Philequity Corner (June 2, 2008)
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Reversal of Fortune?

The peso has lost 7.9 percent since it peaked at 40.25 against the US dollar in February 2008. Year-to-date the peso is down 5.2 percent. Rising inflation, a fiscal shortfall, slower growth and portfolio outflows are being tagged as culprits for the peso's recent decline. These factors, however, do not seem to add up.

Indeed, the start of the peso's decline coincided with crude oil breaking the psychological $100 per barrel level in mid-February and inflation's strong pickup in the months of March and April. The argument is that high food and energy prices would have a disastrous impact on our country's balance sheet. However, the country's net international reserves stood at a record $36.7 billion as of March 2008 - which is enough to cover 6.2 months of imports of goods and payments of services and income.

Meanwhile, the Philippine government announced that it is deferring balancing the budget until 2010 and projected a P75 billion deficit this year. While this may have disappointed expectations and may have triggered selling in the peso & some peso assets, we believe that this figure is acceptable. A deficit equivalent to only 1 percent of GDP is tolerable given the need to sustain the economic growth momentum we have set in previous years. Nevertheless, privatization could provide an upside surprise in the second half of 2008, as there is potential to earn P90 billion from the sale of the government's holdings in San Miguel Corp. and Petron Corp.

The weakest argument is that the peso declined against the US dollar because Philippine GDP growth slowed down to 5.2 percent in the first quarter of 2008. One can reason that since the US economy grew slower at 0.9 percent over the same period, the peso should have been relatively favored more.

One obvious reason for the peso's decline is the portfolio outflows, but it seems to be gradually declining. From a net outflow of $371 million in February, only $198 million was registered in March. By April, net outflow was further reduced to $49.9 million. By implication, if the trend of foreign funds continues to improve then the peso should strengthen.

US dollar appears to have firmed up

For us, in Philequity, the general trend of the US dollar is still the primary factor for the peso. A look at the US dollar index shows that the greenback has firmed up since March. Such pause in the US dollar's decline may have triggered speculative positions on the peso to be unwound.

Given the 15.7 percent rise in peso last year, it is not farfetched if investors decided to take some profits.

US Dollar Index

Source: www.stockcharts.com

While the US dollar appears to have strengthened as of late, the trend is not yet clearly defined. In fact, the US dollar continues to be weak against major currencies year-to-date. Compared to Asian currencies, however, the greenback's performance year-to-date is mixed.

Major Currencies	end-2007	30-May	% Chg
Australian Dollar	0.8753	0.9559	9.2%
Swiss Franc	1.1325	1.0423	8.0%
Euro	1.4585	1.5554	6.6%
Japanese Yen	111.66	105.51	5.5%
Canadian Dollar	0.982	0.9934	1.2%
British Pound	1.9861	1.9822	-0.2%
Asian Currencies	**end-2007**	**30-May**	**% Chg**
Taiwanese Dollar	32.422	30.33	6.5%
Singapore Dollar	1.4409	1.3622	5.5%
Chinese Yuan	7.3036	6.9422	4.9%
Malaysian Ringgit	3.3075	3.2342	2.2%
Indonesian Rupiah	9390	9280	1.2%
Philippine Peso	41.28	43.435	-5.2%
Indian Rupee	39.38	42.16	-7.1%
Thailand Baht	29.9	32.49	-8.7%
Korean Won	935.9	1027.75	-9.8%

Source: Bloomberg

A Shift in Monetary Policy

Aside from the general direction of the US dollar, another major factor that affects the peso is monetary policy. Earlier this year, when most banks and brokerage houses (including us) were targeting the peso to breach 40, the BSP put a floor on exchange prices and bought dollars to defend the P40/$1 level. The same scenario happened in other countries in the region. Back then, Asian governments and central banks were reluctant to let their currencies move against the greenback in order to stay competitive and protect their exporters.

However, with inflation accelerating, some Asian countries like Singapore, Malaysia and China are now allowing currency gains in order to slow inflation (see our article *"Using Appreciation to Combat Inflation"* in the April 28, 2008 issue of **The Philippine Star**).

It is highly probable that the BSP will do the same. Either the BSP increases interest rates or they allow currency appreciation or a combination of both.

Revising our target to 40.50

Despite the recent weakness in the peso, we continue to expect that it will end up stronger in the latter part of the year. Considering that global risk taking conditions have been picking up of late, Asian currencies should go up again as markets recover and portfolio inflows jump back in. In addition, once the BSP increases interest rates, the yield differentials against the US dollar should widen and attract back foreign capital. However, we are revising our end-2008 exchange rate target from P38/$1 to P40.50/$1, which is consistent with the floor price earlier set by the BSP.

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