Philequity Corner (March 20, 2017)
By Wilson Sy

Reversion to the mean

After the dovish comments of Janet Yellen last Thursday, most currencies improved against the US dollar, including the peso. The peso, which reached a 10-year low of 50.40 against the US dollar early this month, strengthened to as much as 50.08, before closing at 50.18 last Friday.

Fed raises rates by 25 basis points

Last week, we mentioned that the odds of a March rate hike was nearly 100% (see *Beware the Ides of March,* March 13, 2017). In line with expectations, the Fed raised its policy rates by 25 basis points during this March meeting. This is the 2nd time in three months that the Fed increased its benchmark rates amid rising confidence that the economy is getting further traction.

Less hawkish than feared

While the 25 basis point hike was widely anticipated, the market was surprised by the Fed's less hawkish guidance. Yellen made it clear that they don't want to move rapidly. In fact, Yellen and the Fed reiterated that the pace of rate normalization would remain "gradual". This caused the US dollar to slide, bond yields to drop and stocks to rise.

Long-term, dollar strength is a good thing - Mnuchin

At the same time, US Treasury Secretary Steven Mnuchin reiterated the importance of long-term dollar strength to the US economy and to its role as the world's reserve currency. While he admitted the short term strength of the dollar could cause certain issues, he said that in the long-term "the strengthening of the dollar is a good thing."

Dollar bull market since "taper speech"

Bernanke's "taper speech" in May 22, 2013 signaled the change in US Fed policy and prompted the dollar bull market. Hence, the Fed policy started to diverge with the policies of the ECB and BOJ which are still on the easing path. This effectively fueled the broad appreciation of the US dollar which has risen roughly 20% since then.

Peso tops out in 2013

The taper speech and its ramifications on the currency markets led us to conclude back then that the peso has peaked against the US dollar. In fact, we immediately published an article calling for the peso's top (see *Peso Tops Out*, May 27, 2013). Subsequently, the peso would drop by 20% or roughly the same amount as the US dollar index appreciation.

Peso reverts back to the mean

After Bernanke's taper speech, emerging market currencies reeled from a "taper tantrum" and weakened against the dollar substantially. Initially, the peso outperformed vis-à-vis Asian currencies. But in the last two years, the peso seems to have reverted back to the mean. Statistics show that prices have a general tendency to revert toward the mean or historical average.

10-year emerging Asian currency performance vs. the US Dollar

In the table below, we show the performance of emerging Asian currencies vs. the US dollar from a year-to-date, 1-year to a 10-year return.

If we look at the 3-year and 5-year horizon, the peso's performance vs. the US dollar is now broadly in line with the movements of the region. Note that over a 10-year period, the peso is still significantly way ahead of the regional average.

Currency vs USD	Ytd return %	1 yr return	2yr return	3yr return	5yr return	10yr return
Malaysian Ringgit	1.1%	-9.3%	-20.0%	-35.4%	-45.2%	-26.4%
Indonesian Rupiah	1.0%	-2.1%	-1.4%	-18.2%	-45.9%	-44.6%
Chinese Yuan	0.6%	-6.6%	-10.5%	-11.8%	-9.2%	10.8%
Singaporean Dollar	3.1%	-3.9%	-1.0%	-10.9%	-11.3%	8.1%
Philippine Peso	*-1.2%*	*-8.4%*	*-12.4%*	*-10.8%*	*-16.7%*	*-3.1%*
Vietnamese Dong	-0.1%	-2.2%	-6.1%	-8.1%	-9.5%	-42.3%
Thai Baht	2.7%	-0.2%	-5.8%	-8.1%	-13.3%	-5.9%
Indian Rupee	3.6%	1.9%	-4.4%	-6.8%	-30.6%	-48.8%
Korean Won	6.1%	3.5%	-0.5%	-6.0%	-0.6%	-19.8%
Pakistani Rupee	-0.5%	-0.7%	-3.1%	-5.7%	-15.5%	-72.6%
Taiwanese Dollar	5.3%	6.0%	2.9%	-0.9%	-3.7%	7.5%
Average	**2.0%**	**-2.0%**	**-5.7%**	**-11.1%**	**-18.3%**	**-21.6%**

Source: Bloomberg (prices as of March 17, 2017)

A weaker peso has its advantages

While many are concerned about the recent weakness of the peso, it is not necessarily bad. The peso is just reverting back to the mean as it seeks its appropriate value. A weaker peso also brings the following advantages:

1) Stimulates exports – A weaker peso makes exports less expensive, making them more competitive in the global market.
2) Promotes local manufacturing – A weaker peso allows import-competing local manufacturing firms to flourish as imports become more expensive.
3) Benefits agriculture – It allows local products to be more competitive against agricultural imports.
4) Boosts tourism – A weaker peso helps increase visitor arrivals and encourages more spending as visitors get more bang for their buck.
5) Favorable to OFWs – A weaker peso translates to increased income for OFWs and higher peso value of remittances. This increases the spending power of OFW families, which in turn stimulates domestic consumption.
6) Boon to BPOs – A weaker peso ensures the competitive advantage of our country's BPO industry. This translates to lower costs and increased earnings from BPO operations.
7) Promotes countryside development – A weaker peso, which is beneficial to agriculture, tourism and local manufacturing, helps promote President Duterte's bid for countryside development.

On the flipside, too weak a peso has its drawbacks such as: higher energy costs, higher inflation, and increasing foreign debt obligations for the government.

A peso supportive of economic growth

Just as an excessively strong peso can be bad for the economy (see *Be careful what you wish for*, May 7, 2012 and *Is the peso too strong?*, Dec. 31, 2012), an overly weak peso can also have negative effects. For us, at Philequity, what is vital for the Philippine economy is a relatively stable peso that will support economic growth. At the same time, we want a peso that will not cause financial turmoil, or as BSP Governor Tetangco puts it a peso "whose movements are not disruptive or excessive."

What's next for the US dollar?

In the aftermath of the Fed rate hike, a typical "sell on news" phenomenon occurred. The dollar has pulled back and looks poised for a consolidation or a correction. Longer term, there are signs that the euro and the yen are stabilizing against the US dollar. As inflation ticks up and growth becomes more consistent for both EU and Japan, the ECB and the BOJ may start scaling back their QE programs. This would be positive for both the euro and Japanese yen. A strengthening euro and yen may then cause EM currencies, including the Philippine peso, to stabilize as well.

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