Philequity Corner (March 3, 2008)
By Valentino Sy

Peso may overshoot our target of 38

Since our forecast of the peso's rise which we wrote more than two years ago (see "*Peso, the strongest currency in Asia*" on Oct. 24, 2005 issue of **The Philippine Star**), the peso has appreciated by almost 28 percent against the US dollar.

During the previous two years (2006 & 2007), we wrote that the factors that will drive the peso's strength will be mainly endogenous: the improvement of the fiscal balance, the current account and balance of payments surplus, growing BPO revenues and OFW remittances and privatization sales by the government. Lately, however, it will be external factors that will contribute mostly to the peso's strength. In fact, the US dollar index, which tracks the currency against six major counterparts, sank to its lowest since its start in 1973.

Thus, while we reiterate our peso target of 38 by end-2008 (see "*Peso at 38 by 2008*" on the Oct. 15, 2007 issue of **The Philippine Star**), the risk now is that it may even overshoot our forecast. This is due to the structural weakness in the US economy and consequently the US dollar.

More Fed rate cuts

Against a slowing US economy, lower US yields and further rate cuts from the Fed, the US dollar continued its decline against most currencies. The greenback fell to its lowest level in three years against the yen and touched the weakest ever against the euro. So far, the dollar has fallen 7.7 percent against the yen year-to-date and is down 6.3 percent against the euro over the same period.

Fed Chairman Bernanke's comments last week saying that the dollar's decline has "resulted in some improvement" in the trade deficit may have signaled the market that the Fed is willing to let the dollar slip further to let the US economy improve. The US dollar should continue to weaken until the economy stabilizes or that there are signs that the Fed is done with cutting rates.

USD vs. Major Currencies	**end-2007**	**Feb. 29**	**% Chg year-to-date**
Japanese Yen	112.35	103.745	7.7%
Swiss Franc	1.1267	1.0408	7.6%
Euro	1.4279	1.518	6.3%
Australian Dollar	0.8767	0.9308	6.2%
British Pound	1.9973	1.9891	-0.4%
Canadian Dollar	0.982	0.988	-0.6%
USD vs. Asian Currencies			
Taiwan Dollar	32.52	30.925	4.9%
Singapore Dollar	1.4467	1.3954	3.5%
Malaysian Ringgit	3.3151	3.2	3.5%
Indonesian Rupiah	9385.28	9104	3.0%
Chines Yuan	7.3141	7.1115	2.8%
Philippine Peso	41.28	40.45	2.0%
Korean Won	936.53	942.3	-0.6%
Indian Rupee	39.435	40.022	-1.5%
Thai Baht	30.27	31.26	-3.3%

Source: Bloomberg

Peso strong despite all the political noise

Asian currencies have also fared well against the US dollar this year. Among the best performers are the Taiwan dollar which is up 4.9 year-to-date, followed by the Singapore dollar and the Malaysian ringgit which are both higher 3.5 percent over the same period. Meanwhile, the Philippine peso remained firm despite all the political noises. The peso closed at 40.45 against the US dollar last Feb. 29, up 2 percent year-to-date.

Widening yield differentials

Cash yield differentials is an important factor in exchange rate dynamics. Different currencies carry different rates of return. A peso deposit, for example, earns more than a US dollar deposit, which in turn, yields more than a yen deposit. Deposit rates on different currencies follow a benchmark set by corresponding countries' central banks as can be seen below.

Overnight lending rates

New Zealand	8.25%
Philippines	7.00%
Australia	7.00%
United Kingdom	5.25%
Euro	4.00%
Canada	4.00%
United States	3.00%
Switzerland	2.75%
Japan	0.50%

Source: Bloomberg

The wide yield differential is the reason why Australia and New Zealand are among the best performing currencies year-to-date. New Zealand already carries a benchmark rate of 8.25 percent, 5.25 percent higher than the US fed rate. Meanwhile, the Reserve Bank of Australia is expected to increase its benchmark rate by 25 basis points to 7.25 percent at its next meeting tomorrow.

In contrast, the US Fed will likely lower its rate by 50 basis points to 2.5 percent this month. This move should favor other currencies, including the peso, vis-à-vis the US dollar as it further increases the interest rate spread.

Diversification

Some central banks like those of China, Russia, Sweden, Venezuela, Iran, UAE, Qatar and Syria have announced their intentions to diversify their reserves away from the US dollar as a hedge against further dollar weakness. Even prior to the central bank announcements, it can be seen that the world's US dollar exposure has already been declining (from 70.5 percent in 2000 down to 63.8 percent in 2007).

Currency composition of official foreign exchange reserves

	2000	2007
US Dollar	70.50%	63.80%
Euro	18.80%	26.40%
British Pound	2.80%	4.70%
Japanese Yen	6.30%	2.70%
Swiss Franc	0.30%	0.20%
Other	1.40%	2.20%

Source: IMF

So far there is still no sign of wholesale diversification of central banks. But with falling US bond yields and depreciating US dollar coupled with multi-decade highs in commodity currencies of Australia and Canada, central banks may soon be prompted to diversify into these currencies. China alone has $1,528 billion worth of currency reserves, while Russia has $484 billion as of end-2007. If this indeed happens, it could spell more trouble for the US dollar in the long run.

For those who continue to ask what to do with their US dollars, note that we have previously written an article about currency diversification on a personal basis (see "*Hold dollars = Lose money*" on Nov. 12, 2007 issue of **The Philippine Star**). We said that even while the dollar has already declined to multi-year lows, it is never too late to diversify into other currencies. In fact, it is always prudent to do so whether one is talking about cash or other asset classes such as bonds and equities.

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