supply was one of the early indicators of the market’s weak appetite, at least for this particular issue.

4. **Constraining technical factors:** The cheapness of the Bond could be partly attributable to the high outstanding amount compared to bonds with similar maturity—PHP 89.3 billion, which is the second largest among the six bonds maturing between 2032 and 2034 (Figure 4). Market demand for bonds with comparable maturity has not been tested in recent years and hence the market’s willingness to absorb the Bond was not a

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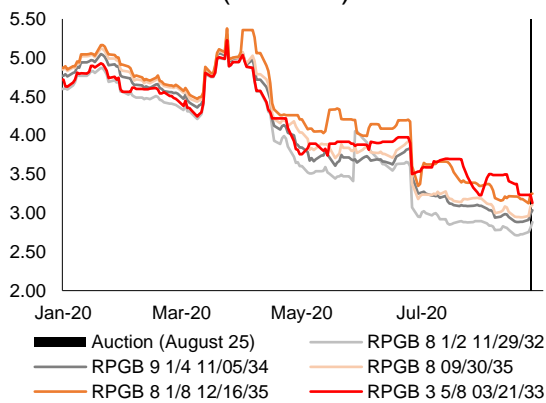
² Defined as the sensitivity of a bond’s price to changes in yield.

given. Meanwhile, the outstanding duration (notional outstanding adjusted for modified duration) is the second highest for any bond issued in 2020—a large outstanding duration hampers the market’s ability to digest the supply.

5. **Alternatives to the Bond:** There are bonds of 20-year tenor, maturing in 2032 (*RPGB 5 7/8 03/01/32* and *RPGB 5 6/8 09/27/32*), with lower outstanding duration (both on account of notional outstanding as well as modified duration). The market’s ability to digest the supply of these bonds at an acceptable yield may have been greater. Based on our model, the yields of these bonds were lower than the implied fair value, thus providing some room for yields to rise with increased supply.

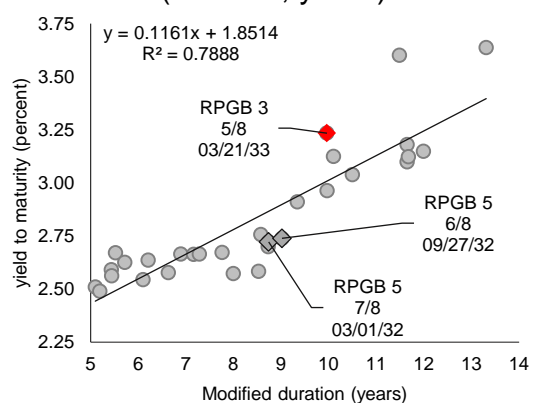
6. **A positive sign:** In our view, the higher yields received at the auction were driven by technical factors specific to the Bond and should not raise much concern over the general appetite for Philippine government bonds. The rejection of bids by BTr is actually a positive sign in that it shows that the government is not under immediate pressure to raise funds and is willing to wait for appropriate yield levels to issue its bonds. However, a risk worth flagging is the widening fiscal deficit and a sizeable issuance plan for 2021. Bond yields may rise as investors position themselves ahead of the increase in supply.

Figure 1. Philippines: Yields of RPGB 3 5/8 03/21/33 and Comparable Bonds (Percent)



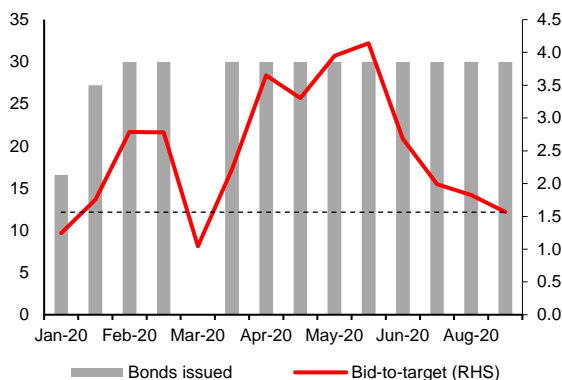
Source: Bloomberg Finance L.P.; and AMRO staff calculations.

Figure 2. Philippines: Bond Yields versus Modified Duration (Percent, years)



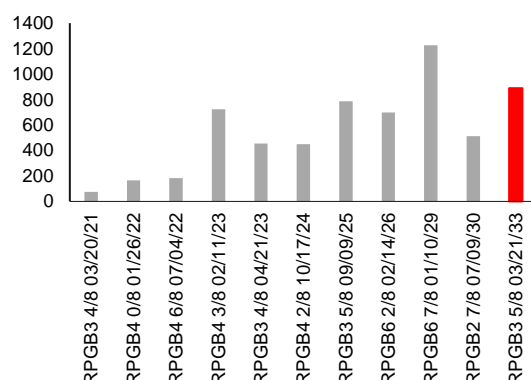
Sources: Bloomberg Finance L.P.; and AMRO staff calculations.

Figure 3. Philippines: Bid-to-Target Ratio for Auctions in 2020 (Billion Peso, ratio)



Sources: Haver Analytics; and AMRO staff calculations.
Note: Bid to target is calculated as the amount of bids received divided by the announced target issuance.

Figure 4. Philippines: Outstanding Duration of Bonds Issued in 2020 (Billion Peso)



Sources: Haver Analytics; and AMRO staff calculations.
Note: Outstanding duration is calculated as the amount of notional bond outstanding times the modified duration of the bond.