

**Philequity Corner (Jan. 30, 2006)**  
**By Ignacio B. Gimenez**

**Buy Asian currencies**

The first month of the year saw much volatility in the currency markets with Asian currencies appreciating strongly against the US dollar. Due to cyclical reasons, this trend is likely to continue through the rest of the year. *We are bullish Asian currencies and we believe that 2006 is the ripe time for these currencies to shine.*

Among the best performers so far this year are the Thai baht (+4.9 percent), the Indonesian Rupiah (+4.4 percent), and the Korean Won (+4.0 percent). The Philippine peso and the Chinese yuan (the two best performing Asian currencies last year) have also strengthened, but have currently taken the back seat and allowed the others to play catch up.

<b>Currency Performance (as of Jan. 27, 2006)</b>	<b>End-05 Price</b>	<b>%Change year-on-year</b>	<b>Current Price</b>	<b>%Change year-to-date</b>
<b>Asian Currencies vs. US Dollar</b>				
Thai Baht	41.01	-5.4%	39.02	4.9%
Indonesian Rupiah	9822	-6.0%	9389	4.4%
Korean Won	1011	2.3%	970.8	4.0%
Taiwan Dollar	32.835	-3.4%	31.979	2.6%
Singapore Dollar	1.6629	-1.9%	1.6278	2.1%
Indian Rupee	45.025	-3.6%	44.145	2.0%
Philippine Peso	53.09	5.7%	52.385	1.3%
Malaysian Ringgit	3.778	0.4%	3.7505	0.7%
Chinese Yuan	8.0685	2.4%	8.0618	0.1%
<b>Average</b>		<b>-1.0%</b>		<b>2.4%</b>
<b>Major Currencies vs. US Dollar</b>				
British Pound	1.7228	-10.2%	1.7674	2.6%
Swiss Franc	1.3157	-15.4%	1.2845	2.4%
Australian Dollar	0.7327	-6.1%	0.7494	2.3%
Euro	1.1837	-12.6%	1.2094	2.2%
Japanese Yen	117.68	-14.7%	117.33	0.3%
<b>Average</b>		<b>-11.8%</b>		<b>1.9%</b>

*Source: Bloomberg*

**A stronger Yuan & the end of Fed tightening**

If you recall, we have been bullish the Philippine peso since Oct. 2005. Among our arguments for sustained peso strength is the further appreciation of the Chinese Yuan and the reversal of the US dollar strength. These are also the catalysts that should propel other Asian currencies higher.

After allowing for a small revaluation in July 2005 (after a decade-long peg to the US dollar), we have reason to believe that Chinese policymakers will tolerate a more flexible and stronger Yuan this year.

Firstly, China's foreign reserves have already accumulated to \$819 billion in end-2005 from only \$614 billion in end-2004. By now, we reckon that China has already overtaken Japan (which has \$847 billion in end-2005) as the world's largest reserve holder. Second, with the Chinese

economy running huge current accounts and balance of payments surpluses, the Yuan is poised to strengthen further even with continued intervention.

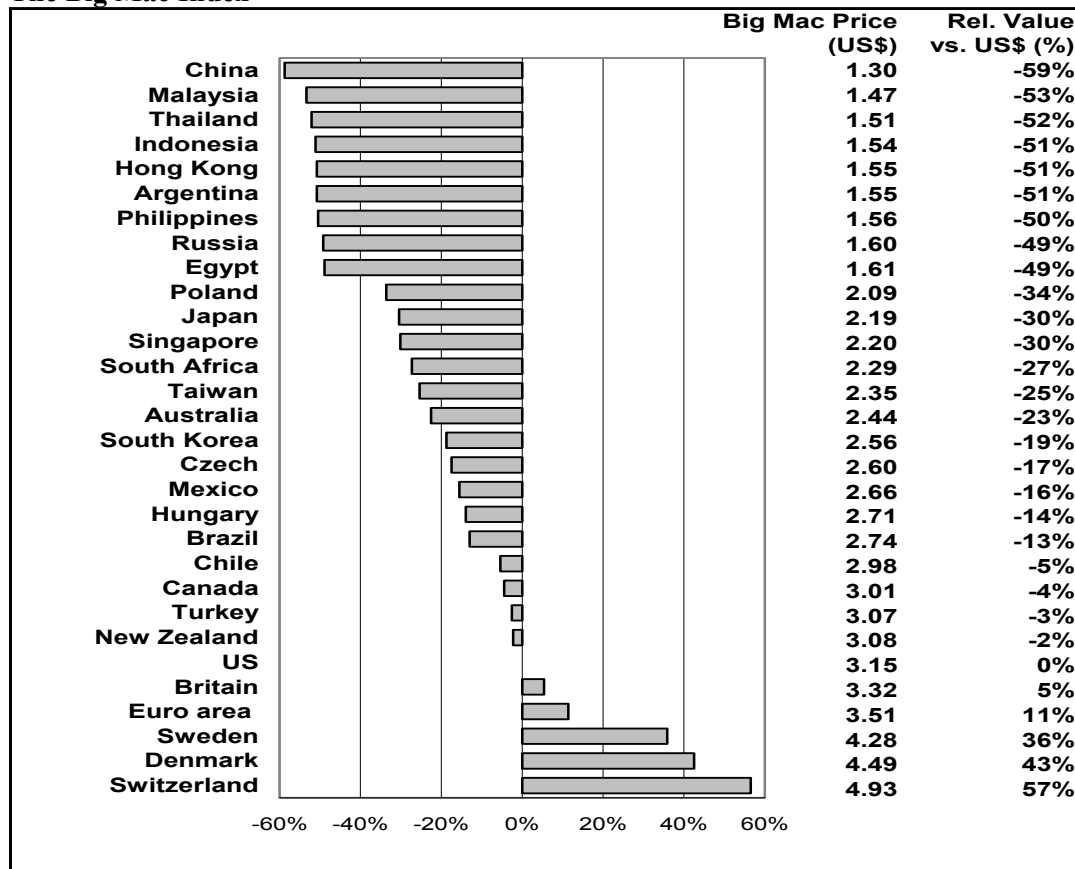
A stronger Chinese Yuan, in turn, would permit other central banks in Asia to let their currencies to trade higher. Threats to export competitiveness should ease with more synchronized currency moves among Asian countries. Also, most major Asian central banks seem to have reached their saturation points with their foreign reserve holdings and are not likely to intervene in case of currency strength. As far as we know, China was the only major central bank in Asia that intervened in 2005 (estimated at around \$185 billion).

Meanwhile, the US Fed is already on its last moves this year on its tightening policy stance. This would effectively end the “high yield” trade that led to the general strength in the US dollar in 2005. Overall, we expect Asian currencies to outperform the major currencies this year just as they did in 2005.

### Purchasing power parity and the “Big Mac” Index

*The Economist* created the Big Mac Index which is based on the theory of purchasing-power parity (PPP). According to the PPP, exchange rates among countries should adjust to equalize the cost of a basket of goods and services, wherever it is bought around the world. In this case, the “basket” is the McDonald’s Big Mac, which is produced in about 120 countries. Comparing actual exchange rates with PPPs indicates whether a currency is over- or undervalued.

#### The Big Mac Index



Source: *Economist.com* (data published on Jan. 12, 2006)

On a purchasing power basis, Asian currencies continue to look inexpensive, according to the Big Mac Index shown above. Six out of the top ten undervalued currencies come from Asia.

The cheapest Big Mac is in China which costs \$1.30, compared with the U.S. price of \$3.15. The implication is that the Yuan is 59% undervalued against the US dollar.

Note that the currencies of Southeast Asian countries are also very much undervalued. This is consistent with the performance of these currencies this January, as described earlier. Only the currencies from Western Europe seem to be relatively overvalued on the basis of the Big Mac PPP.

Of course, in the real world, the determination of exchange rate equilibrium is not this simple. Other factors such as current account surpluses, capital flows, real interest rate differentials, sentiment and even events play a role in exchange rate dynamics. Nonetheless, the old theory of purchasing power parity is able to provide a basic guide on exchange rate valuation between countries.

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