

Philequity Corner (August 18, 2008)
By Valentino Sy

Revival of the US dollar

Last week, we promised to discuss the US dollar which appears to have reversed its course after declining for more than seven years against most currencies. We also said that the revival of the US dollar is one of the major reasons why commodity prices are declining and inflation expectations are showing signs of softening.

US dollar reaches an inflection point

With a lot of bad news on the US economy already priced in the markets, signs of a slowdown in other parts of the world triggered a decisive rally in the US dollar last month.

As you can see from the following table, the US dollar has bottomed against the British pound and several Asian currencies as early as last year. It hit the floor against the Japanese yen, Swiss franc in March 2008. However, the most definitive recovery happened last month, when the US dollar rebounded against the Euro, Australian dollar and the Chinese Yuan.

	Price High	Date	Current Price	%Decline
Major Currencies vs. USD				
Japanese Yen	95.76	3/17/2008	110.22	-15.1%
Swiss Franc	0.9638	3/17/2008	1.0981	-13.9%
Australian Dollar	0.985	7/15/2008	0.8644	-12.2%
British Pound	2.1161	11/9/2007	1.8645	-11.9%
Euro	1.6038	7/15/2008	1.4768	-7.9%
Asian Currencies vs. USD				
Thai Baht	27.5	8/20/2007	33.78	-22.8%
Korean Won	899.69	10/31/2007	1039.85	-15.6%
Philippine Peso	40.25	2/28/2008	45.275	-12.5%
Indian Rupee	39.1737	11/7/2007	43.05	-9.9%
Malaysian Ringgit	3.13	4/23/2008	3.3415	-6.8%
Singapore Dollar	1.3451	7/15/2008	1.4146	-5.2%
Taiwanese Dollar	29.955	3/26/2007	31.345	-4.6%
Indonesian Rupiah	9035	10/8/2007	9190	-1.7%
Chinese Renminbi	6.811	7/16/2008	6.8668	-0.8%
Dollar Index	70.698	3/17/2008	76.873	8.7%

Source: Bloomberg

The main argument going for the dollar is that deteriorating conditions in other countries compels global central banks (other than the US Fed) to ease their respective policy rates. Doing so would reduce the yield premium of many of the world currencies relative to the US dollar.

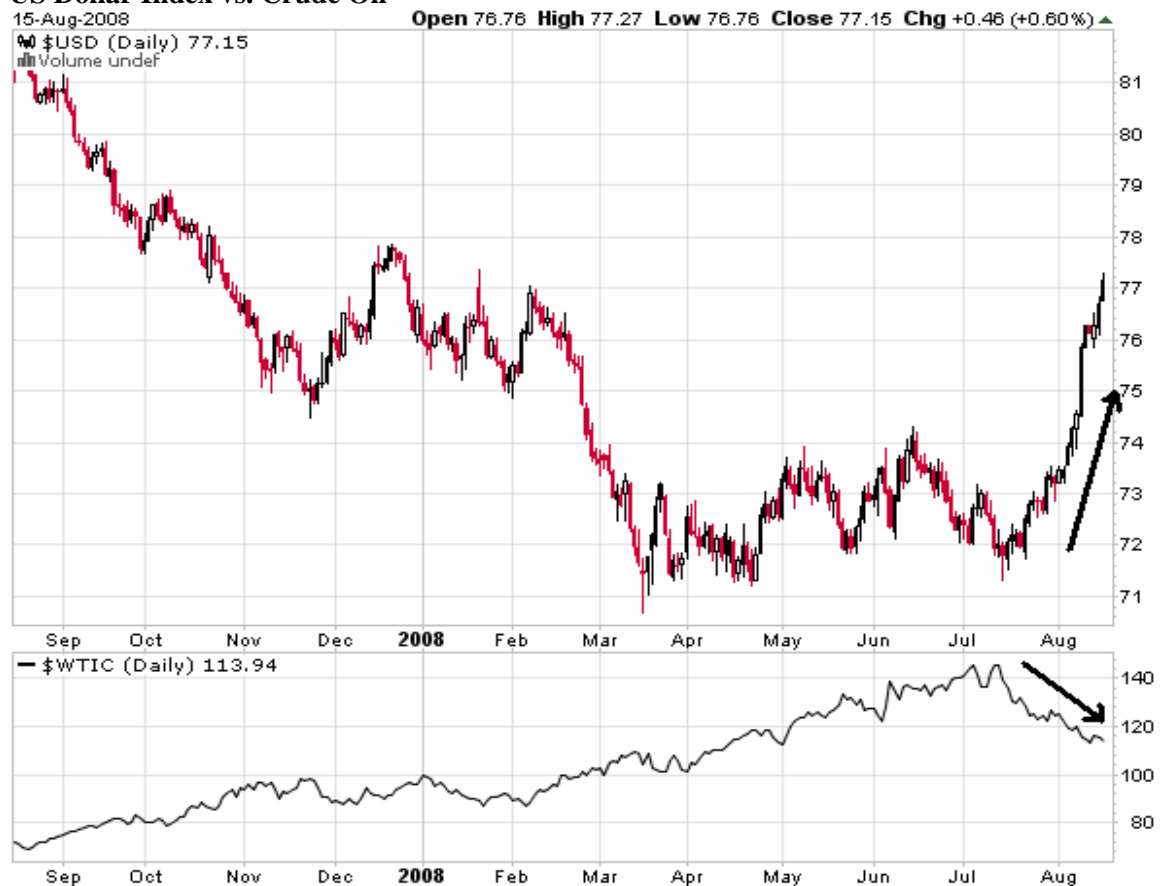
In addition, there are also rumors of a concerted effort by some central banks to prop up the US dollar in order burst the commodity bubble. China, Russia, and Saudi Arabia, for example, have been recently adding to their US dollar reserves at a much faster rate.

Bad news for commodities

The strengthening US dollar is curbing the appeal of commodities as a hedge against inflation. After bottoming out in March 2008 and trading in a tight range for months, the US dollar index (shown in the chart below) is up by 8 percent from its July low.

Subsequent to the US dollar rebound in July, crude oil peaked and is now down 22.7 percent from its high of \$147.27 per barrel reached on July 11. The dollar and the oil price have shown strong negative correlation in the past, wherein increases in one coincides with a drop in the other.

US Dollar Index vs. Crude Oil



Source: www.stockcharts.com

Other commodities have also collapsed as demand for these “hard” currencies waned. Note that precious metals such as gold, silver, palladium and platinum all peaked when the US dollar index bottomed in March 2008. So did a number of agricultural commodities like wheat, sugar and rough rice. Meanwhile, most of the industrial metals declined well ahead as concerns of a global economic slowdown first hit the markets last year.

	Price High	Date	Current Price	%Decline
Precious Metals				
Palladium	595.00	3/7/2008	300.75	-49.5%
Silver	21.36	3/21/2008	12.50	-41.5%
Platinum	2,301.50	3/7/2008	1,454.00	-36.8%
Gold	1,032.70	3/21/2008	793.80	-23.1%
			Average	-37.7%
Industrial Metals				
Nickel	54,200.00	5/18/2007	19,088.00	-64.8%
Zinc	4,658.00	12/1/2006	1,649.00	-64.6%
Lead	3,980.00	10/19/2007	1,679.00	-57.8%
Tin	25,500.00	5/16/2008	18,700.00	-26.7%
Copper	422.00	5/9/2008	329.70	-21.9%
			Average	-47.1%
Agricultural Commodities				
Wheat	1,284.25	3/14/2008	870.00	-32.3%
Corn	779.00	6/27/2008	546.00	-29.9%
Rough Rice	22.72	4/18/2008	16.27	-28.4%
Soybean	1,636.75	7/4/2008	1,246.50	-23.8%
Sugar #11	15.43	3/7/2008	13.39	-13.2%
			Average	-25.5%
Energy				
WTI Crude Oil	147.27	7/11/2008	113.77	-22.7%

Source: Bloomberg

Effect on stocks and the peso

The strength of the US dollar and the decline in commodity prices is good for stocks in the long-run. While it is premised more on a weakness on the rest of the world (which is not good per se) and not much on an upturn in the US economy, this greatly reduces the inflation angst reflected in the financial markets. In effect, this should push expectations for a Fed tightening further out into the future. At the same time, the ECB and other major central banks will likely put further rate hikes on hold.

The Philippine peso, meanwhile, will track the movement of the US dollar against other currencies. In fact, the strengthening of the US dollar against major currencies and the Bangko Sentral's intervention at the P40/\$1 level has stopped the peso from strengthening too much during the start of the year.

We continue to stick with the BSP's target of 42 to 45 for 2008 as discussed in *BSP at the Helm* (see July 28, 2008 issue of The Philippine Star). While it has given up much of its recent gains against the US dollar in sympathy with other currencies, we believe that the improving inflation outlook and our proactive Bangko Sentral will provide stability to the peso going forward.

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