No Whacks At The Philippines

A laugh-line from the Cold War was the Soviet Union was the only country in the world surrounded by hostile communist powers. Had the wholly artificial borders in Eastern Europe been drawn a little bit differently and managed somehow to make Bulgaria abut the Soviet republic of Moldova, this statement would have been false. Bulgaria, despite its alliance with Germany against Russia during both World Wars, always had a cultural soft spot for Russia because of the Tsars' efforts in driving the Ottomans out of their homeland. In addition, there are the ties of the Cyrillic alphabet and Eastern Orthodox Christianity.

The relationship between the Philippines and the U.S. is somewhat similar. The islands became a colony of Spain in 1521 – the Portuguese explorer Ferdinand Magellan sailed under a Spanish flag and was killed there, which makes his status as the first known circumnavigator of the world a tad suspect – and were perfunctorily kept as an American colony after the Spanish-American War and Admiral Dewey's famed victory at Manila. The brutal suppression of the insurrection under Governor-General and later President and Chief Justice William Howard Taft against the American colonization gave the U.S. its first taste of land war in Asia.

All of that was forgiven, and then some, by the shared experience of the U.S. and the Philippines during World War II. The Japanese victories and occupation, which included the infamous Bataan Death March, were seared into the Filipinos' souls; MacArthur's eventual return in 1944 was seen as nothing short of divine liberation. As an aside, the American naval victory at Leyte Gulf in 1944 was not only the largest naval battle in history; it was and probably shall remain the last surface battle fought by the U.S. Navy. Subic Bay and Clark Air base in the Philippines became the home of a gigantic American military presence that ended only after the eruption of Mt. Pinatubo in 1991 rendered the facilities inoperable. The nearby town of Olangapo City was famed as an, um, rest-and-recreation spot well within the budgetary reach of American servicemen and "tourists" from elsewhere.

Just as remittances from Mexican workers in the U.S. constitute an important part of the Mexican economy, remittances from a large Filipino Diaspora are vital to the Philippines' economy; they constitute approximately 10% of the country's GDP. This huge important of capital from expatriates is both a tribute to the Filipino work ethic and a damnation of the failure to create a self-sustaining demand for labor internally; the same can be said for the Mexican workforce in the U.S., of course.

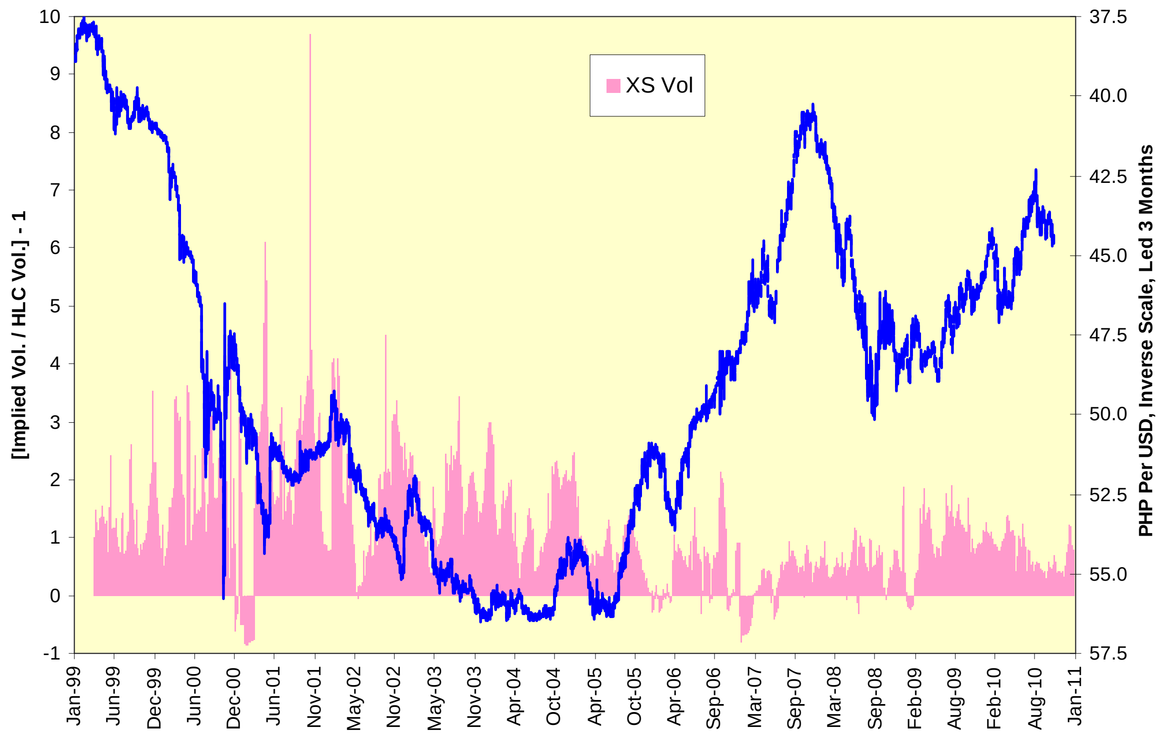
The importance of remittances and the lack of a single dominant domestic industry or export for the generation of foreign exchange have left the Philippine peso in a most unusual situation for any currency. As we shall see below, none of the usual drivers of an exchange rate seem to matter much to the PHP in its exchange rate against both the dollar and the yen; Japan is the second-largest trading partner of the Philippines.

Recent History And Trend

While the PHP was hit during the Asian financial crisis of 1997, it has avoided many of the ups and downs associated with the region since then; a cynic might note it has done a stellar job of the avoiding the region's successes. The tepid history, which has included a five-year selloff against the USD between 1999 and 2005, a strong rebound into 2008, followed by another weakening during the 2008 global financial crisis and yet another rebound starting with the March 2009 low, has been greeted with a yawn in the options market.

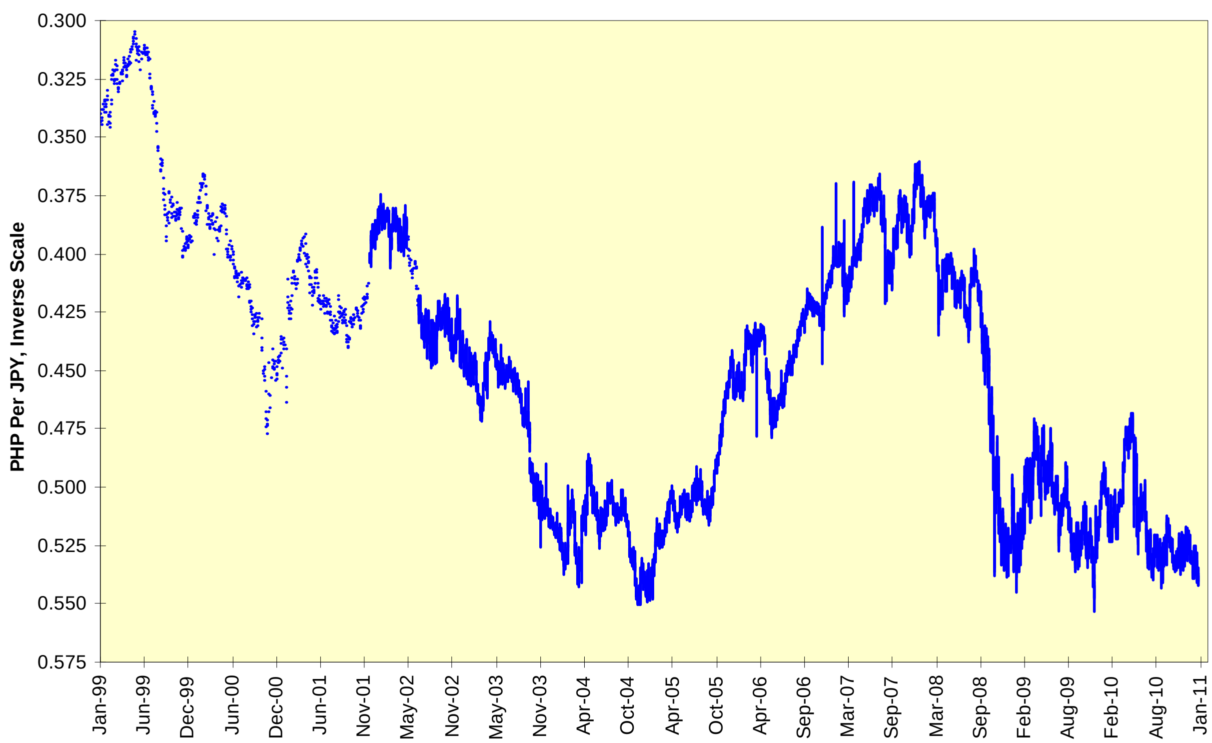
If we map the course of the PHP against its excess volatility, here defined as the ratio of the implied volatility of three-month forwards to high-low-close volatility, minus 1.00, we see how the options market remains in a permanent state of "buying protection" against a declining peso, regardless of the PHP's course. There is a slight leading relationship at a three-month lag between excess volatility and the peso, but one would be hard-pressed indeed to monetize this observation.

Options Market Leads Peso Weakly



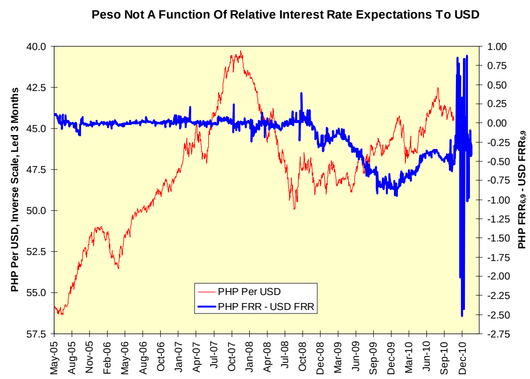
The PHP per JPY rate has had an equally unexciting history. Here we see the same history of weakness into 2005, a rebound, a downturn in the 2008 global financial crisis wherein many yen carry trades were unwound and a second and short-lived rebound once the yen began to weaken in 2010. This is no comparable options market from which to extract an excess volatility measure.

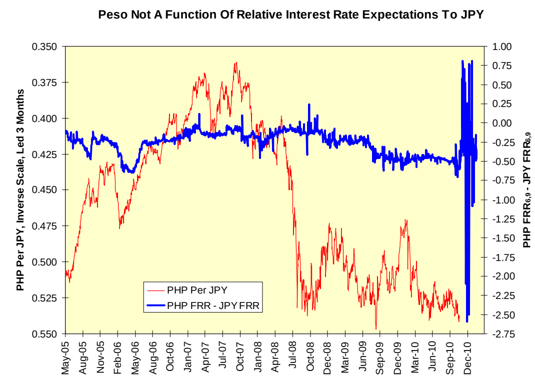
Peso Rebounding Against Yen



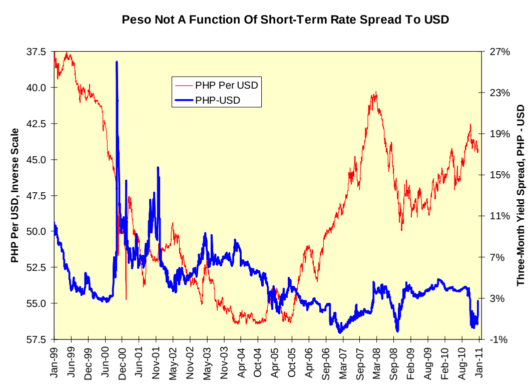
Interest Rates

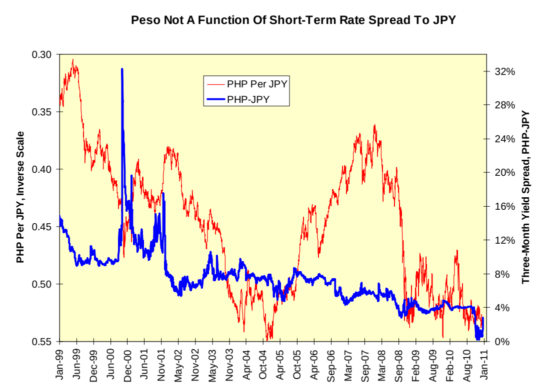
We can split the comparative interest rate picture for the PHP into two views. The first, always preferred for major currencies and seldom calculable for minor currencies, is the interest rate expectation differential as measure the forward rate ratios between six and nine months ($FRR_{6,9}$). This is the rate at which we can lock in borrowing for three months starting six months from now, divided by the nine-month rate itself. The more this $FRR_{6,9}$ exceeds 1.00, the steeper the money market yield curve is. We should expect the differential between the PHP $FRR_{6,9}$ and those of both the USD $FRR_{6,9}$ and the JPY $FRR_{6,9}$ to lead the PHP by three months, with the normal effect being a greater differential leading to a stronger PHP. Even before the PHP $FRR_{6,9}$ began to gyrate seismically after the Federal Reserve's adoption of QE2 in November 2010, the differential was not a strong determinant of the exchange rate against either currency; however, we only have data extending back to May 2005 with which to make this comparison.



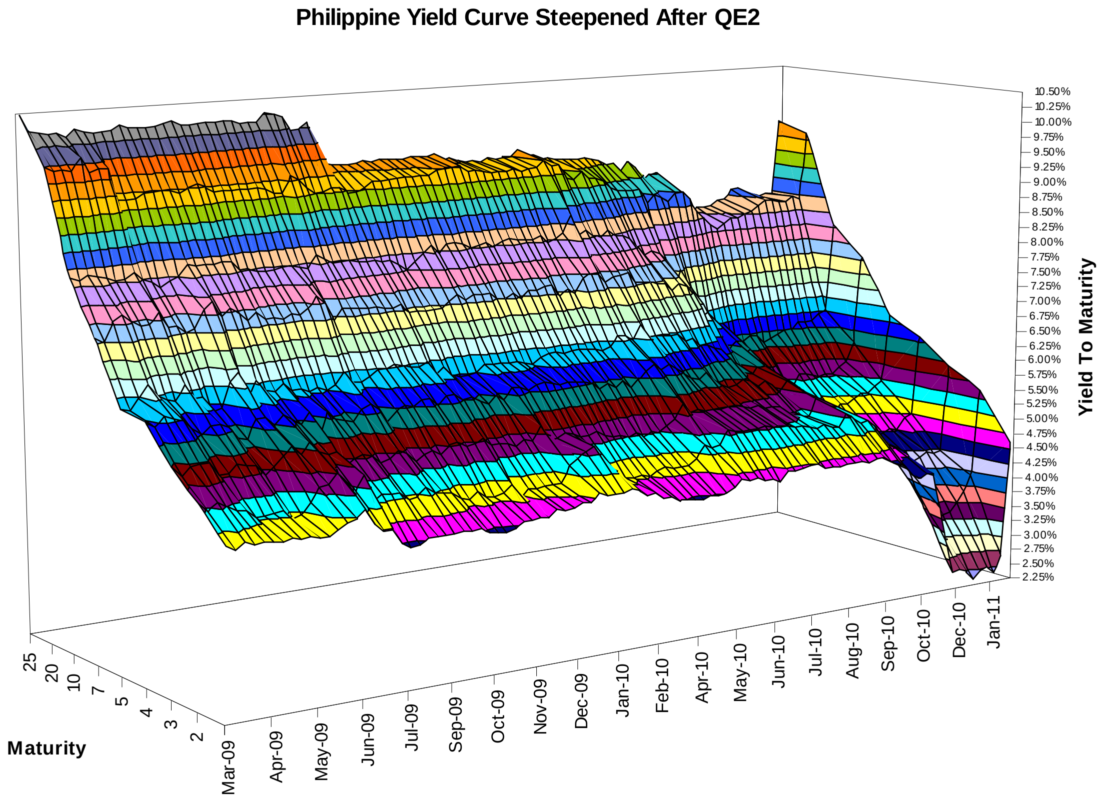


A more common metric for the minor currencies (see "Indonesian Rupiah: River Deep, Bali High," March 2011) is for the currency to track the simple interest rate spread at three months. Yet this does not appear to be the case for either the USD or JPY three-month rate differentials; here we have data extending back through the January 1999 startdate of the euro we use for so many analyses.





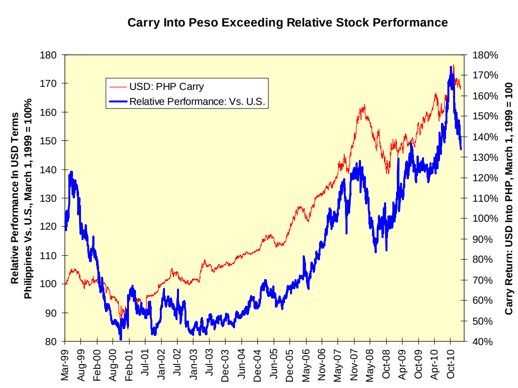
If we wish to extend the interest rate analysis out along the note horizon from the money market horizon, we run into a low-information yield curve, at least since the March 2009 global market low. The yield curve surface here had been unusually stable until QE2 and did not give us any clues to future growth trends or inflationary pressures. The extreme steepening of the Filipino yield curve after November 2010 was unimportant for the PHP.

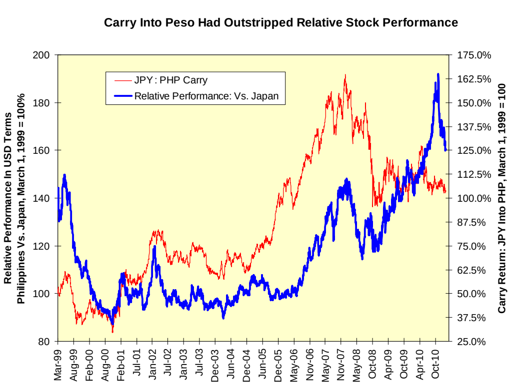


Asset Markets

Finally, has the peso been affected by carry trades from either the U.S. or from Japan? If we map the total carry return between the two funding currencies against the relative total returns in USD terms for the Philippine stock market against the American and Japanese markets, we see an interesting divergence beginning with the March 2009 low. The carry return of the USD into the PHP had been moving in parallel prior to the spate of U.S. rate cuts beginning in late 2007. Those increased both the carry returns and improved the relative performance of the Filipino stock market to the U.S. until an eventual relative performance peak was reached in October 2010.

An opposite shift occurred with respect to the JPY carry into the PHP. Here what had been a strong correlation between the carry trade and the relative performance of Japanese equities broke once U.S. rates started to approach Japanese rates and eventually move under those rates by late August 2009. Once the yen ceased to be the preferred funding currency for the Philippines, Filipino stocks began outperforming Japanese stocks in USD terms into November 2010. Both examples confirm a long-proffered principle low interest rates tend to benefit external debtors more than internal debtors: Even after the late-2010 downturns in relative performance, Filipino equities have outperformed those of the two major funding currencies.





The Philippine peso seems to exist in a sort of netherworld, one where it is used internally by its citizens and bought by expatriates remitting funds, but without a direct connection to the financial and economic drivers seen for other currencies. The country and the currency probably can limp along indefinitely like this; after all, a list of exports from the Philippines has "Goods returned and then re-exported" in the tenth slot. A world-beating economy this is not, but then again, who says the Philippines have to adopt the frenetic export-driven lifestyles of their East Asian neighbors.

When the U.S. dollar was taking one of its periodic nosedives in 2004, it was derided by some as "The American peso," the association with the Spanish-heritage currency not being made as a compliment. Here we see the Asian peso, but somehow we do not see the country as having failed in some mission. It is, in a pop psychology sense, a country and a currency accepting of its role.