Philequity Corner (July 9, 2012)
By Valentino Sy

Too Much of a Good Thing

We were supposed to write about the stock market which broke out of its previous all-time high of 5,300 last week and discuss the rationale behind our new target of 5,800. But we decided to talk about the strong peso which we believe is more pressing and very alarming.

Since the start of the year the peso has strongly appreciated not only against the US dollar, but also against the currencies of our ASEAN neighbors. But most worrying is the peso's sharp appreciation against the rupee, the currency of India which is our competitor in the booming Business Process Outsourcing (BPO) industry. While the appreciation of the peso is good because it reflects the underlying strength of the Philippine economy and the positive investment inflows going into the country, **TOO MUCH OF A GOOD THING IS ALSO BAD.**

Outside the sweet spot

Note that during the past two years, the peso traded between the 42 and 45 range against the US dollar. In our article early this year (see *Peso's Sweet Spot*, January 30, 2012), we wrote that:

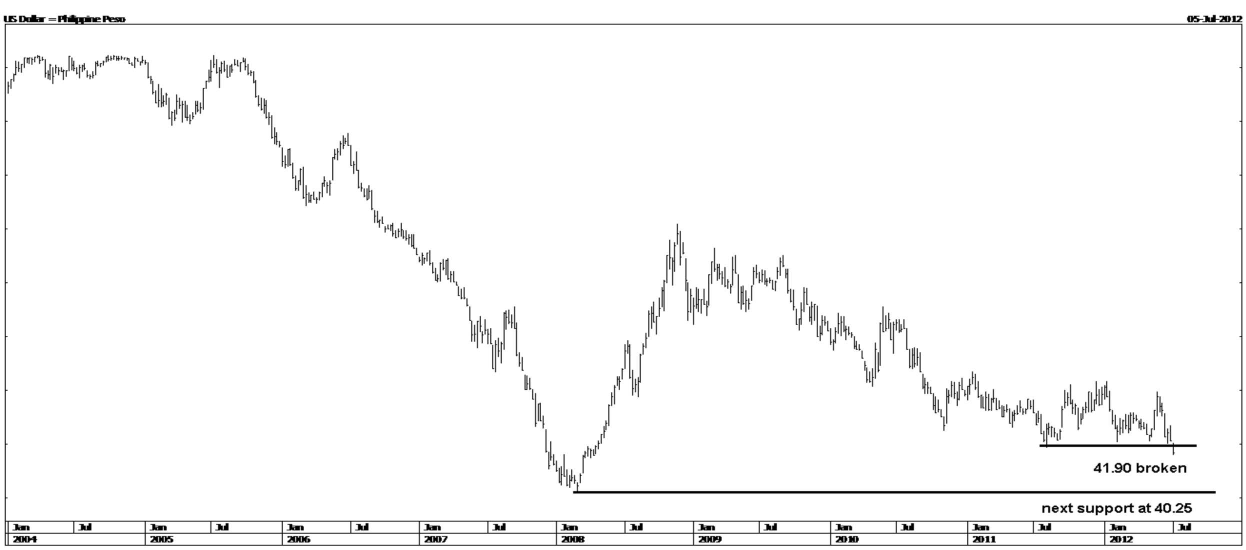
"*At 42 to 45, we believe the peso is in its sweet spot against the US dollar… We do not want the peso to be too strong because if it appreciates too much, it will surely hurt the OFWs, the exports, the BPO industry, and the export sector. At the same time we do not want it to be too weak, more so when inflation starts going up which is detrimental especially to the poor.*"

In another article (see *Be Careful What You Wish For*, May 7, 2012) we had forecasted a stronger peso. We said that we are more concerned of it being strong rather than having a weaker peso. We wrote that:

"*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… The Philippines can afford a weaker peso rather than a stronger one.*"

Last week, the peso broke below 42 against the US dollar for the first time in four years and appears to be headed towards 40.

US Dollar - Peso Exchange Rate (2004 to Present)



Source: Technistock, Philequity Research

Philippine Peso is the Outlier

BSP Governor Amado Tetangco was quoted last week as saying that: *"We are moving in line with other currencies in the region. I think now the peso is probably ahead in terms of value vis-à-vis the other currencies but that's how the market perceives the currencies and we are just allowing the market to determine the rate."*

While we agree that other currencies likewise moved higher against the US dollar the past week, the peso is way ahead of other the currencies in the region. In fact, the peso has proven to be the outlier since the start of the year.

The table below shows the performance of Asian currencies vs. the US dollar year-to-date. Clearly the peso is the outlier, up 4.5% against the US dollar. Behind at second place is Singapore with a 2.03% gain.

The Indian rupee, the Indonesian rupee and the Japanese yen are even down by -4.88%, -3.80% and -3.54% against the greenback, respectively. Likewise the Chinese yuan is down by -1.04%.

Asian Currencies vs. US dollar	Current Price	% Change Month-to-date	% Change Year-to-date
Philippine Peso	41.8500	0.64%	4.54%
Singapore Dollar	1.2726	-0.60%	1.85%
Taiwanese Dollar	29.9220	-0.45%	1.18%
South Korean Won	1,139.4000	0.02%	1.13%
Thai Baht	31.7500	-0.57%	-0.63%
Malaysian Ringgit	3.1922	-0.81%	-0.76%
Chinese Yuan	6.3658	-0.19%	-1.04%
Japanese Yen	79.6600	0.15%	-3.58%
Indonesian Rupiah	9,427.0000	-0.60%	-3.95%
Indian Rupee	55.7950	-0.42%	-5.14%

Source: Bloomberg, Philequity Research

Losing competitiveness in BPOs

Already, our exporters represented by the Philippine Exporters Confederation, Inc. (Philexport) have voiced their concerns. We are sure that the OFWs and their families are also feeling the effects of a stronger peso eating into their purchasing power. But what's more alarming for us in Philequity is how the peso has appreciated against the Indian rupee since the 2nd half of 2011 which may have a big impact on our BPO sector where India is our primary competitor.

Philippine Peso & Indian Rupee vs. US Dollar (2008 to Present)

Source: Technistock, Philequity Research

Since June 30, 2011, the Indian rupee has depreciated from 44.96 vs. the US dollar to 55.66 as of last Friday. Meanwhile, the peso has appreciated from 43.33 vs. the US dollar to 41.87 over the same period. In other words, the rupee is now cheaper by almost 30% compared to the peso.

Two main internal risks for the stock market

In a recent presentation to select clients, we cited the reasons and the catalysts for the PSE index to reach our next target of 5,800. We also pointed out two internal risks that may derail the Philippine economy and the stock market from further improvements. These are the excessive appreciation of the Philippine peso, and a worsening of relations between China and the Philippines (see *Bananas, Pineapples & the Stock Market*, May 13, 2012) which may provoke a trade war or further economic sanctions from China vs. the Philippines.

Learning from Japan

Too strong a peso can be detrimental to the Philippine economy and the stock market. We have to learn from Japan who experienced a strong appreciation in the yen since the mid-1980s. Due to the strong yen, Japan's major exporters became unprofitable and lost market share to competitors from South Korea. Sony, for example, has lost market share to Samsung, incurring a $5.7 billion loss in 2011 vs. Samsung's $18.3 billion income. Similarly, carmakers like Toyota, Nissan and Honda have lost to the likes of Hyundai and Kia in recent years. Meanwhile, the Japanese stock market stagnated and has lost almost 80 percent in value since it peaked in Dec. 1989 and never recovered in what is known as Japan's lost decade (which is more like two decades now).

Swiss franc's peg to the euro

Last year, the Swiss monetary authorities pegged the Swiss franc to the euro when it experienced sharp appreciation as a result of the EU debt crisis. Massive amounts of capital fleeing the eurozone sought refuge in the Swiss franc. The Swiss had to protect their domestic businesses and their exporters from a strong Swiss franc, and hence, the decision to peg to the euro.

Something has to be done

We in Philequity believe that something has to be done to stem the sharp rise of the peso. In fact, the BSP has all the tools and they started moving last week. The BSP indicated that they may introduce new regulations on non-deliverable forwards (NDFs) which should force local banks to unwind their NDF contracts and create demand for US dollar onshore. Also, the BSP may either restrict or set minimum holding periods for deposits in SDAs which should prevent speculators from depositing peso in the overnight market.

The BSP can also lower its policy rates. The current overnight rate (SDA) is 4 percent. This induces a carry trade from speculators (borrow US dollar at 1 percent and deposit in SDA at 4 percent). Theoretically, this carry trade can be infinite as long as speculators have the capacity to borrow and the yield difference is attractive.

So far, inflation has been relatively tame and will probably be at the lower end of BSP's 3% to 5% target this year. This should give the BSP more leeway to gradually adjust monetary policy, prevent excessive capital inflows and thwart undue speculation on the peso.

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