Philequity Corner (July 17, 2017)
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Peso weakness – good or bad?

Last week, the Philippine peso touched 50.82, its lowest level in eleven years. Many investors are concerned as they believe that the weakness of the peso is bad for the stock market and the economy. But is this an accurate assessment?

Why did the peso weaken?

There are many factors which contributed to the depreciation of the peso. We enumerate some of these below.

1. **Current account deficit.** Our current account is projected to come in at a deficit this year after fourteen straight years of surpluses.
2. **Wider trade gap.** Despite the rebound in exports, our trade gap widened faster than expected, thus fueling concern that the acceleration in imports may further worsen our trade deficit.
3. **Slower than expected growth in OFW remittances and BPO revenues.** OFW remittances and BPO flows came in slower than expected and failed to offset a wider trade gap.
4. **War in Marawi.** The Marawi incident raised investor concerns about security risks in the country, especially in Mindanao, and the cost of the war in Marawi.
5. **Technical analysis and the break of 50.** Technical analysis is a widely used tool in currency and stock market trading. The break of the 50 level and the previous high of 50.4 triggered more peso selling.
6. **Narrowing yield differential.** The Fed has raised interest rates three times in the past year while other global central banks have adopted a hawkish stance (*Connect the Dots*, April 3, 2017). In contrast, the BSP has not raised interest rates, which has allowed yield differentials to narrow.

A closer look at the numbers

A closer look at the current account and balance of payment numbers can help us better ascertain the reasons behind the peso weakness and its direction in the future.

1. **Crude oil imports cause current account deficit.** Crude oil prices in 1Q17 rebounded vs. an extremely low base in 1Q16. The base effect resulted in higher import values of petroleum crude, causing our trade deficit to widen. Note that crude oil prices have already stabilized recently.
2. **Frontloading of automobile purchases.** Another contributor to higher imports is the frontloading of automobile purchases ahead of higher excise taxes. Note that this is a one-off occurrence and auto purchases should normalize when tax reform is passed.
3. **Importation of capital goods.** There was an increase in the importation of steel products and other capital goods which are needed for the implementation of infrastructure projects.
4. **Outflows from fixed income portfolios.** So far, we have seen that foreign outflows have come mostly from fixed income portfolios. In contrast, the stock market has benefited from foreign inflows. Year-to-date, net foreign buying in the stock market has amounted to P19.8b.

5. **Peso reverts to the mean.** The peso's weakness has caused it to underperform other currencies in year-to-date terms and in a 1-year time frame. However, the peso's medium-term performance (3-year and 5-year horizon) is broadly in line with the movement of other Asian currencies (see *Reversion to the Mean*, March 20, 2017).

Why peso weakness can be good

While some may be concerned about our currency's depreciation, the peso's recent weakening move also brings some advantages. We enumerate these below.

1. **Higher spending power for OFW families.** A weak peso will result in higher spending power for OFWs and their families as the peso value of OFW remittances will increase.
2. **Competitiveness of BPO sector.** A weak peso will support the competitiveness of our BPO sector. Note that the recent peso weakness coincides with a stronger Indian rupee. Considering this, our outsourcing companies will benefit from more competitive pricing vs. their Indian counterparts.
3. **Boost exports.** Our currency's weakness will make Philippine exports cheaper. With the recovery in global demand, the peso's recent move will contribute to the rebound in Philippine exports.
4. **Imports become more expensive.** With a weaker peso, imported goods will become more expensive and this can lead to import substitution.
5. **Revival of manufacturing sector.** The recent uptick in exports and the import substitution resulting from a weak peso can support the rebound of our country's manufacturing sector.
6. **Support agriculture sector.** Coupled with the right initiatives, a weaker peso can allow local agricultural products to better compete against imported fruits and crops.
7. **Promote the tourism industry.** Since the country is blessed with many scenic sites and natural attractions, a weak peso along with lower oil prices will stimulate our tourism sector.
8. **Create more jobs.** Improving prospects for labor intensive sectors such as manufacturing, agriculture and tourism will result in job creation.
9. **Promote countryside development.** Better performance from our agriculture and tourism sectors will support stronger economic growth in the countryside.

Note that the points that we identified above are in consonance with the government's 10-point economic agenda.

Stock market remains stable despite peso weakness

The weakness of the peso was widely expected by the market. It has been imputed in the earnings estimates of stock market analysts and growth forecasts of economists. In fact, many of them believe that a gradual depreciation is not disruptive to the economy and is acceptable to the market. As such, the market has been stable and confidence in the economy remains strong despite the peso weakness.

Weak yen, strong Nikkei

The example of Japan shows that there are instances when currency weakness can have a positive impact to the stock market and the economy. In Japan's case, the Nikkei strengthens when the yen weakens and vice versa (*Out of the Sandtrap*, April 15, 2013).

Short-term pain, long-term gain

The ongoing weakness of the peso may result in some short-term pain, as it may lead to higher inflation and precipitate portfolio outflows in bonds and stocks. However, if the government successfully implements its economic agenda, our economy will grow faster while also becoming more diverse and more inclusive. If these goals are achieved and our country's fundamentals continue to strengthen, then the currency move should consequently improve and should not be a major concern.

Passage of tax reform can trigger peso rebound

The tax reform package can be a catalyst for the stock market if it is passed in a timely manner and is not watered down. It can also lead to stronger economic growth, as it will free up spending of lower and middle income segments while providing fiscal leeway to increase infrastructure spending. In this light, the passage of tax reform can temper the recent weakness of the peso. Over the long term, a stronger fiscal position, buoyant domestic consumption and robust economic growth resulting from tax reform can lead to a sustained rebound or strengthening of the peso.

Bold and decisive

President Duterte and his economic managers have been bold and decisive in what they want to pursue for our economy. The government aims to deliver breakout growth of 7% or higher while diversifying our economy and making growth more inclusive. The primary goal is to strengthen the economy. Thus, it appears that the economic managers are not too concerned about the depreciation of the peso.

Peso weakness – not necessarily bad for economy

In a recent interview, Finance Secretary Sonny Dominguez said that a weak peso may not necessarily be bad for our economy. Likewise, Budget Secretary Ben Diokno stated that he is not worried about the depreciation of the peso. Similarly, BSP Governor Nesting Espenilla said investors should not stress about the weakness of the peso as underlying fundamentals remain healthy. In addition, he said that the BSP is ready to intervene in the FX market to manage excessive volatility in the peso.

Growth is the end goal

It is therefore clear that our economic managers are steadfast in their ultimate goal of strengthening economic growth by boosting fiscal stimulus and hiking infrastructure spending. As investors monitor the implementation of the Duterte government's economic agenda, the stock market has been stable despite the weakness in the peso. Moving forward, we believe that the direction of the peso will be contingent on the success of the administration's economic agenda. If the government can stay the course with its plans, then the peso should stabilize or even strengthen as our economy and stock market experience breakout performances.

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