Philequity Corner (May 7, 2012)
By Valentino Sy

Be careful what you wish for

In recent years, the Philippine peso and the stock market have shown a strong positive correlation. Whenever the peso is appreciating against the US dollar, the stock market is performing well. And whenever the peso is depreciating against the greenback, stocks are faltering. Last week, the PSE index reached a new high of 5,329 as the peso-dollar rate neared 42 for the second time this year.

Investors long accustomed to this correlation may be wishing that the peso continues to strengthen in the hopes of seeing the market zoom higher. But be careful what you wish for. A stronger peso from hereon may have mixed results. In fact, it may have unintended negative effects on the economy and ultimately the stock market.

Peso among the best performers year-to-date

So far this year, the Philippine peso is among the best performing currencies. It's 5.02 percent gain year-to-date places the peso in 3rd spot in Asia, behind the Indonesian rupiah's 5.55 percent increase and the Malaysian ringgit's 5.02 percent advance against the greenback.

Among the major currencies, the Aussie dollar and the Kiwi dollar are tops with a 6.96 percent and 6.61 percent gain, respectively.

Major Currencies vs. US Dollar	Rate	% Change Ytd
Australian Dollar	1.0193	6.96
New Zealand Dollar	0.7949	6.61
British Pound	1.618	4.95
Swiss Franc	0.9133	2.75
Canadian Dollar	0.9936	2.73
Japanese Yen	79.88	1.34
Euro	1.3152	-0.24

Asian Currencies vs. US Dollar	Rate	% Change Ytd
Indonesian Rupiah	9214	5.55
Malaysian Ringgit	3.0412	5.11
Philippine Peso	42.35	5.02
Chinese Yuan	6.3061	4.05
Singapore Dollar	1.2419	3.75
Korean Won	1131.5	3.18
Taiwanese Dollar	29.235	1.25
Thai Baht	30.96	-1.94
Indian Rupee	53.515	-5.31

Source: Bloomberg

Reasons for peso strength

The general weakness in the US dollar (as seen from the tables above) is currently contributing to the peso's strength. The reasons for the dollar's weakness are the following:

1) **The US dollar carry trade –** The US Fed's policy announcement that they would maintain near-zero rates until 2014 have spurred "carry trades" that are attracting foreign investors to place their money in peso instruments. In a carry trade, investors borrow from countries with very low interest rates such as the US (also Japan, the EU, and Switzerland) and lend the money elsewhere to earn a higher yield. The Philippine benchmark overnight rates of 4 percent make it attractive to investors compared to the near-zero rates in the US.

2) **Resurgence of risk appetite –** Risk appetite tends to be negative for the US dollar. This explains the general weakness of the US dollar against most currencies this year as seen from the tables above. Rising risk appetite can be noted from the rise in global equities, the rally in commodity dollars (Australian, New Zealand, and Canadian) while safe haven currencies (US dollar,

Japanese yen, and Swiss franc) retreat.

3) **Fed's promise of additional QE –** The Fed's promise of additional quantitative easing (QE) in case the US economic recovery falters is clearly negative to the US dollar. QE involves printing money out of thin air to purchase financial assets from banks. This substantially increases the supply of US dollars, and hence, should be positive for the peso in the long run. Likewise, the ECB has its own version called LTRO which is similar to the Fed's QE.

Aside from the external factors contributing to the peso's strength, there are also positive factors inherent to the peso such as the following:

1) **Trust and confidence in PNoy and his economic team.** Most Filipinos believe that we have a no-nonsense, sincere and honest president that is doing what is best for the country.

2) **Record gross international reserves (GIR).** GIR reached $76 billion as of March 2012, which is already double the $37.5 billion held in 2008. According to the BSP, the current GIR level is enough to cover 10.5 times the country's short-term external debt, which is indicative of the country's credit worthiness.

3) **Stable OFW remittances.** OFW remittances during the first two months of 2012 amounted to $3.1 billion, up 5.6 percent year-on-year. The BSP projects remittances to grow by 5 percent to 21.1 billion this year.

4) **Surging BPO revenues.** Revenues from the country's business process outsourcing (BPO) industry reached $11 billion in 2011 and are expected to hit $25 billion by 2016. The Philippines has already overtaken India as the no. 1 call center destination and is moving up into higher-value services like accounting and healthcare insurance processing. The industry now employs more than 600,000 Filipino workers.

5) **Strong capital inflows.** According to the BSP, net inflow of portfolio investments amounted to $438.98 in the 1st quarter of 2012. The strong performance of the PSE index which is already up 21.2 percent year-to-date compared with the MSCI Emerging market index's return of 11.3 percent should continue to attract foreign funds.

6) **Recent IPO's in the PSE.** Net portfolio inflows should continue to surge in the 2nd quarter given the foreign participation in the IPOs of GT Capital, East West Bank and the private placement of Bloomberry Resorts Corp. which together raised approximately $900 million.

7) **Credit re-rating**. The country has come a long way in reducing debt a debt-to-GDP of 74 percent in 2004 to only 50 percent by 2011. The fiscal deficit was also very manageable at 2 percent of GDP in 2011. A credit upgrade which we expect to happen this year would mean more access to low-cost funding and other forms of investments, such as foreign direct investments.

8) **Tourism on the rise.** 1st quarter 2012 data from the Department of Tourism showed a 16 percent rise in tourist arrivals. This puts the Philippines on track to meet its 4.6 million visitor target this year. The public-private partnership (PPP) program of the Aquino government which includes the improvements of major airports, roads and other key infrastructure project is certain to give a boost to the country's tourism sector.

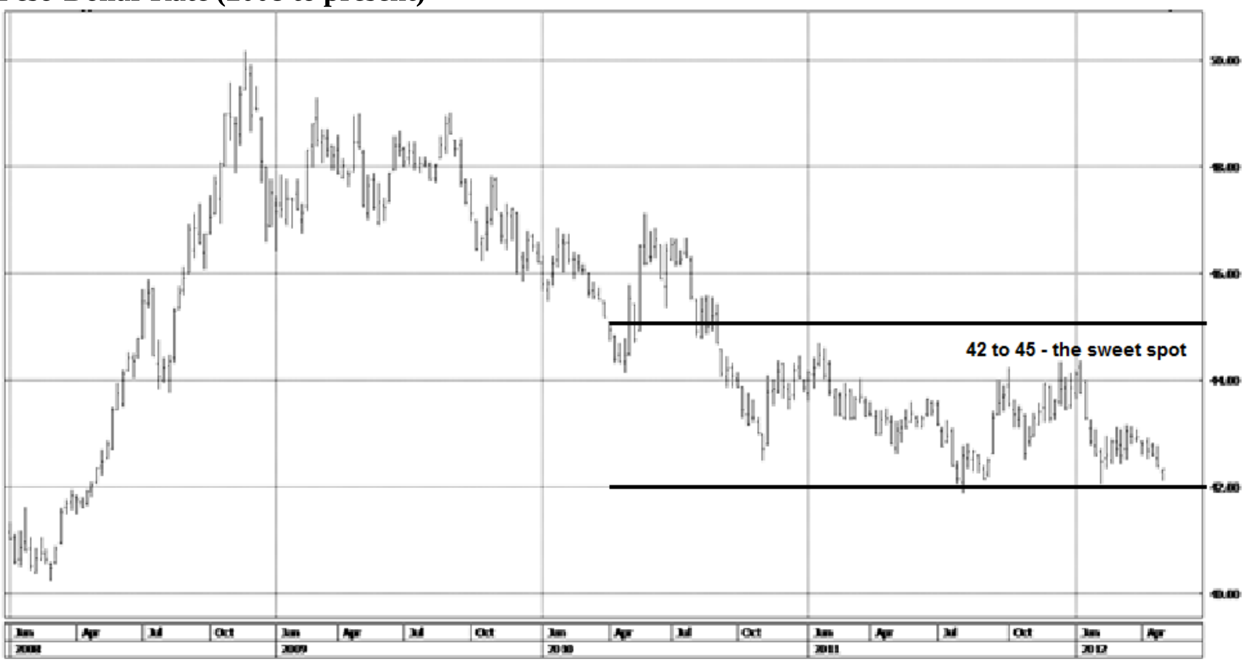
Too much of a good thing is a bad thing

Just like everything else, too much of a good thing is bad. While we did forecast that the peso would go

back to 42, when the peso was weakening at the 44.50 level (see *Why is the US dollar strong & why the Peso softened*, October 10, 2011), we believe that the country is better off with the peso somewhere between 42 and 45.
In fact, the risk to the economy is a peso that is too strong. We are fortunate that the Bangko Sentral ng Pilipinas remains firmly at the helm and would provide support whenever the peso tries to breach the 42 level.

A stronger peso at this point would affect the OFWs, the exporters and the BPOs which are the major sources of our current account surplus and foreign exchange reserves. With inflation still very much under control (despite the recent uptick to 3 percent in April from 2.6 percent in March), the Philippines can afford a slightly weaker peso rather than a stronger one.

Peso-Dollar Rate (2008 to present)



Source: Technistock

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