**Philequity Corner (Nov. 28, 2005)**
**By Ignacio B. Gimenez**

## The Peso marches on

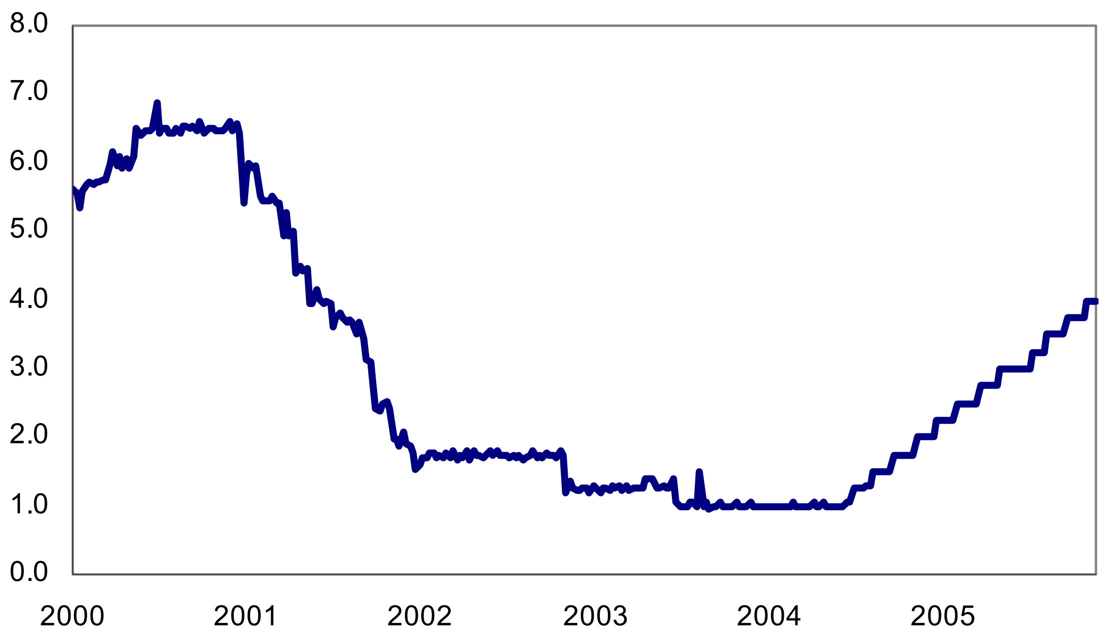
The peso closed at 54.15 against the US dollar last week, its strongest close since May 2005. Year-to-date, it has already appreciated by 3.9% against the US dollar. As we have mentioned in a previous article (***Philippine Peso … The strongest currency in Asia - Oct. 24, 2005***), one of the catalysts for further strengthening in the peso is the reversal of the current US dollar strength against major currencies. True enough, there was a sharp sell-off in the US dollar last week (although it recovered its losses by Friday) as the US Fed hinted that it might be nearing the end of its long, interest rate rising cycle. The minutes of the Federal Open Market Committee (FOMC) meeting last November 1 revealed that some members have cautioned against tightening policy overkill.

## US dollar as a high yield currency

Note that since June 2004, the Fed has raised interest rates 12 times in an attempt to control inflation and cool down an overheated housing market. With the absence of similar hikes by the European Central Bank (ECB) and the Bank of Japan (BOJ), the US dollar, in effect, became a "high yield" currency. In other words, the higher interest rate in the US compared to that in Euroland and Japan became attractive enough to pull massive capital inflows into US assets.

Data from the US Treasury Department as of September shows that net capital inflows to the US climbed to a record high of $101.9 billion – over 40 percent higher than what analysts have forecasted. This is the reason why the US dollar has been strengthening against major currencies despite concerns on the huge US current account deficit. Since the start of the year, the US dollar has gained 15.6% against the euro and has appreciated by 14.2% against the yen.

**US Federal Funds Rate (%)**




*Source: Technistock*

## End of US Fed tightening ?

The most significant new development in the currency markets has been the subtle shift in Fed posturing. The minutes from the latest FOMC meeting suggests that US policymakers have begun to discuss the risks of "going too far with the tightening process." This reduces the odds of a policy overshoot and may induce the Fed to loosen its policy stance earlier than expected.

Note that expectations of the US Federal funds rate reaching 5% (from the current 4%) have been priced into the markets for quite some time now. However, increasing signs of economic cooling, decelerating inflation and lower oil prices have raised the possibility that the feared sharp credit squeeze will be avoided and a "soft landing" can be achieved. As a result, the odds of only a 50 basis points further rise in the Fed rate are increasing. We believe that investors will soon shift their focus on the peaking of the Fed rate rather than on its further rise.

All these developments have caused stocks to rally and commodities, such as gold, to regain its strength. The perception that the US Fed has blinked has brought back a whiff of reflation. Both the S&P500 and the Nasdaq are now trading at new 4 ½ year highs, while the Dow Jones Industrial Average is testing its March highs. Gold reached an 18-year high last Friday, closing near $500/oz.

Though we cannot rule out a final overshoot in the US dollar yet, we believe that the "high yield" trade favoring the currency is in its latter stages. The US job market appears to be weakening, and the US housing boom appears to be past its peak. There are also concerns that the slowdown in real estate will provoke a sharp retrenchment in consumer spending.

We believe that the currency market is at an important inflection point. While the Fed is on its last phase of tightening, other central banks (like the ECB) are only now considering raising rates. Once this policy shift happens, we expect the US dollar to give back some of the gains it accumulated against major currencies this year. ***A reversal of this US dollar strength should accelerate the appreciation of the Philippine peso – on top of the renewed economic confidence, a surge in capital inflows, and record OFW remittances.***

## Sell your dollars

We, in Philequity, continue to be bullish on the peso and Philippine assets in general. The peso easily broke through resistance levels at 55.00 and 54.50. However, we expect stronger resistance at the 53.80 to 54.00 range. In the near-term, we expect the peso to consolidate at current levels with possible pullbacks to 54.50 or even 55.00.

But as we have mentioned in the past article, a number of catalysts exist that could propel the peso even higher. Among them are:

1) Record OFW remittances this December
2) Reversal of the current US dollar strength against major currencies (already showing early signs of happening)
3) Additional interest rate increases by the BSP in step with the Fed's last tightening moves
4) Increase in VAT rate from 10% to 12% by February 1
5) Possible upgrade in the country's credit rating by Moody's, Fitch and S&P
6) Another mini-revaluation of the Chinese yuan
7) Successful privatization of government assets such as the NPC power plants and transmission assets, PNOC-EDC, San Miguel Corp & Meralco shares, etc.

8) Big ticket IPOs, i.e. First Gen, GMA 7

**We therefore view these short-term pullbacks in the peso-dollar rate as opportunities to sell more dollars in exchange for pesos. Long-term, we maintain our BUY recommendation on the peso.**

We received a lot of reactions and inquiries from our article last week (***It's time to make money - Nov. 21, 2005***). To answer your questions:

1) Yes, we manage and operate the Philequity Fund.
2) Yes, Philequity Fund is the best performing fund in the last 11 years. Its compounded annual rate of return since inception (1994) up to last Friday is 20%.
3) And yes, you can call us at 635-6963/635-6965.

*For comments and inquiries, you can email us at gime10000@yahoo.com or info@philequity.net*