Philequity Corner (January 19, 2008)
By Valentino Sy

Peso will follow the risk-aversion trade

With global risk aversion likely to diminish towards the latter part of the year, there is a strong likelihood that the Peso could rally further following its recent display of vigour.

In our article last week (see *2009: A Year of Opportunities* in the Jan. 12, 2009 issue of **The Philippine Star**), we said that policy-induced reflationary efforts by governments and central banks will offset the credit-led deflation. Our view is that towards the end of 2009, the massive fiscal and monetary stimulus coupled with quantitative easing by the Fed will have counter-balanced any deflationary expectations remaining.

In view of that, global risk aversion is expected to be greatly reduced relative to its current level. Hence, the US dollar should weaken as risk capital begins to search for higher yield.

Note that since the global credit crisis and asset de-leveraging unravelled, the US dollar became the safe-haven. It unprecedentedly drove down yields on short-term US Treasuries to almost zero. We expect the opposite to happen once risk aversion eases.

US Dollar Index vs. Short-term US Treasury Yields

Source: www.stockcharts.com

2008: A Deleveraging Story

The strength of the US dollar in 2008 has not been a Philippine based only phenomenon. In fact, it has been a broad-based rally not only against most of Asia but against most of its major trading partners.

Much of these currency movements can be attributed to the unwinding of the “short US dollar carry trade.” In prior years, international investors have massively borrowed against the US dollar (because of relatively lower rates) to buy commodities or emerging market assets or ex-US currencies in search for added yields.

However, the aftermath of the US sub-prime and credit crises, spurred a global margin call or deleveraging which triggered forced liquidations in the commodity trade, in emerging markets or even among the currencies of major trading partners of the US. This eventually morphed into a disorderly rout and panic-stricken sell-offs in many other currencies, including the peso which lost 15.1 percent.

Asia ex-Japan currencies (save the Yuan and the Singapore dollar) declined an average of 12.4 percent against the US dollar. The British pound lost the most, down 27.5 percent. The Canadian loonie and the Aussie dollar depreciated by 24.6 percent and 21.2 percent, respectively, apparently coinciding with the collapse of commodity prices.

Meanwhile, the Yen, which has also been shorted for the carry trade to a large extent, rallied tremendously (up 19.5 percent) on the back of a spike in risk aversion.

Major Currencies vs. US Dollar	**Price as of Jan. 16, 2009**	**2009 YTD %Chg**	**2008 YoY %Chg**
British Pound	1.4736	1.8%	-27.5%
Japanese Yen	90.74	-0.4%	19.5%
Canadian Dollar	1.243	-1.7%	-24.6%
Australian Dollar	0.6732	-2.5%	-21.2%
Euro	1.3266	-5.9%	-4.3%
Swiss Franc	1.1188	-5.9%	6.2%
Average		**-2.4%**	**-8.6%**
Asian Currencies vs. US Dollar			
Indian Rupee	48.72	2.0%	-26.1%
Thai Baht	34.845	1.3%	-17.6%
Philippine Peso	47.2	0.7%	-15.1%
Chinese Yuan	6.8383	0.2%	6.2%
Indonesian Rupiah	11130	-0.1%	-18.3%
Taiwan Dollar	33.39	-1.7%	-1.0%
Malaysian Ringgit	3.578	-2.6%	-5.1%
Singapore Dollar	1.4896	-3.3%	0.2%
Korean Won	1364.5	-7.8%	-35.2%
Average		**-1.2%**	**-12.4%**

Source: Bloomberg

Risk aversion ebbing

Today, however, the dramatic sell-off last year in commodities, equities, emerging market bonds, high-grade and high-yield US corporate bonds appears to be overdone. While we don't discount the fact the lows in these assets may be retested, it is apparent that global risk aversion has been ebbing since late last year.

In our article last week, we mentioned that money has been gradually flowing out of US Treasuries and into municipal bonds, investment-grade & high yield bonds and stocks since November 2008. This movement is also consistent with the peso's appreciation over the same period.

More headway for peso appreciation in 2H09

Going forward, we believe there will be greater headway for a peso appreciation due to the following reasons:

1) No significant slowdown in remittances. We don't expect a drastic slowdown in remittances despite the global financial crisis. In fact, the latest figures as of November still showed a robust growth of 10.5 percent. Government data also showed an increase of 24.4 percent in deployment for the period of January to November 2008.

2) Current account will remain in surplus. While growth in remittances will not be as aggressive as in previous years, we remain confident that the current account will continue to be in surplus. We don't expect the trade deficit to widen since slower export growth will be balanced by substantially less import take-up.

3) Portfolio outflows will not be as bad. In 2008, the Philippines lost a net 1.4 billion dollars in portfolio outflows as funds pulled out of Philippine equities, bonds and bank deposits. In recent months, however, this outflow has abated. We believe that we might be in for a positive surprise in the latter half of the year as the global economy start to regain traction and funds flow back into risky assets.

4) US dollar will be weighed down by heavy cost of bailouts. With the US fiscal deficit estimated to be upwards of $1 trillion and several trillions more committed to various bailouts and stimulus packages, we believe that the US dollar will ultimately come under pressure.

5) Low US Treasury yields will not be sustained. There's a strong likelihood that investors will not continue to tolerate zero returns on short-term US Treasuries. Eventually, funds will flow back to risky assets, which will be negative for the US dollar and positive for higher yielding currencies like the peso.

Technical picture

Technically, it looks like the peso-dollar rate topped out at 50 and initial support now lies at 46. The chart is also forming what potentially looks like a "head and shoulder formation." Eventually, if the neckline support at 46 breaks, we may see the peso-dollar rate going back to 44 and possibly 42.

Philippine Peso (Daily Chart)

Source: Technistock