

THE HOUSE OF BRICS (THE MONEY JUNGLE, PART SIX)

© Leo Haviland, 646-295-8385

July 11, 2011

“Sweet dreams are made of this
Who am I to disagree?
I travel the world
And the seven seas
Everybody’s looking for something.” Eurythmics, “Sweet Dreams (Are Made of This)”

CONCLUSION

Many influential storytellers dream that economies of nations such as Brazil, Russia, India, and (particularly) China are very- or at least sufficiently- independent of America and other so-called advanced realms. Moreover, the BRIC territories supposedly possess enough power not merely to sustain adequate domestic growth, but also- at least collectively- to help drive the overall world economy significantly forward.

However, this endearing fantasy regarding the house of BRICs confronts substantial real practical barriers. Audiences should not have faith in a tempting doctrine of BRIC independence and almost endless and inevitable strength. The BRIC fraternity and numerous other developing regions indeed have built and continue to construct growing economies. Yet as the recent worldwide economic crisis that emerged in 2007 demonstrates, awful problems in a major developed nation such as the United States can spread rapidly and deeply around the world. As this is so, noteworthy troubles in the BRICs or elsewhere can affect advanced nations significantly.

MIRACLE GROWTH...GUARANTEED?

Of course each country is somewhat different. Each has its own compelling tale to tell. Some developing nations thrive in international playgrounds via manufactured goods (China), others with noteworthy assistance from commodity exports (Brazil, Russia). Inexpensive labor helps make many emerging lands globally competitive (China, India). Assorted internal factors obviously affect the rate and extent of a BRIC nation’s economic growth. Yet in any event, in the global economy, marketplaces of key developing domains increasingly intertwine substantially with those of advanced countries.

What’s the current accepted wisdom on the BRIC landscape? Let’s scan the International Monetary Fund’s “World Economic Outlook Update” (Table 1, 6/17/11; 2016 estimates are from the April 2011 WEO “Statistical Appendix”, Table A4). Start with China, the darling of prosperity preachers.

Apparently there’s almost no ceiling on Chinese growth or optimism regarding it. China’s real GDP will leap again in 2011 by 9.6 percent, slipping only to 9.5pc in 2012. In 2016, real GDP stays a lofty 9.5pc. India continues to boom, with 2011 growth of 8.2pc; 2012’s is 7.6pc, with 2016 at an elevated 8.1pc. How about Brazil, a flourishing vista? Its 4.1pc GDP boost in 2011 slips slightly to 3.6pc in 2012, but recovers to 4.2pc in 2016. Russia’s economy blossoms 4.8pc in 2011, rising a further 4.5pc in 2012, with that for 2016 at 4.0pc.

For emerging and developing economies overall, the IMF weathervane spins a 6.6p GDP rate for 2011 and 6.4pc in 2012.

However, the US and some other advanced nations now are running into soft patches, headwinds, and challenges. Near term GDP estimates for America and its allies have slid. The Fed's latest round of quantitative easing ceased at end June. America's previously legislated deficit spending (stimulus, rescue) measures will have less influence going forward for the recovery. Large current and massive long run US federal budget deficits worry marketplace dwellers, as do ongoing deficit squabbles in the Washington playpen. The various ongoing crises of the European periphery unsettle not only other European residents, but also America and beyond. America and its consumer spenders run a huge current account deficit with someone, right? What if US consumers keep their belts rather tight?

Slowdowns in advanced nations probably will help to cut- and by more than a little bit- individual and collective BRIC growth relative to the sunny IMF predictions.

MARKETPLACE ENTANGLEMENTS

Hanoi Rocks sings in "A Day Late, A Dollar Short":
"Cos no one saves the day
It's no one else's fault
If you're a day late or a dollar short"

Review some currency and equity trends for the BRIC quartet via the table below.

The dollar is not the only relevant cross rate for these nations, and it differs in importance between them. **Yet in relation to the greenback from the overall trend and timing angles, the FX trends of these nations parallel each other. All the BRIC currencies rallied versus the US dollar since around late 2008/early 2009.** The rallies from lows to highs have varied in extent. Brazil's distance has been about 40.8 percent, Russia's 25.7pc, India's 15.7pc, and China's 6.3pc. Though India arguably is an exception, BRIC currencies generally have continued to strengthen since the unveiling of the Federal Reserve's latest round of money printing in late summer/autumn 2010.

Major trends in the BRIC stock marketplaces interrelate with those of advanced nations such as the US. Bull moves in BRIC equities commenced roughly around the same time, not merely around the time of those in benchmarks such as the S+P 500 (3/6/09 at 667). The broad real trade-weighted US dollar ("TWD") resumed its bear trend around the time of that March 2009 basement in US equities (March 2009 TWD 96.68), and it has sagged to new all-time record lows recently.

The S+P 500 is modestly beneath its 5/2/11 height around 1371. **Though they haven't fallen out of bed, BRIC stocks have slumped lately at more or less the same time, and they did so before this high in the S+P 500.** Note the timing similarities in the various BRIC April 2011 tops. Because commodities in general have trended up (and down) alongside equities since first quarter 2009, recent declines in the commodity world partly explain falls in Brazilian and Russian equities. However, underline the similar timing in the Chinese and Indian (and Brazilian) November 2010 tops.

Even if the S+P 500 manages to establish highs above those of the May 2011 top, continued declines in BRIC equities would be ominous for the S+P 500 and related benchmarks in other advanced economies.

	<u>Low v Dollar (date)</u>	<u>High v Dollar (date)</u>	<u>Recent Equity Trend: Highs and Current Level</u>
Brazil	2.62 (12/5/08)	1.55 (7/4/11)	Bovespa highs 11/4/10 73100 and 4/5/11 70050; about 61500 now
China	6.892 (12/3/08) 6.818 (9/2/10)	6.46 (7/4/11)	Shanghai Comp 8/4/09 high 3480, also 11/11/10 3185, 4/18/11 3065; now 2800
India	52.18 (3/3/09)	43.98 (10/15/10)	Sensex 21110 tops 11/5/10 + 4/6/11 19810; 18860 now
Russia	36.56 (2/18/09)	27.15 (5/4/11)	RDX (on London Stock Exch.) high 1865 4/6/11, 1725 now

What about current FX rates for these four nations? The Chinese and Brazilian currencies remain near their peaks of a few days ago. Also, the Russian ruble at 28.00 is around its bull move pinnacle, as is the Indian rupee at 44.40.

Add a further window for the commodity perspective. The broad GSCI's major low was around the time of that in the S+P 500, on 2/19/09 at 306. The Goldman Sachs Agriculture Index low was 3/2/09 on 268. Compare the timing of gold's low on 10/24/08 at 681. The broad GSCI achieved highs around 4/11 and 5/2/11 at 762; compare highs in BRIC equities (and the S+P 500). The GS Ag Index plateau was a bit earlier, on 3/4/11 around 571. For Russia in particular, keep in mind the 4/11 and 4/28/11 highs in Brent/NSea crude oil around 12700. Gold's recent high at 1577 on 5/2/11 occurred the day of the S+P 500's.

Though Australia is not classed as a BRIC, surveyors often label it a commodity currency. The Australian dollar reached its major low against the US dollar at .601 on 10/27/08. Though it flew to a high on 1.101 on 5/2/11, its current level around 1.760 still neighbors that level. Also, note the declines in its equity marketplace alongside those in the BRICs, especially China. An Australian equities guidepost, the AS30, has been unable to sustain its 4/11/11 high of 5070 (compare mid-April 2010 at 5050).

Though South Korea is not a BRIC, its currency likewise has rallied against the US dollar over the past couple of years. From a low of just under 1600 on 3/6/09, the won has advanced to about 1060 now. The South Korean equity bull move high to date is 2230 (Kospi; 4/27/11).

For the US dollar and stock marketplace perspective, and thus also in relation to the BRICs, watch Mexican trends. Note the similar timing of the Mexican peso's bottom versus the US dollar at 15.59 (3/9/09). At around 11.58, it remains fairly close to its recent crest of 11.48 (5/2/11). Mexican stocks (IPC) at 36500 are resting beneath their 1/3/11 top at 38880.

From the standpoint of the broad real trade-weighted dollar, China is far and away the most important BRIC nation. It is about 19.9pc of the TWD. Brazil is only 1.9pc, India 1.7pc, and

Russia just over one pc. Australia is only 1.3pc. Mexico, however, captures a 10.4pc share. South Korea takes 3.7pc.

The nominal broad TWD made a low on 5/2/11 at 94.05 (compare the high in the S+P 500). However, the broad real trade-weighted dollar (monthly average; 1973=100) achieved new record lows in May and June 2011. The April 2011 TWD was 81.40, with May 2011 at 81.32, and June 2011 81.26. The prior major support around 84.00 less five percent is 79.80, less 10pc is 75.60.

WOLF AT THE DOOR? OR ALREADY INSIDE?

“You need more than luck in Shanghai”, says the actress Rita Hayworth in “The Lady from Shanghai” (Orson Welles, director; 1947).

The BRIC edifices are not straw structures. Yet despite the squealing and diligent huffing and puffing by their fervent fans, BRICs (and similar nations) are neither impregnable nor entirely solid. BRICs are not walled off from advanced nations (and other developing lands). Not only are they vulnerable to allegedly “outside” forces. Their own inside factors and developments (perhaps influenced by those intertwining outside variables) can weaken their economic foundations (and political and social stability). Issues related to inflation, government and consumer debt (and leverage), currency strength (weakness), and so forth are not unique to America and other developed nations. A quick mention of several topics indicates their notable significance for BRIC and related emerging economies. They are not mere bric-a-brac for the international economy as a whole either.

At some point, joyous carnivals end. All else equal, major currency appreciation can start to erode a nation’s competitiveness (growth rates and potential). So can high real interest rates. Doesn’t sustained significant currency appreciation of the home currency risk wounding that country’s equity prices (profit margins) if such equities are closely linked to international trade?

Given low interest rates in the United States (and Japan), some carry trade money probably has ventured from dollars and yen into higher yielding domains such as Brazil and Australia. One can compare various interest rate time horizons and trading vehicles, but take the two year note. The US two year government yields about half of one percent. Brazil’s two year is around 12.7pc, that of Australia around 4.7pc (Mexico 5.0pc, South Korea 3.7pc).

In any event, Brazil’s economic growth seems to be confronting threats from its strong currency and high domestic interest rates.

India’s two year rate is around 8.2pc. However, India faces inflationary challenges and has boosted rates to combat them. According to the Financial Times, India has the highest inflation of any big emerging market, with May 2011’s an annual 9.1pc (6/16/11, p2). Some estimates place 2011 Indian wages rising 13.0pc, with those in China up 9.0pc. (Financial Times, 5/13/11, p4). Higher commodity prices have been partly responsible for inflationary worries in India and China. China has tried to slow credit growth via raising reserve requirements.

All else equal, large wage increases and strengthening currencies slash relative international competitiveness and thus to some extent diminish the merit of growth stories. And a significant

upward move in interest rates or a slash in credit availability may mean curtains for some weaker borrowers (and those who lent money to them).

If the fiscal and banking crisis related to the European periphery can spread through Europe and around the world, so can the unearthing and spread of a significant problem in a nation as crucial as China. China is no house of cards, but its deck does not hold only aces.

Prior to the financial fires that began burning more visibly in 2007, how many players, regulators, or armchair quarterbacks declared that the US housing boom was likely to suffer an unhappy ending? Is China's local government debt only a local problem?

The International Monetary Fund's "Fiscal Monitor" summarizes general government gross debt for various countries as a percentage of GDP (Table 1, 6/17/11). For 2011, that for the United States is 98.3, that for the Euro area 87.9. These numbers apparently take into account not only federal (national) government debt, but also local government debt. For example, the US's Congressional Budget Office projects that federal debt held by the public at end 2011 will be about 70 percent of GDP ("the highest percentage since shortly after World War II." ("CBO's 2011 Long-Term Budget Outlook", "Summary", 6/22/11, p ix). By the way, the 40 year US average is 37 percent.

According to the IMF, the general government gross debt to GDP level for China in 2011 is only 16.5pc. That for India is 66.2, Brazil 65.6, and Russia 11.4.

However, for China, these IMF statistics probably do not take into account, at least in any significant fashion, local government debt (as they do for America and the Euro area). So what's the right number? It probably is at least the 16.5pc (from the IMF) plus another 27 or 30pc, or a total of 43.5 to 46.5pc. China's national auditor put local government debt at \$1.7 trillion dollars at end 2010, or about 27pc of GDP. A similar revelation from China: its central bank estimated local liabilities as high as 30pc of GDP at end 2010. (NYTimes, 6/28/11, ppB1, 6,). Anyway, these obligations appear far in excess of the officially declared debt balance of less than 20pc. In some more worrisome estimates (conjectures) place China's overall explicit debt load at 70 (yes, seventy) pc of GDP. One widely quoted observer asserts that contingent liabilities rather than explicit debt on books may take it to over 150pc of GDP (Financial Times, 6/28/11, p3).

Maybe given China's huge foreign exchange reserves (including US Treasury securities) and earning power are more than sufficient to meet any of its local or other debt problems. But what if it becomes less of a net buyer of US Treasuries (or starts to sell them)?

Chinese stock marketplaces are not the only relevant chapter of the China story or a complete reflection of the China scene. Yet the gradual decline of the Shanghai Composite from its August 2009 high, not just the more recent tops, is noteworthy.

Does Russia's roof have a leak or two? The Bank of Moscow is to receive a \$14 billion state rescue, "the largest bail-out in Russian history." (Financial Times, 7/2-3/11, p8).

Historians chronicle international economic crises before the one that erupted in 2007. Problems may occur in homelands other than BRICs. Remember the Asian financial one during 1990s.

In that regard, recent concrete news hints the Asian financial crisis could have a new version. Is the South Korean economy to some extent a house of sticks? See the “Press Release” of its Financial Services Commission (6/29/11). At end March 2011, Korea’s household debt has had an annual growth rate of 13.0pc on average since the Asian financial crisis [of over ten years ago]. This exceeds nominal GDP growth of 7.3pc over the same period. “The growth of household debt during the post-crisis period is attributed to the combination of various factors such as low interest rates, abundant liquidity, expectations about rise in real estate prices, and excessive lending by financial institutions.” Incidentally, does this at all recall the United States during the blissful Goldilocks economy?

However, the FSC believes current household debt levels are broadly manageable. South Korea nevertheless has dug up measures to contain potential risks from household debt.