

BRIC's – Leading the investment opportunities for 2009

Tony Rumble, PhD¹

The GFC of 2008 hastened the already occurring relative demise of the US and many developed economies relative to the emerging economies of China and India. Industrialisation and urbanization of China and India's massive populations will continue to drive their economic development. By 2040 China's GDP will be stronger than the US and India's will be a close third. Russia and Brazil are modernizing and their rapid economic growth benefits from large commodity and natural resource reserves. The cost and risk of the US and other G7 economies response to the GFC poses severe short to medium term impediments to strong economic growth in those countries, making them significantly less attractive for investors for at least the next 5 to 10 years. Even without the rise of the BRIC economies, the problems in the US and other G7 economies makes it imperative for Australian investors to immediately re think their current approach to portfolio construction.

I. Overview

To protect and grow their wealth, Australian investors must make significant changes to their traditional approaches to portfolio construction. In Part II we survey the global macro economic data to show why key US asset classes (equities, bonds and real estate) will struggle to generate suitable returns for at least the next 5 to 10 years. In Part III we examine the economic growth drivers for the BRIC sector and the specific risks and opportunities for each component country. In Part IV we examine the merits of accessing the BRIC sector by active or passive (index) investing. We then suggest some possible approaches to portfolio construction to take account of the re alignment of risk and return between traditional and emerging markets like BRIC.

II. The Problem(s) with the US

The US is a great and vibrant powerhouse of economic and business acumen and entrepreneurship. Without the US we wouldn't have Apple, IBM, Microsoft, Boeing, etc. Those that are tempted to write off the US should also note that the US capacity for re invention is well known ... amongst the largest US companies in 1960 was Dow Chemical, which doesn't even exist in that form today – it's been replaced by Microsoft (which didn't even exist in 1960)!

But the US has been living on borrowed money for far too long, and its massively expensive military has drained the national coffers even further. Consider the reality of the observations of Marc Faber:

¹ Founder, LPAC Online Pty Ltd. (c) 2009 LPAC Online Pty Ltd - This information is provided as an educational service only for enrolled students of LPAC Online Pty Ltd. No action should be taken on the basis of or in reliance on the information, opinions or conclusions contained in this document. In preparing the information in this document, LPAC Online Pty Ltd did not take into account the investment objectives, financial situation or particular needs of any particular investor. Before making a decision to invest, investors should consider the appropriateness of the product having regard to their relevant personal circumstances. This document is not, and is not intended to be, an offer or invitation for subscription or sale, or a recommendation, with respect to any proposed offering of any other security, nor is it to form the basis of any contract or commitment.

“Once in a great while, the world undergoes big changes. The great discovery voyages at the end of the fifteenth century led to a huge enlargement of the world’s economic sphere. Venice – master of the previously important Mediterranean trade routes, and the world’s richest and most powerful city – was thrown into a corner of the world...

The breakdown of the socialist/communist ideologies at the end of the twentieth century and the end of the policies of self-reliance and isolation on the Indian subcontinent were the other big changes. Suddenly, three billion ambitious and motivated people joined the world’s free market economy and capitalistic system. These new citizens of the global economy are striving mightily to raise themselves to the level of affluence they see in their Western counterparts. Simply put, the free world has been joined by more than three billion people who have a similar frame of mind as the American pioneers of the nineteenth century”.²

It’s hard to disagree with that statement, based as it is on demographic reality. The statement implies that this drive for self improvement will lead to higher standards of living and economic growth in China and India, as well as in those countries that provide inputs to them. We will test that proposition in this paper.

But it’s hard to *agree* with Faber’s next statement, which cuts at the core of the economic wisdom behind the global response to the GFC:

“...economic policy makers in the United States have totally lost their way”.³

To understand how deep the US malaise is, we need to compare the claims of the likes of Faber (who speaks of the US in terms akin to Zimbabwe and Weimar Germany) with the analysis of orthodox economists, who view the US response to the GFC as overall being well conceived and implemented, and highly likely to restore the health of the US economic system.

Our view is that the US response to the GFC will repair the US financial system and allow for the recovery of the US economy; but that the great drivers of wealth no longer exist for the US to the same levels as they did over the last 50 years.

In the next Part we will compare this to the economic health of the BRIC economies (which do enjoy many of the positive drivers for growth which the US experienced in the last few decades).

It’s true that commentators like Schiff do propose that the US is in the midst of a “secular bear market” – ie a sustained and prolonged bear market, in which the peaks and troughs of the share market (which seem to people at the time to be suggestive of a bull market) are really no more than the ebbs and flows of a prolonged period of economic pain. Whether this view is correct can never be properly tested until after the event. But look at how clearly Schiff describes the origins of the current US malaise:

“By (2007), the nation had undergone a radical transformation in terms of its economic infrastructure and its economic behavior. A service based economy had largely supplanted one based on manufacturing that was now at a competitive disadvantage to producers in Asia and elsewhere who were less burdened by regulation, high taxes, and mandated worker benefits. America had become a nation of consumers, and manufacturers were disappearing.

² Faber M, in Foreword to Schiff, Peter: [Bull moves in bear markets](#), (2008, John Wiley and Sons)

³ Ibid.

Reflecting that reality the balance of trade was running huge deficits, with imports exceeding exports by \$800bn annually. Federal budget deficits ranged between \$300bn and \$400bn yearly, caused by trillions of dollars of Government spending for the Iraq and Afghanistan wars, entitlement programs, debt service, and other expenses ...

The national debt, owed in large part to China and other trading partners, exceeded \$9 trillion...

So to say the United States government was operating on borrowed money and dangerously dependant on foreign suppliers and lenders was to make the understatement of the millennium."⁴

By any measure, this is toxic stuff!

The problem for the US as Schiff sees it, is that the consequence of the US Fed's actions is that the US Government has had to create hugely increased volumes of bonds, to fund the TARP, TALF and other measures. It's inevitable in the world of supply and demand that a huge increase in the supply of those bonds will inevitably drive their prices down. And since, for bonds, the consequence of a lower price is a higher interest rate, this must inevitably lead to rising bond yields. And higher interest rates, coupled with the massive injection of liquidity into the system, has the tendency to also drive up inflation. (It's only the phenomenon known as "quantitative easing" which has kept the lid on US rates for the moment.)⁵

The core of Schiff's ideas highlight the link between US bond issuance, US inflation, interest rates, looming rises in US bond yields and US\$ depreciation.

He concludes that (US) investors should shun bonds and cash and that US equities will only sparingly grow in real terms (eg. oil producers, oil industry participants, and some global stocks). He does advocate buying commodities, gold, commodity stocks and currencies...all of which are bullish for Australian stocks. He also advocates buying BRIC assets.

How correct is Schiff? The rapid and recent rise in long-term yields seems to be consistent with his thesis.

Or is it? Good, orthodox economists like Saul Eslake of the ANZ interpret the rise in bond yields this year as almost entirely attributable to the gradual return to "normalcy" in financial markets after last year's huge shocks. The extremes of risk aversion unleashed by the various stages of the crisis, in particular the collapse of Lehmans, which saw 'risky' assets such as stocks and non-government debt securities (and high-beta currencies such as the A\$) fall sharply in value were paralleled by a 'flight to quality' of which the greatest beneficiaries were US Treasury bills, notes and bonds and (in currencies) the US dollar and (for a while) the Japanese yen.

The rise in bond yields since the end of 2008, and the fall in the US dollar since the same week in which the US stock market bottomed, are all part of exactly the same phenomenon - this is the main reason why US bond yields have risen more than other G7 bond yields, because they initially fell much further. At ~3.8% US 10 year yields are almost exactly where they were just before the collapse of Lehmans, which is probably more or less where they should be. Note that corporate

⁴ Schiff, P; op cit, page 7.

⁵ Quantitative easing refers to the practice where the US Fed buys US Government bonds above their original issue price, implying a reduced (sometimes negative) real return on them.

bond yields have been falling while government bond yields have been rising - more evidence that what we are looking at here is a 'return to normalcy'.

Eslake suggests that another way of thinking about this is by looking at the spread between conventional and indexed 10 year bond yields as a proxy for market inflation expectations. Back at the end of 2008, this spread was down to as low as 15 basis points - ie the market was flirting with the possibility of deflation, a very unpleasant prospect indeed and another sign of the extent to which fear was driving market sentiment. Now the spread is close to 200 basis points - implying that the market expects inflation to be in line with the Fed's long-standing de facto inflation target. The counter view, expressed by the likes of William Keenan at Lonsec, is that even though the US is likely to stage an economic come back over time, in the near term the prospect for rising bond yields is more severe than the orthodox view admits.

No Greenshoots for Bonds

Greenshoots for equities or not, there has been a profound change in the Australian and US equity markets since March this year, vindicating the actions of global central bankers to stem the systemic problems of the GFC. The resulting stock market rallies can best be explained as a direct result of those regulatory efforts and the likelihood that they have allowed us to avoid a complete global melt down. In Australia rising share prices in quality stocks have brought the market back to where it might have been at the bottom of a "normal" recession and bear market. Further Australian sharemarket gains will depend on GDP growth and resulting earnings improvements – which if Ken Henry is correct will start to be seen perhaps as early as the end of this year, growing strongly in 2010 and 2011. For now, with many shares seeming to be fully priced, investors have started to look again at bonds as a way to generate good returns with relatively low risk. That is likely to be a fool's paradise, with the looming profound risks in the US and global interest rate markets.

For investors looking to protect their capital – as well as accessing good prospects for income and growth – in 2009/2010, we advocate:

- good quality Australian "blue chip" shares, with a focus on defensive stocks like the banks and quality resource and energy stocks: these assets will benefit from Australian GDP growth and the renewed demand for commodities as global and Asian economies continue their recovery;
- careful investment into growth economies such as the "BRIC" (Brazil, Russia, India, China), (either alone or in combination);
- assets that provide a hedge against the prospect of rising inflation, such as gold;
- exposure to commodities directly, through investment funds that are linked to the performance of those commodities.

China can rely on its huge cash reserves to fund its recovery programs but the US has to rely on massive increases in government debt. US government bond issues have increased dramatically in the last 12 months and will continue to ramp up as the GFC response packages are fully implemented. In a country that nearly collapsed as a result of its unsustainably high public and private debt levels, further debt issuance can only be achieved by paying higher and higher interest rates – and that is the source of the problem for investors in bonds and bond funds. In a rising interest rate environment, previously issued bonds that pay lower returns will suffer from falling capital value. Unless you can buy bonds directly and hold till maturity, you will lose capital by being exposed to bonds.

It's not just the skeptics like Marc Faber that are predicting problems for bond investors. Mainstream portfolio advisers like William Keenan from Lonsec are making the argument to their clients, albeit in more moderate terms than Faber and think alike such as Peter Schiff. Keenan commented recently that, "I think the rise in bond yields has the potential to turn nasty." His assessment is that US bond rates will rise soon, and significantly:

"My belief is that the Chinese, Japanese and Russians are wary of buying anything longer than 5 years. Yes they are buying US treasuries but only short-term paper where they can be sure of getting their money back and limit any potential losses from falling USD and rising bond yields. Investors are becoming wary of 5, 10 and 30 year paper. Would you invest in US 30 year bonds at 4.6%? Do you think that is a good return for a Country that has public debt approaching 100% of GDP?"

The consequence of rising US bond issuance isn't just that rates on new bond issues will rise. Look how enmeshed this is with other key parts of the financial markets:

- US property mortgage rates are linked to US government bond rates. Keenan notes: "If these yields continue to rise because no-one wants the paper, then mortgages will rise also".
- The US Fed is managing interest rates by a process known as "quantitative easing" which means that it stands in the market to buy bonds at prices above par (implying a lower or even negative yield). To finance this, the US Fed prints money, increasing the money supply and devaluing existing money on issue. As Keenan notes: "If the Fed has to do this on a large scale to keep bond yields down then the US\$ will weaken due to the large currency debasement that is going on by the US Fed monetising US Govt debt."
- The impact of a falling US\$ flows into commodity prices, which are already starting to rise as stockpiles fall and economic growth resumes (see the article in this week's Eureka Report on rising commodity prices). A falling US\$ drives commodity prices higher, leading to higher inflation and even less demand for US\$ denominated assets especially bonds. Keenan again: "Hence bond yields rise because of less demand AND fuel prices rise in the US. Very nasty."

As Keenan notes, the US is caught in a bind:

"Which ever way the Fed goes, it can't avoid rising bond yields.

Do nothing, bond yields rise as bond issuance ramps up massively."

Step in and buy bonds, USD falls and foreign demand for US bonds decreases further - the Fed has to step in to buy even more, which weakens the USD even further

Keenan's view is that the US inevitably will have to take some very harsh medicine – which does seem to be factored into the US political psyche with discussions this week in the US financial media that President Obama's healthcare reforms will be shelved this year. As Keenan prophetically comments:

"The only way out of this dilemma is for the US Govt to face up to the fact that it cannot afford to keep racking up debt when it already has \$10 trillion against an economy worth \$14 trillion. It must reduce spending and /or increase taxes at some point soon. Both of which are unpleasant for the US economy and US consumers. This is why I do not expect a V shaped recovery (in the US) but a long L shaped flat period."

Avoiding the risks of investing in the US, or in the bond markets that will suffer from collateral damage as the US rebuilds its economy, will be key to preserving and growing your wealth in 2009/10.

Economic growth drivers for the BRIC economies

BRIC is an acronym for Brazil, Russia, India and China and was coined by Goldman Sachs in their global economics paper “Building Better Global Economic BRIC’s” in 2001. By 2007 GS were able to write:

“Since then, these countries. equity markets have seen a remarkable increase in their value: Brazil has risen by 369%, India by 499%, Russia by 630%, and China by 201%, using the A-share market, or by a stunning 817% based on the HSCEI. The equity market performance is just one manifestation of the staggering rise in BRICs. importance to the global economy. In our 2001 paper, we argued that the BRIC economies would make up more than 10% of world GDP by the end of this decade. In fact, as we near the end of 2007, their combined weight is already 15% of the global economy.”⁶

The BRIC countries were selected for specific analysis because they share the following attributes:

- They are the largest and fastest growing of the “emerging” economies;
- They have massive populations and are experiencing rapid growth in levels of urbanization, industrialization, national and personal incomes, infrastructure development, capital market development, etc;
- They enjoy massive stores of natural resources (Brazil, Russia) or they are massive users of natural resources (China, India);
- As a result of these attributes, they are supplanting developed nations rankings in world GDP, eg its likely that by 2040 China will have overtaken the US as the world’s largest economy.

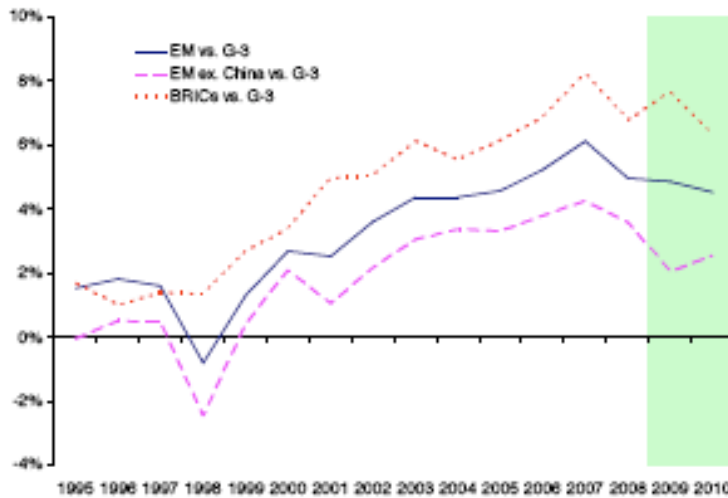
For those interested in the detail of the BRIC “dream” there is detailed material available on the Goldman Sachs “BRIC” website (<http://www2.goldmansachs.com/ideas/brics/brics-dream.html>) and also at Wikipedia (<http://en.wikipedia.org/wiki/BRIC>). Goldmans predict that China and India will become the dominant providers of manufactured goods and services in the world, and that Brazil and Russia will become the dominant providers of natural resources.

Clearly, any rationally constructed investment portfolio will have meaningful exposure to the BRIC sector – and will beware of retaining for too long, exposure to countries and company’s which are being displaced by BRIC activity. In the next Part we look at how to avoid the danger of under-investment in BRIC and over-investment in the developed nations.

We can illustrate the key benefits and risks of BRIC investing by various economic data: in figure 1 below we see that although the BRIC economies are part of – and therefore prone to the same cycles as – the global economy, they remain more resilient than the G3 nations:

⁶ Goldman Sachs: BRIC’s and Beyond , (November 2007), p. 5.

2. EM Real GDP vs. G-3 Growth Differential¹
(PPP weighted, in percent, 2000 – 2010E)



¹ Average of GS and IMF forecasts for GDP Growth in 2009-10

Although Russia and Brazil have experienced negative GDP growth as a result of the GFC (weathered by China and India largely through domestic expenditure), by next year (2010) all 4 of the BRIC economies are predicted to return to positive GDP growth:

1. BRICs Real GDP Growth by Region¹
(PPP weighted, in percent, 2000 – 2010E)



¹ Average of GS and IMF forecasts for GDP Growth in 2009-10

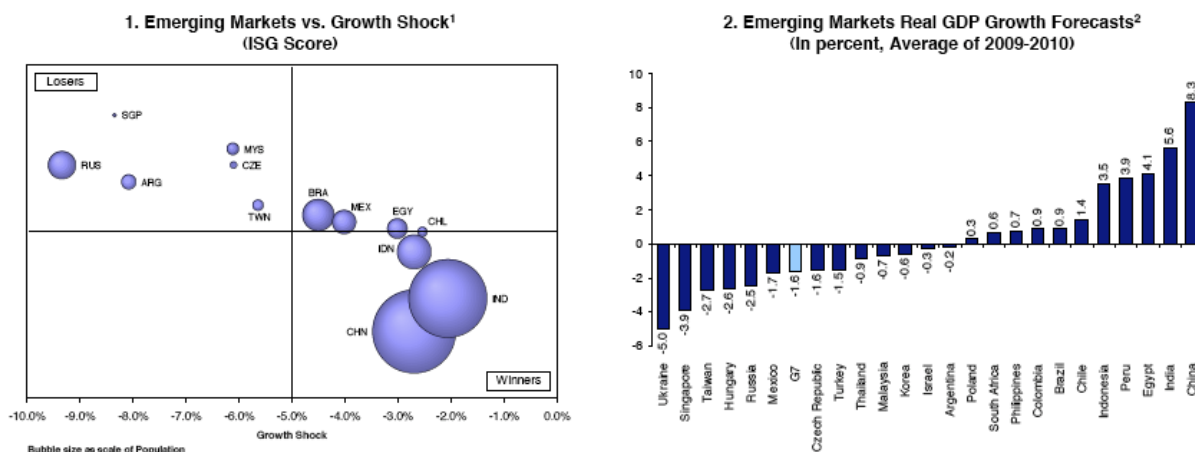
Charts Source: Investment Strategy Group, GS Research, International Monetary Fund.
This is for informational purposes only. This material represents the views of the Investment Strategy Group of the Investment Management Division of Goldman Sachs and is not a product of the Goldman Sachs Global Investment Research Department. Past performance is not indicative of future result, which may vary.

Key factors which have impacted the BRIC country's ability to weather the GFC include:

- Population size (larger populations of the BRIC countries relative to smaller emerging economies drive domestic demand as a buffer to falling demand for exports);
- Degree of openness of domestic economies (each of the BRIC economies has a relatively closed economy and can thus better control responses to the GFC);

- Reliance on commodity exports (here, Russia and Brazil are faring economically worse than China and India, although as energy prices rebound, Russia's economy will grow, too);
- Level of reliance on external capital (China's massive foreign currency reserves have helped it maintain strong economic growth, stimulated by government spending).

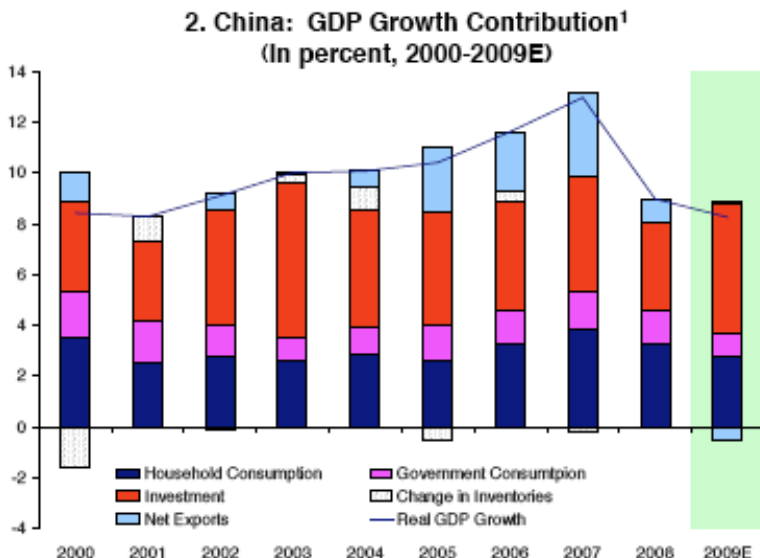
Taking these factors into account, China and India are currently best placed to weather the global economic storm, whilst Brazil and Russia will return to positive GDP growth as a result of the recovery in the global economy and resource prices.



¹ Growth Shock: GDP Growth Differential (Avg. 2009-10 - 2007-08). Forecasts for 2009 and 2010 correspond to the average of GS and IMF estimates.

² Average of GS and IMF forecasts for GDP Growth in 2009-10

China is expected to grow at 7% to 8% in 2009 and 7.5% to 9.5% in 2010:



¹ GS forecasts for GDP Growth in 2009

Charts Source: Investment Strategy Group, CEIC, GS Research.
This is for informational purposes only. This material represents the views of the Investment Strategy Group of the Investment Management Division of Goldman Sachs and is not a product of the Goldman Sachs Global Investment Research Department. Past performance is not indicative of future result, which may vary.

IV. Buying BRIC – Active or Passive?

Most investors are familiar with the frequent underperformance of actively managed investment funds. Compared to their reference benchmarks (eg. in Australia, most active equity fund managers are benchmarked against the S&P/ASX 200 index), median fund managers underperform more often than not. Fees are one factor, high turnover is another: since the methodology of benchmark aware fund managers relies on closely replicating the moves of the reference benchmark (with slight “bets” above or below the movements of the index), these managers are forced to sell shares when the market falls, and to buy shares when it rises again. This locks in losses in falling markets and generates tax liabilities as markets rise and fall.

APRA has recently concluded that, from their perspective as regulator, passive index funds are more likely to beat actively managed equity funds: see <http://business.smh.com.au/business/expert-fund-management-not-worth-the-effort-20090705-d99d.html> :

“In a damning finding on the benefits of “active” fund managers, research from the Australian Prudential Regulation Authority shows superannuation investors would be better off on average with their money invested in “passive” low-fee index funds.” (SMH, 6 July 2009).

Many investors seek to avoid these problems by investing in low turnover, concentrated share portfolios, with “direct” share investing a clear preference for many DIY Australian investors. Index investing is another popular way to avoid the problems of active funds. It’s virtually impossible to replicate the direct investing approach for international and especially emerging markets, such as BRIC. Intending BRIC investors are thus faced with the choice of either using an actively managed share fund, either one offering broad based international equity exposure, or one offering specific emerging market or BRIC exposure. For investors seeking pure BRIC exposure, indices such as the Standard & Poor’s “BRIC 40” index offers some attraction. There are specific investments available to Australian investors offering exposure to the S&P BRIC 40 Index.

The S&P BRIC 40 Index is compiled by S&P with a specific methodology, which is documented and available for review at the S&P BRIC 40 website: <http://www2.standardandpoors.com>, search for “BRIC.”

The methodology seeks to provide returns in line with the overall market performance of the 4 constituents, ie. the market “beta.” In turn, this index approach recognizes that it is hard consistently to outperform equity markets, especially in relatively illiquid markets like those of the BRIC sector. S&P summarise the methodology as follows:

“The S&P BRIC 40 index is designed to offer exposure to four emerging markets: Brazil, Russia, India, and China. Brazil, Russia, India, and China have together been known as the BRIC countries. They are actively watched by investors in recognition of their potential to move from emerging market status to developed market. The index includes 40 leading companies from these four countries. All constituents trade in developed market exchanges (Hong Kong Stock Exchange, London Stock Exchange, NASDAQ, and NYSE) ...

Universe. All constituents of the S&P/IFCI indices for Brazil, Russia, India, and China comprise the starting universe.

Listing. Stocks in the starting universe that do not have a developed market listing are removed.

Public Float. All stocks with a float adjusted market cap less than the “Market Cap Threshold” and/or average three month daily value traded less than the “Liquidity

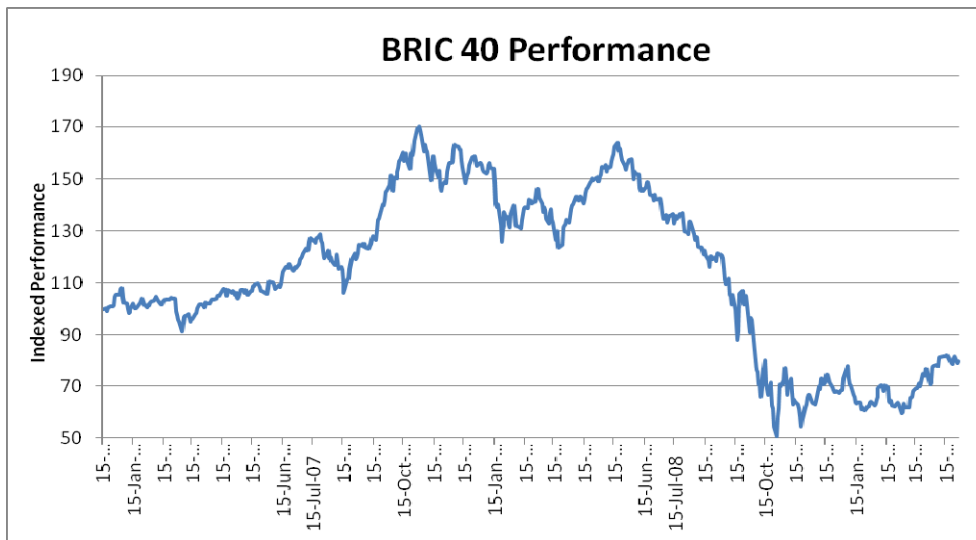
Threshold" are removed. Currently, the Market Cap Threshold is US\$1 billion and the Liquidity Threshold is US\$5 million.

Multiple Share Classes. If a stock has multiple share classes, the share class with lower liquidity is removed.

Final Index Membership. Remaining stocks are sorted in decreasing order of their market cap. The top forty become index members."

(http://www2.standardandpoors.com/spf/pdf/index/SP_BRIC_40_Factsheet.pdf)

The S&P BRIC 40 Index has fallen sharply from its highs but has rebounded as global economic recovery proceeds:



Australian investors will normally benefit from using investments over the S&P BRIC 40 index which offer protection against FX movements, and should also carefully consider using capital protected investments – this allows the investor to gain exposure to the growth potential of the BRIC sector but to avoid the inevitable volatility of equity markets which may well be magnified in emerging markets like the BRIC sector.

(c) LPAC Online Pty Ltd - This information is provided as an educational service only for enrolled students of LPAC Online Pty Ltd. No action should be taken on the basis of or in reliance on the information, opinions or conclusions contained in this document. In preparing the information in this document, LPAC Online Pty Ltd did not take into account the investment objectives, financial situation or particular needs of any particular investor. Before making a decision to invest, investors should consider the appropriateness of the product having regard to their relevant personal circumstances. This document is not, and is not intended to be, an offer or invitation for subscription or sale, or a recommendation, with respect to any proposed offering of any other security, nor is it to form the basis of any contract or commitment.

