



Monetary Policy and International Stock Markets

Hike! Cut! Pause! Any of these three words being uttered by a country's Central Bank Governor as it relates to the benchmark/ overnight lending rate could have an impact on the performance of the stock markets. Prior to any announcement there is usually wide speculation by investors of what will happen and this expectation tends to feed into the stock market activity but why is this?

A country's Central Bank uses monetary policy to achieve its mandated goals which might include achieving price stability (that is, controlling inflation or promoting optimal inflation) or maintaining foreign exchange rate stability for example. The tools of monetary policy – open market operations, cash reserve requirements for commercial banks and the benchmark / overnight lending rate – are used to influence the money supply. When expansionary measures are taken, the Bank may buy securities, lower the cash reserve requirement or decrease the benchmark rate. All of these actions have the effect of increasing liquidity in the system thus fuelling spending. This economic stimulation tends to result in higher inflation. On the other hand there are contractionary measures which would include the Bank selling securities, raising the cash reserve requirement or increasing the benchmark rate. These actions in effect pull money from the financial system and have been used in cases where the major goal is to keep inflation at a particular target.

The announcement of the benchmark lending rate by Central Banks is keenly anticipated by investors. When this rate is changed it is usually in response to the rate of inflation or as a means of stimulating the economy. The purpose is to affect overall economic conditions and by extension there is an impact on the financial markets. For example, a country's currency can be affected, especially so when that currency floats freely against other currencies. The benchmark rate influences other interest rates, from loan and mortgage rates to rates of return on government securities. If the benchmark rate is low then rates of return would be low as well so investors may be less inclined to place money in that country's currency and as such the demand for it declines and therefore the value of the currency is affected. Recently however, currencies with low interest rates began attracting investors, not for investing purposes but for borrowing to invest in higher yielding currencies, a phenomenon known as the "carry trade", but the effect is the same since these investors eventually sell this low-return currency to purchase others. Just as the foreign exchange market can be affected so can the stock market.

There tends to be an inverse relationship between stock market performance and interest rates, that is, as interest rates rise stock prices decline and conversely as interest rates fall stock prices increase. A couple of explanations can be given for this.

Firstly, at a broad level, fixed income and equity investments in a number of cases compete for investor's cash. With equity, there is the possibility of greater returns but of course with the accompanying higher level of risk of loss. Fixed income investments are less risky, however, if rates are very low, investors may be more willing to "try their hand" at the equity markets in the search for greater return. When interest rates rise investors may be more willing to accept a return that is still

lower than what the stock market has to offer but with a level of risk that they are more comfortable with, thus they would choose to invest in an interest-bearing instrument versus stocks. This has the effect of reducing the demand for equity overall and therefore to decreased stock prices.

Secondly, and more specifically, the performance of the companies listed on the exchanges can be affected thus rendering them less attractive investment possibilities. For companies that sell consumer goods and services a rate hike is not very good news. As noted above, the benchmark rate influences other rates such as loan and mortgage rates and as such it may become more difficult for consumers to access funds to make certain purchases such as vehicles or homes. Overall, increased rates have the effect of contracting the economy and this is usually accompanied by a reduction in consumer spending on non-essentials so companies that sell discretionary consumer goods such as electronics, jewelry, furniture and trendy clothing may feel the brunt of an increased benchmark rate.

Companies are also negatively affected by increased rates if they have large debts to pay or need to borrow to purchase inventory. The increased costs associated with borrowing would eat into company profits unless it can pass this increase on to consumers and manage other operating costs to counter the increase in borrowing costs. So when interest rates increase, a company may have little prospects for growth given reduced demand for its products, its profits may be affected or it may be unable to meet debt obligations and be at risk of ceasing operations. In such cases, an investor would not be interested in purchasing shares of that company or would be willing to do so only at a lower price. Therefore, reduced demand could lead to lower stock prices. There are other factors such as changes in fundamental valuations of listed companies due to higher interest rates, among others that negatively affect stock prices but the inverse relationship remains the same.

Knowledge of this relationship between monetary policy rate setting and the stock market should be useful in making decisions for your international stock portfolio. Of course this is only one of the many variables that would inform your decisions. For example, though the benchmark rate in the US has been declining since September 2007 the stock market has been performing poorly (sporadically at best) because negative investor sentiment has outweighed other factors. Nevertheless an understanding of the impact of monetary policy actions on the stock market should come in handy in making your investment decisions.

Current Happenings in Local and International Markets:

- June 23 pay day for RBTT shareholders
 - TTSE market activity slows
 - RBTT reports flat results
 - Cemex plans US\$300 million port
 - Wal-Mart Gains From Oil's Rise as Consumers Drive for Discounts
 - Bank of England Keeps Rate at 5% on Inflation Concern
 - Airline Industry to Suffer \$6.1 Billion Loss in 2008, IATA Says
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Table 1: Regional Market Performance (as at 5 June 2008)

Index	Closing Value	Weekly Change (%)	Monthly Change (%)	YTD Change (%)	1 Year Change (%)
TTSE Composite	1,135.78	-0.46	4.07	15.37	25.87
All Trinidad	1,485.63	0.89	5.74	23.13	30.97
JSE Index	110,168.85	-2.33	0.46	2.47	22.72
JSE Select	3,041.31	-4.83	1.00	4.61	24.41
All Jamaica	110,720.10	-4.26	0.69	4.59	23.74
BSE Composite	1,065.12	1.02	3.37	3.53	11.65

Table 2: International Market Performance (as at 5 June 2008)

Index	Closing Value	Weekly Change (%)	Monthly Change (%)	YTD Change (%)	1 Year Change (%)
S&P 500	1,404.05	0.41	-0.24	-2.98	-7.96
Nasdaq Composite	2,549.94	1.66	3.48	-2.29	-4.02
Dow Jones Industrial	12,604.45	0.08	-2.81	-3.37	-7.09
German Dax	6,941.83	-1.60	-1.56	-12.67	-13.09
FTSE 100	5,995.30	-1.20	-3.54	-6.57	-9.64
Nikkei 225	14,341.12	1.53	2.08	-6.31	-21.30
Hang Seng	24,255.29	-0.53	-7.37	-11.99	9.00
Eurostoxx	3,682.83	-1.85	-4.89	-15.13	-18.01

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