Philequity Corner (January 30, 2012)
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Peso's Sweet Spot

The Philippine peso has been stable compared to most currencies despite the escalation of Europe's debt crisis in the 2nd half of 2011. With all the problems in Europe, the peso did not depreciate as much. At worst it depreciated by only 5.2 percent from 41.97 against the US dollar in August 1, 2011 to 44.15 in January 6, 2012.

Comparatively, the euro weakened as much as 15.5 percent from a high of 1.494 in May 4, 2011 to a low of 1.2624 in January 13, 2012. Meanwhile the US dollar index depreciated as much as 12.7 percent from its low of 72.95 in May 2, 2011 to a high of 81.51 in January 13, 2012.

If the problems in Europe are perceived to be getting resolved, we see the peso strongly going back to 42 – a level where we expect the Bangko Sentral ng Pilipinas (BSP) would intervene to support the dollar just as it did in the past.

Peso weakness was a buying opportunity

In an article we wrote three months ago (see *Why the US dollar is strong & why the Peso softened*, October 10, 2011) we said that the dollar rally is an opportunity to buy the peso.

"Over the long-run term we do not find any fundamental reasons why the peso should continue to decline against the US dollar. Our country's fundamentals remain very sound. We do not have the structural problems of the EU and the US. We have much healthier fiscal and current account balances. We have a steady supply of US dollars coming from OFW remittances and BPO revenues."

"Philippine banks' exposure to the eurozone is also minimal. Moreover, with our international reserves at record highs of $75 billion (as of August 2011), we now have more flexibility to withstand external shocks."

We also noted that between 44 and 44.50 are good levels to buy the peso which eventually proved correct.

"We therefore see the decline in the peso as only temporary. We believe that 44 to 44.50 should be good levels to buy the peso. Historically, the peso tends to strengthen towards the end of the year as more remittances flow in time for the Christmas season."

Philippine Peso (January 2010 to present)

Source: Technistock

Strong move to start 2012

The peso has made a strong move so far this year appreciating 2.4 percent to close at 42.85 against the dollar as of last Friday. This is because the main reasons for the temporary dollar strength during the 2nd half of 2011 have started to reverse.

1) **EU debt crisis showing early signs of resolution**. Investors have become more optimistic that Greece and its private sector creditors would soon reach a debt-restructuring agreement. This optimism is evident in the recent strength of the euro which rose to a six-week high of 1.3219 on Friday. The euro has now rallied almost 5 percent from its low of 1.2624 registered two weeks ago.

2) **Risk OFF trades now back to Risk ON**. While the US dollar benefited from the "flight to cash" late last year as global assets were sold en masse, investors are now pouring back in. Partial easing of global liquidity conditions especially in Europe switched investors back to "risk on." Europe averted a major funding crisis in December after ECB President Mario Draghi cut interest rates twice and allowed banks to borrow nearly half-trillion euros ($655 billion) from the ECB at low rates for three years instead of one year.

3) **US monetary easing extended through 2014.** Last week, Fed Charman Ben Bernanke announced that they are going to maintain rates near zero through 2014 while keeping the possibility of another round of quantitative easing (QE3) on the cards, further fueling investor risk appetite. Commodities, equities, high-yield bonds and other risk assets have strongly rallied since mid-December 2011.

In addition, there are also factors that are causing inherent strength in the peso.

1) **Record gross international reserves (GIR).** GIR tallied $75.3 billion as of end-2011, surpassing BSP's target of $70 billion. According to the BSP, the current GIR level is enough to cover 11.1 months worth of imports and 10.5 times the country's short-term external debt.

2) **Stable OFW remittances.** OFW remittances are expected to amount to $20.1 billion in 2011, 7.1 percent higher than in 2010. This year, the BSP projects remittances to grow by 5 percent to 21.1 billion.

3) **Record BPO revenues.** Revenues from the country's business process outsourcing (BPO) industry are expected to hit close to $9 billion in 2011. Recent endorsement by US President Barrack Obama of House Bill No. 3596 or "Call Center and Consumers Protection Bill", however, have caused some worries. While this may likely be just an election ploy to get re-elected and may not be a serious concern for the moment, we urge our government to actively negotiate and lobby against this protectionist stance.

4) **Record fund inflows since December 2011.** According to Bloomberg data, foreign investors have poured in $1.2 billion in the past two months, the most since they began tracking the data in 1999. BSP Governor Amado Tetangco said last week that the Fed's decision to maintain near-zero rates gave the country "some policy breather to concentrate on improving domestic demand." Thus despite the BSP's 25 basis points cut on policy rates two weeks ago, foreign funds continued to flow in and the peso continued to rise.

5) **De-facto credit rating upgrade**. Last December, Standard and Poor's raised its outlook for the Philippines to positive from stable, indicating that a rating upgrade is likely soon. Despite being two notches still below investment grade, the recent $1.5 billion global bond offering by the government was 8 times oversubscribed and fetched a record low 5 percent yield.

42 to 45 is the sweet spot

We are taking this opportunity to congratulate BSP Governor Tetangco for doing the right thing, i.e. maintaining the peso-dollar exchange rate at its sweet spot. At 42 to 45, we believe the peso is in its sweet spot against the US dollar. The BSP likes the exchange rate to stay in this range because it is good for the economy. Philequity also likes the peso to stay here because it is likewise good for the stock market.

We do not want the peso to be too strong because if it appreciates too much, it will surely hurt the OFWs, the exports, the BPO industry, and the export sector. At the same time, we do not want it to be too weak more so when inflation starts going up which is detrimental especially to the poor. In fact, the BSP can use peso strength as an effective tool to offset rising prices of oil and agricultural commodities such as rice, wheat and sugar which we usually import.

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