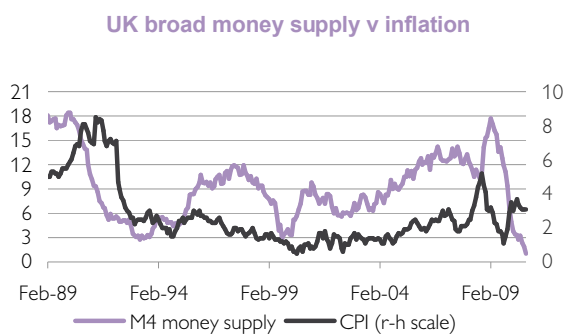




The second round of Quantitative Easing by the US was clearly a catalyst for markets last quarter. As central banks set sail into uncharted water, we consider some obstacles, and opportunities, that may lie in wait not only for developed economies but also emerging markets.

Interest rates in developed countries have remained low and monetary policy loose for nearly two years now, which has led to concern about future inflationary pressures. The key features of this recession, however, have been an acute decline in output in these developed economies often accompanied by elevated unemployment, which tend to be deflationary.

Banking systems remain dysfunctional, through both impairment losses and new capital regulations, and are particularly reluctant to extend credit to small businesses and new enterprises. This has led to money circulating slower through the economy and also has helped ameliorate inflationary pressure.



Source: Bloomberg

This has led some central bankers, including US Federal Reserve Chairman Ben Bernanke and the UK's Adam Posen, to look beyond the immediate economic outlook and consider the longer-term risks.

These risks include the accumulation of financial problems, ongoing fiscal austerity and trade- and currency-related conflicts, all of which serve to reduce investors' risk appetites and corporations' productive capacity.

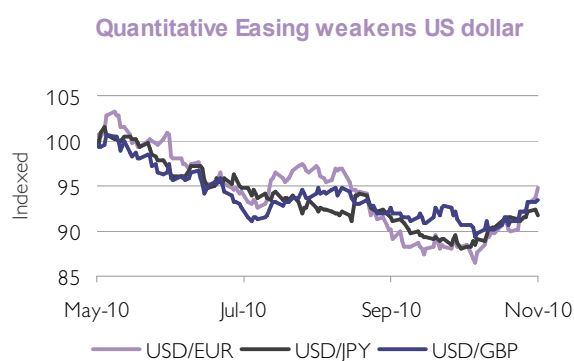
In addition, central bankers must be cognisant of the personal and political toll that high unemployment creates. This encourages a proactive stance, particularly where inflation is not an immediate threat, as is the case in the US.

This analysis has encouraged some central bankers to espouse further asset purchases or quantitative easing, which for practical reasons tends to be concentrated on government bond markets.

This policy works through reducing real rates, boosting inflation expectations and encouraging switching into other asset classes, which lifts risk appetite and confidence, essential precursors to economic growth. Critics cite the diminishing effectiveness of this, as yields are already low, and the dangers to monetary stability, the currency and even central bank independence.

This policy has now started in the US, with the announcement of a \$600bn purchase programme over eight months. The Japanese have also begun, with a £37.5bn programme, which includes £3.5bn of equity and real estate security purchases. The Bank of England remains ready to resume asset purchases if UK growth disappoints, while the ECB remains reluctant to countenance this policy. The challenges to fiscal sustainability, however, particularly in peripheral European nations, has led to a more nuanced approach.

As shown in the chart below, the UK, EU, and Japan have all seen their currencies rise versus the dollar. Low interest rates and modest growth prospects, however, reduce the attractions of the major developed countries, particularly on a foreign exchange basis.



Source: Bloomberg

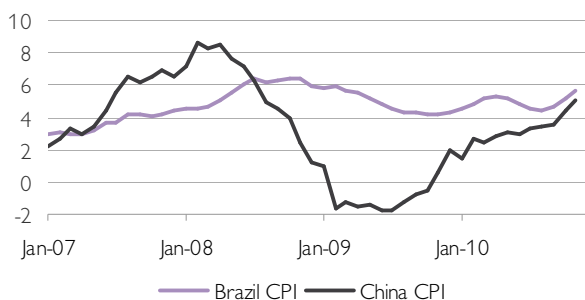
In contrast, global capital is being directed at emerging markets, which quantitative easing is only encouraging. Interest rates in emerging markets tend to be higher than in the developed world, which support higher currency valuations. The growth environment is also stronger, both domestically and through rising trade with other emerging economies. Plus, debt levels are less of a concern for emerging market consumers and the financial system.

Rather than a straightforward, fundamentally driven appreciation of emerging market currencies, we have seen resistance from central banks in developing countries, as they seek to protect their manufacturing and export sectors from declining competitiveness. This has created tension on a global basis, with the undervaluation of the Chinese Yuan a good example.

On the one hand, fair trade proponents argue that emerging market currencies are undervalued given recent growth and stronger purchasing power. Their current account or trade surpluses continue to grow, which translates into higher foreign exchange (FX) reserves.

On the other hand, emerging market central banks argue that their economies cannot safely absorb these flows, and the most likely outcome, if left unchecked, is higher domestic money supply, loan growth and ultimately inflation. An uncontrolled bubble would endanger the improvements in living standards and financial market returns achieved over the last decade.

#### Inflation in emerging markets



Source: Bloomberg

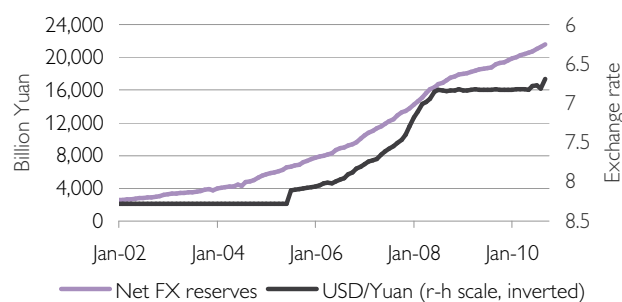
As a result, emerging market central banks find themselves in a difficult position, unwilling to accept a higher currency due to its effect on exports and economic growth, or to reduce interest rates to US levels, which would stoke inflation.

In addition, they are likely to be concerned about the temporary or cyclical nature of these flows, given the long history of falling foul of the fluctuating risk appetites of Western investors.

Capital control is one of the few solutions available to emerging markets, and this is also implicitly being endorsed by the International Monetary Fund. Thailand and Brazil have recently imposed capital controls, with Brazil including a 6% surcharge for fixed income securities and 2% for equities.

In recent decades, China has retained resolute capital controls, both of the price and access to the currency, with registration and quotas required to purchase mainland equity securities. China's main focus remains the wider liberalisation of its financial system. As significant progress has been made in the last 15 years, the clamour to improve access as well as revalue the currency is unlikely to abate.

#### China's FX reserves and currency



Source: Bloomberg

The potential for further capital controls in emerging markets will remain a feature and, although it is contrary to the theme of globalisation and deregulation, must be seen as a consequence of the credit crisis.

The present environment is creating a positive investment opportunity, as risk assets are generally responsive to improvements in global economic growth, which has become apparent in equity and commodity markets in recent months.

We would voice some caution, however, given the unprecedented macro economic circumstances. In these conditions, the risk of inappropriate policy responses (or errors) from both emerging and developed market central banks is elevated, and could be a source of concern in 2011.

C. Hoare & Co.  
37 Fleet Street  
London EC4P 4DQ

T: +44 (0) 20 7353 4522  
F: +44 (0) 20 7353 4521

C. Hoare & Co.  
32 Lowndes Street  
London SW1X 9HZ

T: +44 (0) 20 7245 6033  
F: +44 (0) 20 7823 1975

[www.hoaresbank.co.uk](http://www.hoaresbank.co.uk)

For questions about this article, please contact:

David Crichton ([david.crichton@hoaresbank.co.uk](mailto:david.crichton@hoaresbank.co.uk))  
Head of Economics & Asset Allocation

Richard Garland ([richard.garland@hoaresbank.co.uk](mailto:richard.garland@hoaresbank.co.uk))  
Senior Investment Strategist

David Cavaye ([david.cavaye@hoaresbank.co.uk](mailto:david.cavaye@hoaresbank.co.uk))  
Chief Investment Officer

### **Important Information**

The information contained within this document is believed to be correct but cannot be guaranteed. Opinions constitute our judgment as at the date shown and are subject to change. This document is not intended as an offer or solicitation to buy or sell securities or other investment or banking products, nor does it constitute a personal recommendation.

No part of this material may be (i) copied, photocopied or duplicated in any form, by any means, or (ii) redistributed without the prior written consent of C. Hoare & Co.

Published on the 11th January 2011 by C. Hoare & Co., 37 Fleet Street, London, EC4P 4DQ.

C. Hoare & Co. is authorised and regulated by the Financial Services Authority (FSA) with Registration Number 122093. The FSA's address is 25 The North Colonnade, Canary Wharf, London, E14 5HS.