<u>THE HOUSE OF BRICS- HOW SOLID?</u>

© Leo Haviland, 646-295-8385 December 13, 2011

In "Jack Straw", the Grateful Dead sings: "We used to play for silver now we play for life
And one's for sport, and one's for blood at the point of a knife"

MARKETPLACE TALES

Fires from European sovereign debt and banking fields have consumed marketplace attention for months. Audiences fear the ominous pull of America's fiscal whirlpool. Damaged United States household balance sheets and banking and real estate sectors remain fearsome. Terrifying dives and exhilarating leaps in European and United States stocks- and intertwined interest rate, currency, and commodity twists and turns- fascinate onlookers. The worldwide economic disaster that erupted in 2007 still burns on, despite the deluge of money printing and flood of deficit spending by the US and many of its allies. American maneuvers on policy interest rates (maintain Fed Funds at rock-bottom levels) and foreign exchange (keep that dollar feeble) likewise have helped to reduce but have not solved the international crisis.

The ongoing worldwide economic debacle that emerged in 2007 demonstrates that frightening problems in a major advanced country such as America can voyage around the globe. Therefore troubles in one or more of the BRICs or elsewhere can affect developed nations significantly. Given international economic interdependence, marketplace trends in other regions and countries intertwine with and help to illuminate those in Europe and America. What does travel through the diverse forests of Brazil, Russia, India, and China (the so-called "BRIC" nations) reveal?

Though the BRICs are key sources of world growth, they also reflect global growth patterns. BRIC territories do not possess sufficient independent firepower to propel the overall world economy significantly and permanently forward. In recent months, BRIC stocks have declined substantially. This BRIC equity weakness warns of current and further upcoming economic slowdowns not only in those countries, but sluggishness and even downturns elsewhere.

BRIC currency trends relative to the US dollar interrelate with this story told by equity playgrounds. Recent weakness in these BRIC foreign exchange cross rates reflect and confirm the fragility in BRIC stock benchmarks. For several years, the song of "weak US dollar equals (reflects; produces) strong stocks, strong US dollar equals weak US stocks" has been popular. One can elaborate this melody. Thus "weak US dollar equals strong US (and related nations; worldwide) stocks and strong (or at least relatively more) US (and related; global) economic growth." And so: "strong US dollar reflects weak American (and related; global) stocks and weak (or at least relatively less) US (related; worldwide) economic growth."

The world and its entangled variables are far more complicated than such formulas suggest. BRIC interest rate levels and trends entangle with those elsewhere. Commodity prices matter. And history is not destiny. For example, a crash in the US dollar may well coincide with a collapse in American (and other stocks).

Suppose nevertheless that major moves in American equity trends at least roughly resemble (fit), whether sooner or later, those in BRIC (and other key) nations. That has been the case during the current financial crisis. Then substitute the term "BRIC nation currencies in general" for the reference to the US dollar. Therefore, the hymn can warn: "weak BRIC nation currencies (in general; from the standpoint relative to the US dollar) equals (reflects; produces, even if eventually) weak American (not just BRIC) stocks and weak US economic growth".

HOUSE OF STRAW?

Some developing nations thrive in international playgrounds via manufactured goods (China), others with noteworthy assistance from commodity exports (Brazil, Russia). Though BRIC nations tell a variety of stories, the common theme is one of growth. Their tales reflect in various ways the chronicles of developing and emerging nations in general. A stock marketplace trend need not be mirrored by its real GDP patterns, but it often is..

The BRIC nations are not houses of straw. These countries have many strong components. However, their economic foundation and construction are not perfect. Also, BRIC structures attach to those of neighbors around the globe. So BRIC economic frameworks, like those in America and Europe, can suffer from cracks or endure some painful burns.

I. STICKING IN STOCKS: "I wanna live on solid rock I'm gonna live on solid rock" sings Dire Straits in "Solid Rock"

****

Is a dreadful wolf outside our door? Central bankers and other once-bullish clairvoyants increasingly huff and puff that the US economy and those of other advanced nations are running into headwinds. Yet many sentinels retain devout faith in unending Chinese growth. However, those bewitched by this joyful Chinese gospel should take a close look at Chinese equity trends. Those of the other three BRIC lands offer similar unsettling signals.

The table below details key time and price turns for BRIC stock signposts- Brazil's Bovespa, China's Shanghai Composite, India's Sensex, and Russia's RDX.

These significant moves in BRIC stocks do not duplicate each other, but they are close enough to suggest the existence and consequences of economic (financial) globalization. The price, time, and trend ties in the BRIC universe "in general" follow those in America's S+P 500. For the following table, recall the S+P 500's major peak on 10/11/07 at 1576, with its final high 5/19/08 at 1440. Keep in view its crash-and-burn collapse into the major valley at 667 on 3/6/09.

Don't overlook the S+P 500's 4/26/10 high at 1220. It fell to 1011 on 7/1/10. Around the time of the 1040 bottom on 8/27/10 (near the 10/4/11 trough at 1075) and up through November 2010 (S+P 500 low 11/30/10 at 1174), the Federal Reserve unveiled its second round of money printing (QE2). More recently, note the S+P 500's 5/2/11 top at 1371, followed by those on 7/7/11 at 1357 and 7/21/11 at 1347. The broad Goldman Sachs Commodity Index achieved highs on 4/11 and 5/2/11 at 762; compare the roughly similar timing of highs in the S+P 500 and BRIC equities. After descending to its 10/4/11 depth at 1075, the S+P 500 climbed to 1293 on 10/27/11.

	2007/2008 High (date)	**2008/2009 Low (date)**	**Recent High (date)**	**Recent Low (date);**	**[12/9/11 level]**
Brazil	73920 (5/29/08)	29435 (10/27/08)	73103 (11/4/10) 70108 (4/6/11) 63891 (7/4/11)	47794 (8/8/11) 49433 (10/4/11)	[58236]
China	6124 (10/16/07)	1665 (10/28/08)	2827 (7/18/11)	2307 (10/24/11)	[2315]
India	21207 (1/10/08)	7697 (10/27/08)	21110 (11/5/10) 19810 (4/6/11) 18818 (7/8/11)	15479 (11/23/11)	[16213]
Russia	2353 (5/19/08)	663 (3/6/09)	1863 (4/6/11) 1728 (7/8/11)	1095 (10/5/11)	[1291]

Note that the July 2011 high in the Shanghai Composite is under the 8/4/09 summit at 3480 and the 11/11/10 top at 3185, and even 4/18/11's 3067 height. Thus despite all the talk about how wonderful, amazing, magnificent, productive, strong, powerful, and healthy China's economy is, stock marketplace highs keep drifting lower and lower as time passes. This suggests that there's more lurking in and around the China situation than bullish variables and related windy rhetoric.

In addition, the 2307 Shanghai Composite low on 10/24/11 and the 2319 one on 10/12/11 are very close to the 7/2/10 one at 2320. Between the 8/4/09 and 11/11/10 tops, there also was one in mid-April 2010 around 3180. Compare the timing of the S+P 500's on 4/26/10, the last important high before QE2. Suppose China's stock marketplace sustains a decline of under the 2300 support level. This would suggest that Chinese quantitative (and other) easing/growth spurring measures are not succeeding very well. Given an intertwined worldwide financial marketplace, that would hint the S+P 500 will retest its 1000/1040 support range and that the US economy probably will weaken.

Suppose Brazil, India, and Russia likewise display stock marketplace highs around April 2010. Suppose they reached significant lows after this date that were made fairly close in time to those in China (7/2/10) or the US (7/1/10, 8/27/10, or 11/30/10). Thus rallies in all the BRICs, even if they began a bit earlier than this, eventually would tie into the Federal Reserve's crucial QE2 money printing festivities. What if these various mid-year 2010 lows have been (or are being) challenged in recent weeks? All of this is the case. Interestingly, and of particular note this autumn, the Chinese stock marketplace has shown much less buoyancy than its BRIC and American counterparts.

First, compare China with India regarding a spring 2010 equity top and decline. The Sensex's 4/7/10 elevation was 18048. It slumped to 15960 on 5/25/10 (compare the 15331 low on 11/3/09). Compare the 11/23/11 low at 15479 with that May 2010 low. Incidentally, note the double top of the Sensex's January 2008 and 2010 highs.

What about Brazil? It attained a noteworthy high on 4/9/10 at 71989 before tumbling to 57634 on 5/20/10. It smashed through its May 2010 low with its troughs on 8/8/11 at 47794 and 49433 on 10/11/11. Like the Indian stock playground, Brazil's has rallied somewhat, but still hovers rather close to its mid-2010 lows.

What about Russia? Mild (so far) Russian political unrest has started to capture headlines. The Russian equity pattern parallels the Brazil, China, India, and US ones. Recall the timing of its 4/15/10 ceiling at 1577. It broke down to its 5/25/10 low at 1321. Though it rallied fiercely, it later fell under that May 2010 low, touching 1251 on 8/11/11 and 1095 on 10/5/11.

Consequently, this similar equity downtrends since summer 2011 in the BRIC universe points to substantial downside risks for the S+P 500 and worldwide (not just BRIC) growth. One or more BRIC stock benchmarks (and especially those of China) probably will break under their support levels of mid-year 2010. This probably will occur alongside declines in the S+P 500.

II. <u>BRANCHING INTO CURRENCIES</u>: "I will not allow violence against this house", says a character in Sam Peckinpah's 1971 film, "Straw Dogs"

****

Based on the history of the past few years, some US dollar strength (even if modest) likely will accompany the falls sin the S+P 500 and other key equity guideposts.

Given recent attention on the European scene, let's first scan some Euro FX history versus the dollar. An important Euro FX rally against the greenback accelerated from around the time of the initial Fed revelations regarding its fervent quantitative easing program. Recall the 1.2588 low on 8/24/10. The Euro FX peaked on 5/4/11 at 1.4940. Compare dates for the S+P 500 and the Russian ruble. It attained highs, but at a lower level, in late summer around 1.4540/1.4550 on 7/26+8/29/11. Compare the Euro FX's 7/26/11 interim high with the timing of the S+P 500's late July top, as well as for pinnacles in Brazil, India, and Russia cross rates against the dollar. The Euro FX deteriorated to 1.3146 on 10/4/11 (compare the S+P 500 low), but it rallied to 1.4247 on 10/27/11 (remember the S+P 500 top that day).

From the standpoint of the broad real trade-weighted dollar, China is far and away the most important BRIC nation. For 2011, it represents about 19.8pc of the TWD. Brazil is only 2.1pc, India 1.8pc, with Russia just over one pc.

The following table details currency trends for the BRIC quartet.

All the BRIC currencies rallied against the US dollar since around late 2008/early 2009. The US stock marketplace blast-off began in March 2009 as the dollar sagged. Stocks rallied as the dollar withered.

However, the dollar on balance has rallied against the currencies of Brazil, India, and Russia since late July 2011. It has edged slightly upward against China's since mid-November. The broad real trade-weighted dollar reached its all-time low in July 2011 at 80.5 (monthly average; 1973 to the present), with November 2011 at 84.4. The nominal trade-weighted dollar, which has daily data, made its lows on 5/2/11 at 93.9 and 7/26/11 at 93.7; in addition to the cross rates for Brazil, India, and Russia, compare these dates with the tops in the S+P 500 in May and July 2011.

	Low v Dollar (date)	**High v Dollar (date, pc rally)**	**Recent Low v Dollar (date, pc decline)**;	**[12/9/11 Level]**
Brazil	2.620 (12/5/08)	1.529 (7/26/11, 41.6pc)	1.955 (9/22/11, 27.9pc) 1.916 (11/25/11)	[1.798]
China	6.892 (12/3/08) 6.847 (3/3/09) 6.818 (9/2/10)	6.336 (11/14/11, 7.5pc from 3/3/09)	6.390 (11/28/11, (about one pc)	[6.365]
India	52.18 (3/3/09)	43.86 (7/27/11, 15.9pc)	52.73 (11/22/11, 20.2pc; compare the 3/3/09 peak)	[52.04]
Russia	36.56 (2/18/09)	27.15 (5/4/11, 25.7pc) 27.90 (7/27/11)	32.89 (10/11/11, 21.1pc)	[31.49]

Thus the weakening of BRIC currencies in general versus the dollar, though their peaks in recent months occurred on different dates, tends to confirm the fall in the S+P 500 since May/July 2011.

****

The Chinese currency obviously has depreciated much less against the dollar from its highs than the other three BRICs. This flat to declining trend for the renminbi versus the dollar admittedly has only lasted about a month. Yet its equity marketplace- since long before July 2011- has been getting weaker and weaker.

China's economy is not a house of cards. It has many strengths and it indeed may continue to grow more than that of many other nations. Also, many wizards believe the Chinese currency is undervalued against the dollar. The US, a key Chinese trading partner, has pressed for further appreciation of the renminbi. So regardless of what's going on in other BRICs and their currencies, why isn't China's currency continuing to strengthen against the dollar?

The key point is that Chinese currency appreciation, which had been slow yet persistent, now seems to be taking a breather. In the context of China's substantial bear trend in equities, and given China's status as a major exporter nation with massive foreign exchange reserves (a large bankroll to solve minor problems), what does this currency "non-appreciation"/modest depreciation against the US dollar suggest?

It indicates difficulties facing China finally have become quite significant- and more substantial than most China watchers recognize. In other words, China's economic challenges (such as inflation, rising wages, weak property prices, substantial local government debt) may have grown to become a "fairly big problem", even if Chinese authorities have not confessed to this. However, China did cut its reserve requirement ratio recently. So even if China's stock marketplace is not an ideal benchmark for assessing "the overall Chinese economy", at some point its stock price level and trend, when interpreted alongside other variables, can identify (coincide with) noteworthy Chinese economic problems.

Continued weakness in Chinese stocks (slowing Chinese growth) probably will do more than merely parallel weakness in other BRIC (and other emerging/developing) nations. It will link up with further declines in the S+P 500 (slower growth or downturns in America and other advanced nations).