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CAPITAL MARKETS AND EMERGING MARKETS

It looks like London and New York, where the masters of the universe paid themselves many hundreds of millions or even billions, each, for their efforts in 2007, have managed to create quite a financial mess over this past year, and it should take the aforementioned masters several years and much personal effort to work their way out of it. What kind of impact is this going to have on the rest of the world, especially on the newly successful emerging markets? Can they decouple from the financial centers or will the reduction in dollar and hard currency funding bring these growth stories to an end?

The US and British financial system, which is centered on commercial banks, regulated by the Fed and the BoE, has allowed shadow banking institutions to take over about one third of the financing volume over the past few years. These unregulated institutions, which have generally funded themselves by borrowing short-term from other institutions, with back-up credit lines from banks, have been unable to support their asset books as their financial health came under question. These organizations, in the myriad of forms that they take, are either in the process of being merged into commercial banks, cutting their asset book to a more fundable size, or going bankrupt. As a result getting a loan from one of these institutions is nearly impossible, and the commercial banks that have suffered significant losses from the advances that they have made to these shadow banks are almost as stingy. The conveyor belt of credit has broken down. The credit drought will result in long recessions for the developed world. Without expanding credit economic growth cannot exist.

What happens to the country, far outside of the money centers, that has managed to run a current account surplus and has a sizeable reserve position? Can it still grow without money from New York or London? In the 1991 to 1993 period, during the last financial snafu plus recession in the US, the emerging markets did extremely well as the very low interest rates allowed them to attract whatever capital was available and their equity markets moved sharply higher. Will the same thing happen this time? Although each situation is different, the chances are fairly good that many of the emerging countries will outperform the major countries in the next two years.

Critical to this assessment is the depth of the financial slowdown in the US. So far, the Fed has pushed interest rates low enough and signaled that it would support major investment banks, the largest members of the shadow banking system, but this is no guarantee that these organizations will be able to expand their balance sheets by making loans. Rates should drop even further, and this should reduce losses in the asset portfolios, suppressing deflationary tendencies and further improving asset quality. With low interest rates and robust asset portfolios, the reserves of the emerging governments will be protected from loss, while making them lousy investments compared to investing in their home economy. As there is much excess savings and unused buying power in these countries, which can be turned into growth in the years ahead, wise policies should unlock this growth while the developed world slows. ✘

CYCLICAL PERSPECTIVE

Floating currency rates and the free movement of capital leads to some pretty interesting results in a small country, especially one without a dominant trading and capital partner. One of the purest examples is New Zealand. Since the introduction of Rogernomics by the Roger Douglas of the Labour Party in 1984, which turned a tightly controlled economy into one of the freest on earth, eliminating capital controls and freeing interest rates, the New Zealand dollar has moved down and up in very wide swings. These movements are a function of the internal economic cycle, as one might expect, but they are even more influenced by the flow of international capital and the general level of global liquidity. In the last 15 years, the Kiwi has been below .5200 in 1993, above .7100 in 1996, below .4000 in 2001 and above .8200 earlier this year. With movements like these, one might expect internal booms and busts, but

the economy has been positively boring in comparison with the currency.

The chart below shows the decline from the last high in late 1996 to the low in 2001 and the rally that more than doubled its value back to 23-year highs earlier this year. The currency roughly follows the growth rate of the GDP (not shown), and the short-term interest rates follow the currency in a longer-term smoothed manner. The more dominant factor is the percentage of New Zealand government debt held by offshore accounts, a statistic that indicates the attractiveness of Kiwi interest rates, both at that time and projected into the future, and market expectations of the future value of the currency. The trend of foreign ownership is rather steady and very slow to turn. It usually reverses several months after interest rates turn. This month it dropped 0.3% and a turn is underway. 

