Lower income countries attractive

Lower income economies will offer an opportunity in the months ahead as the developed world struggles with recovery, writes **Peter Hensman**.

The debate surrounding the exit strategy from the extraordinary monetary stimulus that has followed the collapse of Lehman Brothers continues to build, while the first interest rate increase of the cycle from Israel at the end of August could easily be dismissed as having relatively limited implications for markets and economies more broadly. That the Reserve Bank in Australia chose to raise interest rates on October 6 did catch market attention.

Despite the analyses of Federal Reserve speak hinting at a move toward tightening monetary policy in the US, as Fed chairman Ben Bernanke shifts his language from believing in the need for extremely low interest rates to an environment in which only accommodative polices remain appropriate for an extended period, the lead from Australia is unlikely to be quickly followed in the major economies.

Australia has had a remarkably good credit crunch. At the headline level, there has not been a technical recession in terms of back-to-back quarters of falling GDP. Furthermore, house prices and home credit have responded well to the sharp reduction in interest rates and unemployment remains at historically low levels. Hence, although the unemployment rate has risen from a low of four per cent to 5.7 per cent, this compares to a 2001 peak of seven per cent and a level that approached 11 per cent in the early 1990s. With the latest labour market report showing a 40,000 month-on-month increase in the number of employees compared to a consensus expectation for 10,000 jobs being lost, and with the six-month change in employment turning positive, conditions are very different from those in the US. There the non-farm pay roll report for September showed a worse-than-expected 265,000 decline in the number of jobs. With the Federal Reserve mandated to maintain the maximum level of employment consistent with stable prices and long-term bond yields, it is difficult to envisage the Fed being able to justify a rate increase anytime soon.

The focus of the FOMC on the level of activity compared to potential output was reiterated in the speech given by Federal Reserve vice chairman Donald Kohn in an address to the National Association of Business Economists on October 13. The return of growth to the economy is not a sufficient condition to cause the Fed to raise rates.[1]

Interest rates

Arguably, as the market reaction to the rate increase in Australia demonstrates, this pressure on the US to maintain low interest rates creates a dilemma for the rest of the world. Expectations for further rate rises in Australia contributed to further appreciation of the Australian dollar. Economies that have been less adversely affected by the credit crunch, where emergency interest rate levels are perhaps no longer appropriate, face the prospect of strong currency gains and a commensurate loss of export competitiveness as the indication of healthier local attracts global capital flows. Yet, for many, the prospect of allowing stronger domestic demand growth at the expense of export performance represents something of anathema. Hence, closely following the decision to raise rates in Australia, the Bank of Korea sought to quash expectations that a rate increase was imminent there. The bank's governor went so far as to indicate that he had not intended to signal an imminent rate increase after the meeting in September and that the Bank of Korea would likely need to see fourth quarter GDP statistics before any move to raise interest rates could be made.

Absent an unexpectedly strong and prolonged recovery in US demand that contributes to a significant reduction in US unemployment, there seems little that will derail the rebalancing of global demand. Where several developed economies are credit constrained, the JPMorgan emerging market bond yield has declined to a yield of 6.3 per cent, matching the 2007 low. This is helping car sales in Brazil, India and China (but not Russia) to rise strongly. In the former three, car sales are already at new record highs. In the US, the end of the cash for clunkers programme has contributed to a slump in US auto sales to a 9.3 million annualised rate in September. This compares to a 27-year low of 9.1 million in February. Hence, it is now Hong Kong where luxury apartment prices have just surpassed their 1997 high for the first time and where new wine auction price records are being set. This is very much the reverse of the environment created by the currency crises of the late 1990s. Then it was the demand destruction in the developing world that created the space and backdrop for the NASDAQ surge and the subsequent housing bubble.

Now it is likely that it will be the sluggish recovery and loose policy stance in the developed world that will allow there to be the room for the developing world to expand. In a world struggling to find growth opportunities, the expansion of lower income economies that is confirmed by the early moves to raise interest rates remains an attractive investment opportunity.[2] MW

Footnotes: *1 Datastream, October 2009. 2 Bloomberg, October 2009. This article is issued by BNY Mellon Asset Management International Limited to members of the financial press and media. This article is the view of Richard B. Hoey, chief economist at The Bank of New York Mellon Corporation. This document should not be construed as investment advice.* ***Registered Office****: BNY Mellon Asset Management International Limited, Bank of New York Mellon Centre, 160 Queen Victoria Street, London EC4V 4LA. Registered in England No. 1118580. Authorised and regulated by the Financial Services Authority. BNY Mellon Asset Management International Limited is a wholly owned subsidiary of The Bank of New York Mellon Corporation. www.bnymellonam.com*