

BRIC Country Update: Slowing growth in the face of internal and external challenges

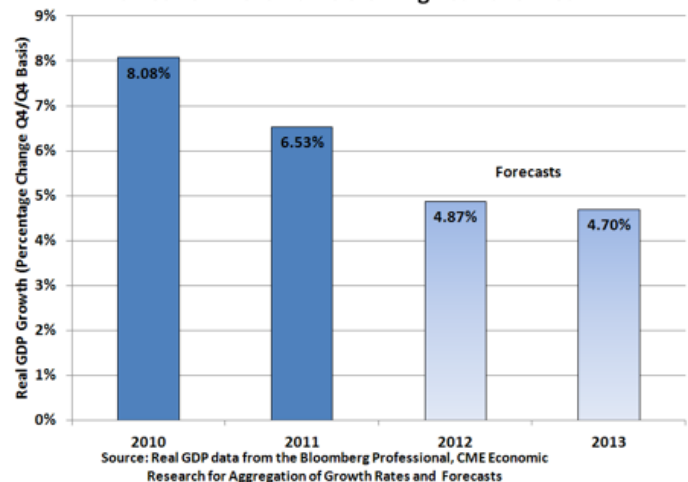
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The so-called BRIC countries - Brazil, Russia, India, and China - are struggling hard to ease policies and maintain economic growth in the face of a slowing global economy not of their own making. Unfortunately, country-specific internal challenges are making their economic deceleration more severe. We are unwilling as yet to project actual recessions for any of the BRIC nations, but all of them are likely to experience slower real GDP growth in the second half of 2012 and in 2013 than was hoped only a few months ago.

Emerging-market countries provided the dynamic growth engine to drive the world economic expansion in the past decade. In 2000, the BRIC's share of global GDP was 8%; by 2010 this share increased to 25%. A significant portion of the world's GDP growth during that decade was fueled by the BRICs. This suggests that a BRIC slowdown now will be more detrimental to the world economy than it would have been in the not so distant past.

While not coming to a complete halt, the BRIC economic engine is sputtering. In 2010, the size-weighted average of the real GDP growth in the BRICs was 8.1% before slipping to a respectable 6.5% in 2011. Unfortunately, the BRIC-weighted growth for 2012 is forecast to decelerate further, to below 5%, and remain there through 2013 before picking up again.

BRIC Real GDP Growth is Slowing Year over Year



The most important reason for the growth slowdown is the ever worsening economic situation in Europe, followed closely by the general lack of economic leadership and market confidence coming from the aging industrial countries. One cannot, however, lay all of the economic challenges in the BRIC countries at the doorstep of Europe's debt crisis and the massive policy uncertainty associated with the coming fiscal cliff in the US. The BRIC economies also face very distinct issues and structural problems of their own, which are strikingly different from country to country, and in many cases work to constrain their abilities to offset the negative forces coming from the mature nations.

This report is organized as follows. First, we will present a concise economic update for each BRIC country, focusing on their specific domestic challenges. Second, we will draw some themes together to try to better understand what it means for

markets and for the world economy to lose, even if only for a few years, such an important engine of growth.

I. Country Reviews

A. Brazil

Brazil's economy bounced back very quickly in the immediate aftermath of the financial crisis in late 2008. After experiencing negative real GDP growth in 2009, 2010 was a banner year, with annual average growth hitting 7.6%, but then slowing sharply to 2.7% in 2011. For 2012, it's looking even a little weaker. These annual average numbers mask a volatile quarterly pattern, with the low point coming in the first half of 2012. We are looking for slightly better growth trending into 2013, but still, our projections are for a weak 1.5% in 2012 and only a modest 2.5% in 2013 as Brazil's recovery from its growth pause commences.

Since the mid-1990s, Brazil's central bank has aimed at maintaining a modest premium in short-term rates relative to inflation in order to offer investors a real return over inflation and to build confidence that the country has put its hyperinflation heritage well into the past. This policy was largely successful in building central bank credibility. While Brazilian inflation runs higher than in mature industrial economies, given the youthfulness of the nation and the inherent frictions involved in building a robust middle class, the 5.3% annual average inflation rate from 2005 through 2011 is a very respectable accomplishment.

With the global growth slowdown, the central bank has taken the view that future inflation is less of a risk and that short-term rates can be lowered – in advance of inflation declines. The overnight benchmark SELIC rate controlled by the central bank has been brought down from the 12% territory in 2011 to the 8% zone. A few more rate cuts are likely.

The lower rates may give the economy a little stimulus, but their rallying impact is constrained because it also plays into the challenges of a volatile currency. On net over the past decade, the Brazilian real was an appreciating currency as the central bank established inflation-fighting credentials and the dynamic economy attracted international capital. While a strong currency can be a sign of a healthy economy, the Brazilian

government has perceived that the currency can be “too strong” and may work to weaken domestic industry and hurt export levels. In the more recent period, these worries about a too-strong currency have been replaced by the challenges of managing currency volatility in global risk-on, risk-off markets.

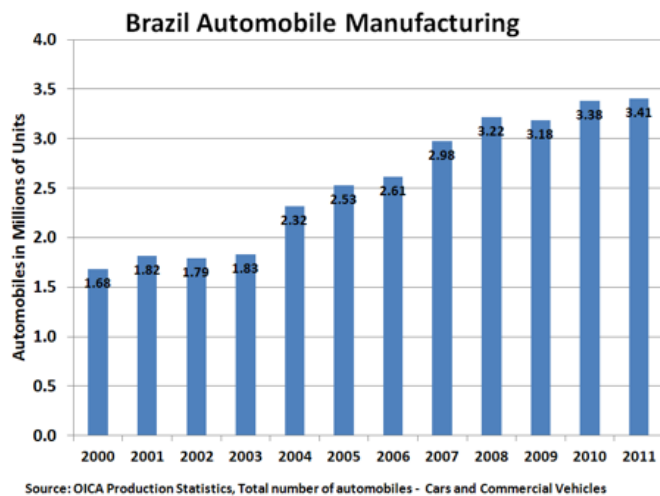
The real has depreciated in response to the “risk-off” nature of global markets amid Europe's debt crisis, losing about 9% against the U.S. dollar so far this year. Like most emerging market currencies, the real tends to be viewed by global investors as more risky and hence when market fears are rising and investors are deleveraging, the real may see some depreciation versus the US dollar. In addition to the global context, the aggressive lowering of the SELIC rate has worked to reduce the rate differential cushion that supported the currency in the past.



Brazil's government and central bank have not welcomed a volatile exchange rate. While the Brazilian technocracy perceives many plum benefits of having a modestly weaker currency – there exists concerns when the real depreciates sharply and suddenly. A weakening currency can trigger inflationary pressures, as all imported goods (both intermediate inputs for production and consumer goods) become more expensive. Additionally, all dollar-denominated debt will have higher servicing costs when calculated in the real. Finally, an excessively volatile currency may lead to depressed foreign investment, as most investors run from volatility and uncertainty. On net, the interest rate decreases and weakening

of the currency are likely to help economic growth bounce off recent first half 2012 lows, but the stimulative effects are constrained by the global economic slowdown.

Brazil also maintains a relatively aggressive stance towards protecting its own industries for internal political reasons. The net weight of the political protectionist measures can make economic adjustments in tough times considerably harder due to the rigidities that are imposed on the economy.



One example is the focus on the automotive industry. Auto exports are currently weak and overall production has stagnated. In 2011, Brazil only exported 15% of the 3.4 million cars it produced. Meanwhile, Brazil's huge domestic market is also being flooded by Chinese and Mexican imports. Car imports increased 30% in 2011, which fostered worry among government officials and led to trade disputes with Argentina, Mexico and China. Brazil recently demanded a re-negotiation of an auto trade agreement with Mexico and increased taxes on some cars, including those from China.

Other examples include laws that constrain expansion of the energy industry. In the mid-2000s, Brazil discovered offshore oil reserves comparable to what was found in the North Sea. But the government requires Brazilian domestic interests hold at least a 65% stake in deepwater drilling projects; onshore, Brazil mandates 85% control. While Petrobras, the state-controlled oil company, is committed to meeting the requirements of the domestic content laws, the practical reality

is that development of oil reserves has been set back several years and will come at a much higher expense than was initially thought, to the detriment of real GDP growth.

These protectionist moves in automobiles, energy, as well as in many other areas of the economy create inflexibilities that make it harder for Brazil to adapt to changing world economic conditions. When Brazil averaged 5% real GDP growth or better, the costs were less visible. In these tougher times, protectionist policies that work to insulate Brazil's industry from external competition are probably shaving 1% to 2% off the long-run real GDP growth average for the rest of the decade.

Due to the protectionist government measures, weakened global demand and an overall "risk-off" attitude globally, we are forecasting only a slight increase in Brazilian real GDP growth from the low point in the first half of 2012. Real GDP growth may be an anemic 1.5% for 2012 and increase into 2013 to 2.5%. There is some risk of an uptick in inflation due to recent currency depreciation, but this may well be offset by the generally sluggish global economic conditions.

B. Russia

Russia's reported real GDP growth rates have been relatively stable for the last two years at around 4%. Given the troubles in Europe, volatility in global energy prices and slowdown in China, we do not view the stability of the reported data as indicative of what is really happening in the country. Our view is that economic growth in Russia is about to slow markedly due to lower crude oil prices and the recession engulfing Europe. Demographically, Russia is a relatively old country and its history of challenged property rights combine to mean that its private sector is not dynamic enough to pick up any slack when energy exports decline. We are not sure when GDP data will reflect the slowdown, but our projections are for only 2% real GDP growth through 2012 and into 2013.

In contrast to our weakening growth story, we see some upward pressure on inflation. Russian inflation currently sits at a post-Soviet low, but higher food prices and new, higher utility tariffs from the Putin government may push prices higher toward the 4% to 5% range.

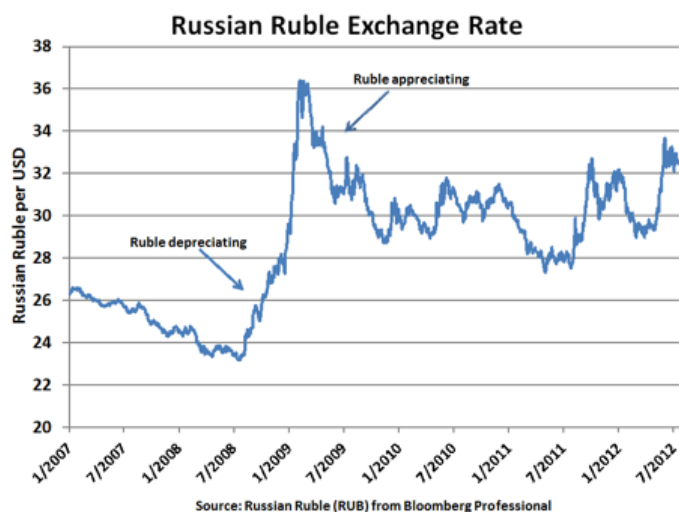
The key to Russia's economy is simply that it is the world's largest energy producer. In fact, 75% of Russia's exports are oil and natural gas. Russia's economy has never achieved much diversification in terms of international competitiveness and the economy can be viewed as a one-trick pony – what happens to commodity prices is tightly associated with what will happen to growth in the economy. And just as with the economy, the Russian government depends on oil and gas receipts. In 2011, the oil and gas industry provided almost half of the state's revenue – though in 2012 the price of oil has been under pressure from the global slowdown.

Over the long-term, Russia's energy prospects are challenged by the developing trade-offs between oil and gas. Russian natural gas is typically exported on contract terms linked to the price of crude oil. While this made good sense in the past, the explosion of natural gas supply in the U.S. and likely rise in production levels in the Middle East and China suggest that Russia's ability to sell gas by linking the price to oil may not last the decade. There are impediments to global competition in gas that will slow the process. Middle East gas has to be liquefied and shipped in order to challenge Russia's current client list, but this is starting to happen given the wide price gap between cheap gas at the source and more expensive oil.



The Russian ruble has not suffered as much as some other emerging market currencies during the risk-off trading environment caused by the European debt crisis, reflecting the rising dollar price of oil prior to summer 2012. When the ruble

had bouts of weakness, it has often been related to political fears. Political uncertainty in Russia is more pronounced and can spook markets more so than any other BRIC country. Just note how Russian capital outflows increase dramatically before any election – a clear and decisive sign that investors are especially wary of political upheaval and disruption in the country. In early 2012, ahead of a presidential election, US\$ 33.9 billion in capital left the country. In 2011, there was \$ 80.5 billion in capital outflow, attributed to uncertainty regarding presidential elections.



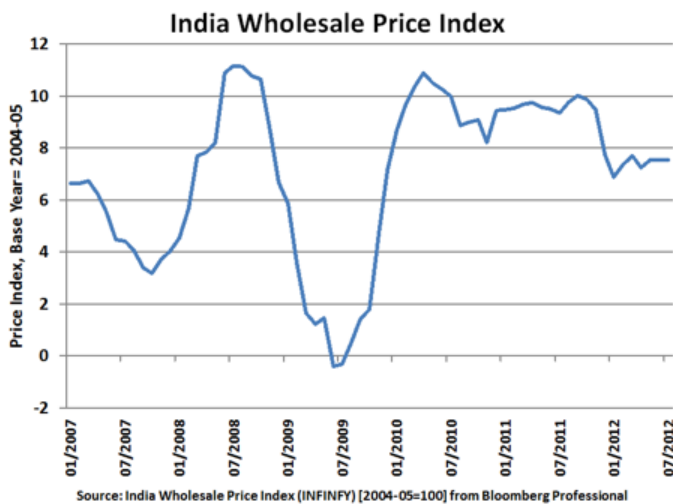
Russia is aware that to attract and keep international capital, it has to improve investor perceptions of the stability of contract law and rules of commerce. The government is making efforts, such as its recent ratification to join the World Trade Organization. Russia is currently the largest economy not in the WTO and will be joining the group in August. It will take time to see if this initiative improves investor sentiment.

C. India

Growth in India slowed considerably in the first half of 2012 from the rapid pace of the past decade. During 2000-2010, India posted annual average real GDP growth of 7.4%. While growth slowed a little during the 2008 financial crisis, India largely escaped without much damage. For 2012, though, real GDP growth may slow to the 3% territory. While India's real GDP growth is slowing in part due to the global slowdown, there are two important domestic challenges — namely, inflation and

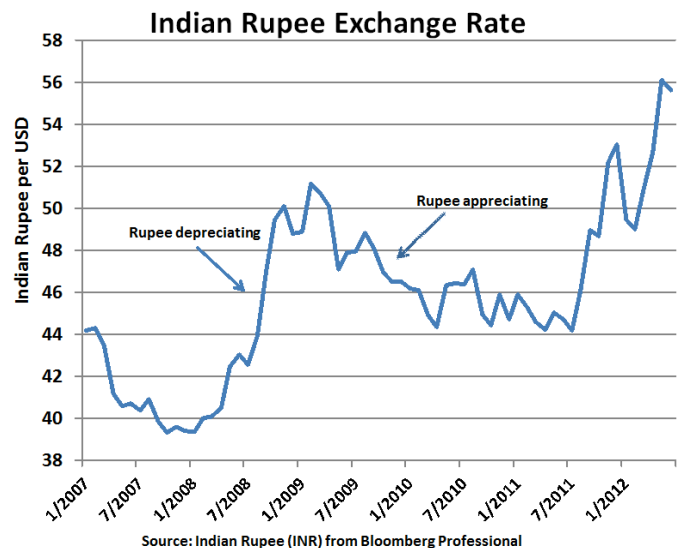
international investor confidence that are further hindering economic activity.

Inflation in India has been a persistent problem, rising above 10% in 2009 and only now coming down into single digits. Core inflation (excluding food and energy) is slightly better-contained, decreasing from 7% at the beginning of 2012 to 4.8% in May. Nevertheless, there are inflation worries, as inflation and the depreciation of the rupee are intricately linked. A further weakening of the currency makes imports more expensive, causing a rise of domestic prices, too. The rupee has depreciated 4.7% against the U.S. dollar this year after slipping 18.7% in 2011. India's inflation outlook will continue to be concerning. With the government set to reduce its subsidy spending on a range of goods this year, a further depreciation in the rupee and a strong chance food prices will rise leads us to project that inflation may increase to 8% by the year's end and that India's struggles with inflation are far from over, even in the context of a sluggish world economy.



The first part of India's inflation problem actually starts with its energy policy. Unlike its Russian neighbor, India is highly dependent on imported oil, with imports accounting for more than 75% of crude needs each year. A depreciating rupee can significantly increase the local price of oil even if the global price is falling. Moreover, the government subsidizes energy prices to insulate the economy. In fact, since June 2011, the public has not experienced any increase in fuel prices – and there was public outcry over the last increase. Indian government

officials are aware the public would not react well if prices were increased now. Currently, the government provides fuel subsidies to state-run retailers to keep the prices beneath what market forces would dictate. The losses incurred by oil companies and retailers from selling fuel at state-set prices are recouped by the subsidies. In the last fiscal year, subsidies (provided on food, fuel and fertilizers) paid accounted for 2.4% of GDP. The government is set to cut all subsidies spending to 2% of GDP in 2012, in an effort to streamline spending. However, outcomes from cutting oil subsidies do not look promising - either oil companies will take larger losses or the price of fuel will rise substantially. Our view is that the arithmetic of the budget means that the government will have to face the political consequences of reducing fuel subsidies sooner rather than later.



The second part of India's inflation problem relates to the depreciating rupee. India does not easily welcome foreign investment, which typically enters the country in the form of minority partnerships with Indian companies. Control stays in Indian hands. More recently, the poster child for India's reluctance to accept direct investment was the rejection of Wal-Mart's plans to open stores, but there are many other examples. The result has been a growing backlash by international investors towards India. There has also been some capital flight from inside India. India rigidly controls how its citizens and companies can invest outside the country, but inflation worries and the weakening currency have created

a cycle of further encouraging some wealth to move outside India where possible for capital preservation purposes. As a result, the rupee has come under strong selling pressure in 2011 and 2012. The weakness of the rupee reinforces the inflation cycle, and the inflation challenge in turn slows economic growth prospects.

D. China

China grew at 10%-plus real GDP rates for 25 years as it built a modern infrastructure in record time to accommodate a vast migration from rural to industrial urban areas. The economic growth tide, however, has now turned. While China is still experiencing growth rates that would be most welcome in any of the developed countries of the West, it has also seen a relative economic slowdown more severe than many analysts had hoped. China's real GDP growth rate dipped below 8% in the second quarter of 2012 and further declines in the year-over-year percentage growth rate are anticipated. We see economic growth slipping toward 6.5% on average for the rest of the decade, and then even slower growth in the following decade as the rural-to-urban migration diminishes and the reality of the aging of the labor force hits growth prospects hard.

Weak external demand from the European Union (EU) is a strong factor aggravating China's growth in 2012. EU imports of Chinese goods fell by 3% in the first quarter of 2012 compared with the same period in 2011. The EU accounts for almost 20% of China's total exports, and further declines are quite likely given the economic distress in Europe. But it is not just falling demand from the EU; annual growth of total Chinese exports in 2011 was 20.3%, while annual growth for 2012 is expected to be less than 10%.



The declining exports are due to the recession in Europe and general global slowdown, but the timing complicates Chinese economic growth management quite severely. China is in a transition from a dependence on infrastructure spending toward a more domestic consumption growth model. While this is a natural transition for an emerging market country, it comes with its own difficulties.

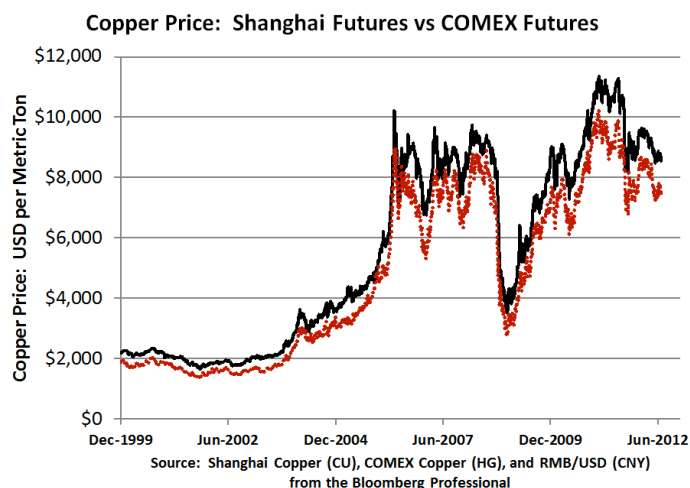
The Chinese middle class grew by 35% from 1990-2008, according to the Asian Development Bank, an important testimony to the tremendous progress China has made in modernizing its economy. Unfortunately, an expanding middle class cannot be equated with a Chinese culture that favors saving over consumption. The structure of the Chinese family lends itself to holding high amounts of savings, and the country's health systems are still being built. Because the Chinese population is aging quickly, this puts increasing pressure on the resources of the extended family to provide the social safety net.

The saving-consumption question rears its head in interesting ways, and it has been a factor in the property boom. The Chinese property market has always been an alternative to bank savings. A solid property boom was already in play before the 2008 financial crisis. In response to the crisis, China unleashed an economic stimulus package of nearly a trillion renminbi. Developers in China were given a new lease on life and began another round of building of residential properties. Many wealthy Chinese bought housing as investments – compared to leaving money in the bank (bank deposit rates are nearly the same as inflation rates). Chinese housing prices soared, and have been doing so over the past five years.

Whether there has been a true increase in demand or just speculative forces at work has concerned the Chinese government considerably. And while some will argue that China has not/is not experiencing a property bubble – one need only look at the actions of the Chinese government to surmise if they are concerned about a bubble – and it appears they are. The central government has put a price ceiling on new homes, raised the down-payment required, created new property taxes and overall started to regulate the property market sector. The full effects of a largely over supplied property market coupled with overheated prices are not known yet – there is an obvious chance this could have very negative effects on the economy. If,

however, the government can further deflate the bubble, as it has been working to, then any potential consequences could be mitigated.

The slowdown in overall spending on infrastructure, government attempts to control the housing market, and the general deceleration of export growth have a direct impact on China's demand for commodities. Take copper, for example - a key metal for any industrializing nation. Copper is a primary input in building the various components of a city and China has done much building of this type to support its rural-urban migration over the years. China buys a staggering 38% of the world's copper –and China's demand helped to push the price up substantially even after the financial crisis when the price dropped severely. However, more recently, the growth slowdown of the BRICs has been a primary contributor to the current weakness in copper. In a similar vein, China's demand for oil has also slowed, impacting world prices.



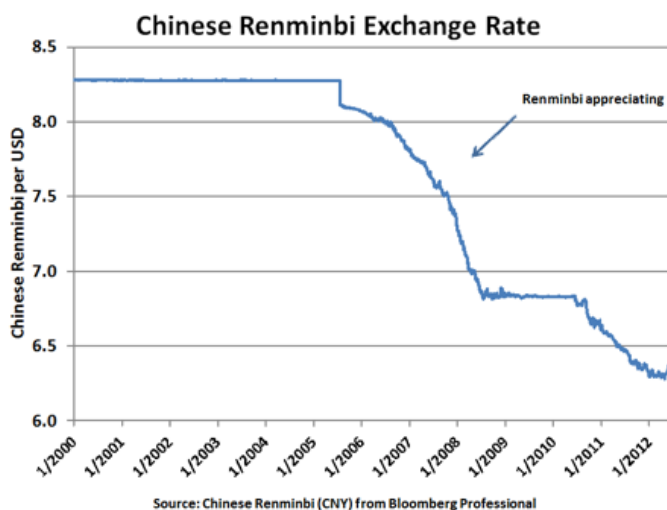
As we move into 2013, China's imports of crude will grow much more slowly than in the past. China currently uses approximately 9.5 million barrels of oil a day, which is up from 5 million barrels a day in 2000. Platt's recently announced that Chinese oil demand fell in June for the first time in three years. We note, however, that a one-time drop is not necessarily indicative of changing trends – and could be representative of noisy data – but oil demand is definitely slowing.

Regarding supply, China is taking steps to expand domestic production, adding 764,000 barrels a day of crude refining capacity in 2012, bringing total refining capacity to about

11 million barrels a day. China has also invested to create partnerships with oil and gas companies around the world and acquired reserves. The recent agreement by Cnooc Ltd., China's largest offshore oil and gas exploration company, to buy Canadian energy giant Nexen Inc. is a prime example.

Internally, there is also the challenge of a Chinese banking system that is still modernizing. This has resulted in a shadow banking system, or network of informal lending, that totals an estimated \$1.3 trillion. Shadow banking has provided capital for smaller companies often not able to receive funding because large banks have an affinity for lending to larger, state-owned companies. But the shadow system has the potential for abuse and other problems. As one example, a severe private financing crisis in the city of Wenzhou occurred last year, with more than 40 business owners defaulting on loans. The economic consequences were intensified by the fact that the loans had been funded largely in part by local household savings aimed at seeking higher returns on their money.

If all of these issues were not enough, China is in the process of handing over leadership to the next generation. The exact structure of the new politburo is still not known and will be unveiled in the fall. But one can be sure that the new leaders are going to be tested right from the start of their tenure. Guiding an economy into a more consumption-oriented growth model, dealing with the health care demands of an aging population and continuing the development of a modern and sophisticated banking system would be hard enough without the headwinds from a global economic slowdown.



To cushion the economy from the global slowdown and to encourage more consumption, China lowered interest rates and encouraged an expansion of new loans from the banking sector. Additionally, the pace of normalization of the renminbi appears to be accelerating. Our perception is that China's leaders have a firm commitment to guide the country to what they consider its rightful place on the global stage. While the global economic slowdown comes at a tricky time as China is shifting its growth model, if anything, the country is likely to redouble efforts to sustain its pace of growth so that it can move even faster toward making the renminbi a global currency.

II. Market Implications

The economic slowdown in the BRICs is more severe than many had expected and hoped, and the implications for global markets are just now being appreciated. The rising BRIC share of the global economy means that the world has ratcheted up another notch in terms of financial and economic integration, with implications from energy to commodities to currencies and beyond.

The most obvious ramifications of the BRIC slowdown are on the commodity front. BRIC countries and their emerging market colleagues were the drivers of economic growth in the past decade, which meant they were the drivers of commodity prices. As economic growth decelerates rapidly in these countries, so does energy and commodity demand. Downward pressure on **oil prices** and other key commodities, such as **copper**, are likely to continue until one can be sure that the growth trend in the emerging market countries is moving higher again. We are not at that stage yet. BRIC nations, in their own

individual ways, are all trying to cope with the global slowdown, but each country has its own impediments to growth. While 2012 and 2013 appear to be a bottom to the deceleration cycle, and a BRIC recession appears to have been avoided, it is too early to project a new growth cycle commencing or to describe its nature.

Currency markets are at a pivotal point for following the progress in the BRICs. As the European saga continues, so does global deleveraging. Investments in BRICs tend to be on the high-risk, high-return part of the spectrum, and thus are highly vulnerable so long as global institutions, in this case led by European banks and countries, are deleveraging. To varying degrees all the BRIC currencies have succumbed to the "risk-off" environment caused by the European debt crisis. Even the **renminbi** has shown a little weakness, but the downside leader has been the Indian rupee with its more serious internal inflation issues.

To varying degrees, BRIC currencies represent high-risk, high-return carry trades, due to the near-zero level of interest rates in the U.S., Europe and Japan compared to the much higher rates in the emerging market world.

When BRIC currencies start to appreciate it will be a sign of confirmation of two important new trends. First, a necessary, but not sufficient, condition for BRIC currency appreciation is that the global deleveraging process is abating. Second, to complete the scenario, economic growth and the ability to attract capital needs to return to the BRICs.

Brazil

| Q4/Year | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|-----------|------|------|------|------|------|------|------|------|------|------|
| GDP | 6.2% | 2.2% | 4.9% | 6.6% | 0.9% | 5.2% | 5.3% | 1.4% | 1.5% | 2.5% |
| Inflation | 7.5% | 5.7% | 3.1% | 4.5% | 5.9% | 4.3% | 5.9% | 6.5% | 5.5% | 5.0% |

Russia

| Q4/Year | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|-----------|-------|-------|------|-------|-------|-------|------|------|------|------|
| GDP | 6.2% | 7.8% | 8.9% | 9.2% | -1.3% | -2.6% | 4.9% | 4.8% | 2.5% | 2.0% |
| Inflation | 11.7% | 10.9% | 9.0% | 11.9% | 13.3% | 8.8% | 8.8% | 6.1% | 4.5% | 6.0% |

India

| Q4/Year | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|-----------|------|------|------|------|------|-------|------|------|------|------|
| GDP | 6.4% | 9.7% | 9.4% | 9.6% | 5.8% | 7.4% | 8.2% | 6.1% | 3.0% | 3.5% |
| Inflation | 4.6% | 5.3% | 6.7% | 5.5% | 9.7% | 15.0% | 9.5% | 6.5% | 8.0% | 9.0% |

China

| Q4/Year | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|-----------|------|------|-------|-------|------|-------|------|------|------|------|
| GDP | 9.5% | 9.9% | 10.4% | 11.2% | 6.8% | 10.7% | 9.8% | 8.9% | 7.2% | 6.5% |
| Inflation | 3.2% | 2.4% | 1.6% | 2.8% | 6.5% | 1.2% | 1.9% | 4.6% | 3.5% | 4.0% |

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