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The 2011 Outlook: Is This the "BRIC" Decade?[1]

Highlights

- The BRIC concept that was developed by Goldman Sachs ten years ago to describe the growing importance of Brazil, Russia, India and China, has gained widespread popularity owing to their strong economic growth and stellar investment returns. Goldman's researchers are also optimistic that recent growth trends can last for decades, driven by the rise of the middle class and consumer spending. They believe this also bodes well for future investment returns in these countries.
- By comparison, my own assessment is more guarded for several reasons. First, there are pitfalls in extrapolating recent trends in these countries, as they each face important challenges ahead that could alter their growth trajectories. Second, equity markets in these countries no longer are cheap, as they already have priced in favorable growth prospects.
- In sum, while investing in BRICs proved to be the right strategy for the past decade, performance is likely to be more uneven in the future. Also, because there are vast differences among the four countries, investors need to assess the risks and rewards associated with each of them separately, rather than banking on momentum (or slogans) to carry the day.

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[1] *This title was taken from a Goldman Sachs research report with the same heading. See BRICs Monthly, May 20, 2010.*

Growing Popularity of BRICs

In 2001, Jim O'Neill, Goldman's Chief Economist, created the acronym BRIC to describe the growing importance of Brazil, Russia, India and China in the global economy. Today, some ten years later, the concept has become widely popular, and it has been embraced in the media as well as by leaders of these countries. Based on the performance of their economies and markets over the past decade, it's easy to understand why.

According to Goldman's research[2], the four economies contributed over a third of world GDP growth in the past decade, and they now represent almost one quarter of the world economy in purchasing power terms. From an equity market perspective, the results are even more impressive: Russia's traded index rose by 884%, followed by China H-shares (610%), the BSE in India (319%), and the Bovespa in Brazil (294%). By comparison, returns for the U.S. and other developed markets over this same period were flat to down marginally.

Looking ahead, Goldman's researchers remain very optimistic about the BRIC economies in the current decade. They envisage that the BRICs, as an aggregate, will overtake the US by 2018, and by 2020, they expect the BRICs to account for a third of the global economy (in PPP terms) and contribute about 49.0% of global GDP growth.

The crux of Goldman's analysis is that these trends will be driven by the rise of the middle class: "In the last decade alone, the number of people with incomes greater than $6,000 and less than $30,000 has grown by hundreds of millions, and this number is set to rise even further in the next 10 years."

The principal conclusion from Goldman's research is that the BRICs are a powerful force to be reckoned with and there is no turning back. O'Neill, who now serves as Chairman of Goldman Sachs Asset Management (GSAM), summarized his views as follows: "The BRICs story continues to be one of the most, if not the most, important investment themes of our generation, with more and more financial market movements influenced by these countries' economic progress and their actions."[3]

What Could Go Wrong?

While the BRIC acronym has served its purpose of attracting attention to this group of large and rapid growing economies, as part of our investment philosophy at Fort Washington, we always ask ourselves the above question. Consequently, after reading several of Goldman's research reports on BRICs, I was surprised by the limited discussion of the potential risks associated with these economies and markets. In fact, I could find very few qualifications in the research reports I reviewed. As discussed below, my principal concerns with Goldman's ringing endorsement of BRICs relate to: (i) problems of extrapolating economic trends into the distant future; and (ii) the assumptions embedded in GSAM's equity market valuations.

Pitfalls of Extrapolating Economic Trends

There is no disputing that the past decade was truly exceptional for emerging economies and for the BRICs in particular. It was, by far, the best decade for these countries in the post WWII era.

In large part, the superior performance was the result of improved economic policies, as the BRICs and other emerging economies took steps to reduce their dependence of foreign capital inflows following the financial market turbulence in the 1990s in Latin America, Asia and other parts of the world. As a result of these policy reforms, these economies experienced faster growth, lower inflation, reduced budget deficits, improved current account performance and a massive build-up of foreign exchange reserves. Consequently, they were also in better shape to weather the 2007-2008 financial storm that hit the United States and other developed economies particularly hard.

[2] *Ibid*
[3] *BRICs and Beyond, p.153.*

Looking ahead, a key issue is whether the BRICs and other emerging economies can continue to perform as well as they did in the past decade. I have little doubt that China and India will grow faster than the developed economies, based on demographic trends and the fact that it is easier to grow at high rates in the early stages of economic development. That said, one should not assume persistent high growth rates are a given, as these countries face some serious challenges ahead. As discussed below, I have more reservations about Brazil and Russia, as their growth prospects are heavily dependent on prices of natural resources.

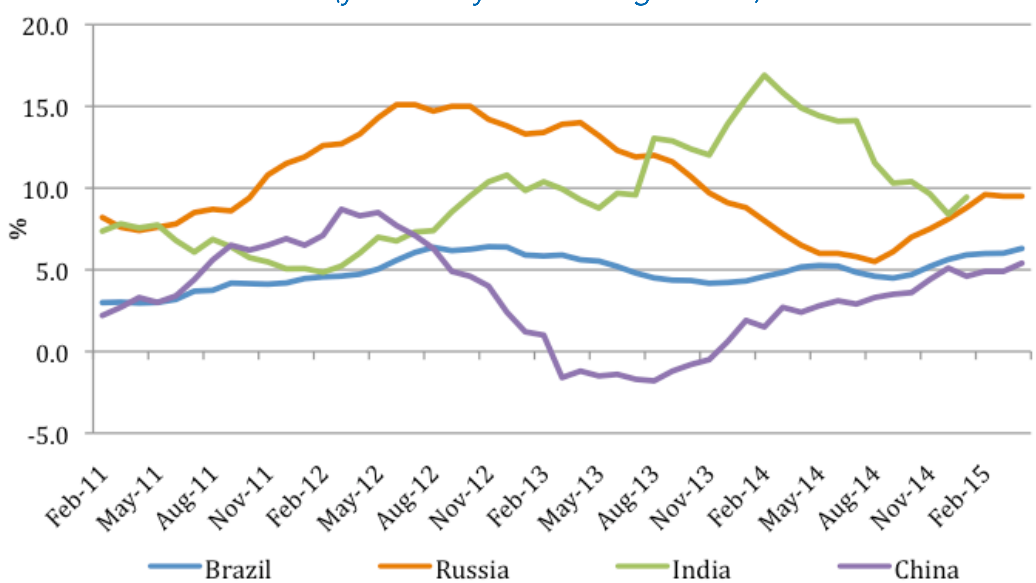
Near-term Challenges

The main challenge currently confronting the BRICs is accelerating inflation (Figure 1). In each of the four countries, consumer price inflation rates are running well above the comfort level of policymakers – China (5%+), Brazil (6%+), and India and Russia (9.5% each). This mainly reflects a surge in food and energy prices, which have relatively large weights in their consumer price indices.

The respective central banks have responded by tightening monetary policies, but not enough to curb inflation or to deter speculation in property and asset markets. Consequently, market participants are anticipating further increases in short-term interest rates, along with various types of administrative controls to dampen credit creation.

Further complicating the situation is an ongoing influx of foreign capital, which policymakers are seeking to discourage. The problem is particularly acute for Brazil, which has seen its currency appreciate more than 60% (inflation adjusted) in value in the past two and one half years. As a result, it remains to be seen whether policymakers in the BRICs will be able to engineer a "soft landing" or whether policy tightening will eventually lead to a growth recession.

Figure 1: Inflation in the BRICs is Accelerating
(year over year % change in CPI)



Source: Bloomberg

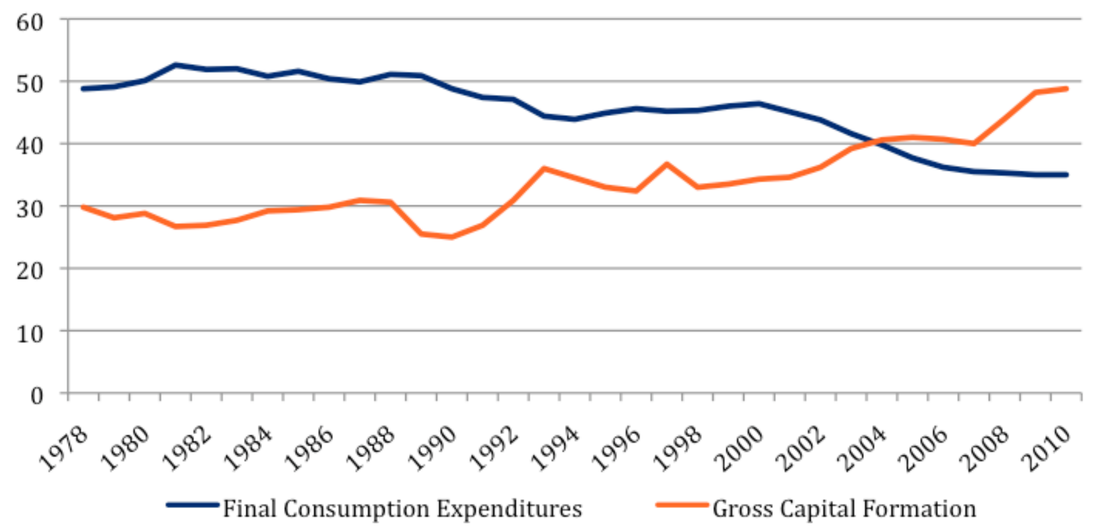
Longer-term Challenges

Looking beyond the near term, the BRIC economies also face critical structural challenges. The transformation of China's economy, which began three decades ago under Deng Xiaoping, is nothing short of remarkable, and it is a testimony to China's leadership and the entrepreneurial spirit of the Chinese people. Yet, China's current leadership has also acknowledged that its economic growth model is "unstable, unbalanced, uncoordinated, and ultimately unsustainable."

One of the biggest challenges for China is that it has relied extensively on export-led growth, rather than fostering growth of domestic demand. Chinese policymakers acknowledge there are limits to this strategy, particularly now that growth in the U.S. and other developed markets has slowed. Accordingly, the recent 12th Five-Year Plan is geared to achieve a shift toward domestic-led growth.

Nonetheless, while the latest plan spells out actions that need to be taken to achieve this goal, it remains to be seen whether it can be implemented successfully. Indeed, the trend over the past two decades has been for consumer spending as a percent of GDP to decline from 50% to 35%, while investment spending has nearly doubled and is approaching 50% of GDP (Figure 2). I question whether any nation can invest this much of its economy productively.[4] Two other countries that experienced similar patterns of growth and which were expected to overtake the United States – the Soviet Union (in the 1950s and 1960s) and Japan (in the 1970s and 1980s) both faltered under the weight of redundant capital.

Figure 2: China's Rebalancing Imperative
(Share of GDP in %)



Source: National Bureau of Statistics of China

The manner in which China handles this transition, moreover, will have important implications for Brazil, Russia and other resource-rich economies. Over the past decade, they were major beneficiaries of the strong demand for raw materials emanating from China's transformation. However, a recent report by Bank Credit Analyst (BCA)[5] indicates that China is becoming more efficient in terms of resource usage per unit of output, and BCA forecasts that China's consumption of base metals will slow in the future.

At the same time, BCA believes that the short-fall in raw material production is about to end in the next few years, as new production facilities comes on stream. By that time, interest rates in the U.S. and other developed economies are likely to be considerably higher than currently, which could place added pressure on commodity prices. If so, both Brazil and Russia could find their terms of trade – i.e., the ratio of prices of exports to imports – turning much less favorable than in the past ten years. In my view, there is little evidence of economic and political reform in Russia, whose growth prospects are heavily influenced by oil prices. Brazil, by comparison, undertook more significant reforms under the Administration of President Lula da Silva, but it remains to be seen whether his successor, Dilma Rousseff, will be as effective in leading the reform process.

Weighing these considerations, we believe the growth rates for the BRIC economies could moderate as they confront these challenges. Accordingly, we are reluctant to extrapolate recent economic trends over decades.

[4] *For a more detailed discussion, see Nouriel Roubini, "China's Unbala nced, Uncoordinated and Unsustainable Growth Model," April 11, 2011.*
[5] *"The Long Term Outlook for Commodity Prices," April 2011.*

BRIC Valuations: No Longer Cheap

Whichever view one subscribes to about the economic prospects for the BRICs, investors ultimately must assess what expectations are priced into the markets and whether they are reasonable. Ten years ago, when these economies were less widely followed by investors and their markets had been pummeled during the Asian financial crisis, these markets were cheap, because expectations were low. Today, by comparison, after the huge run-ups in these markets, it is questionable that this is still true.

But this still begs the question: Are the BRIC markets expensive, cheap, or reasonably-valued? One can get different answers depending on the methodology used to assess equity market valuations and the underlying assumptions. Based on the framework GSAM uses, BRIC equities appear cheap relative to bonds in their respective countries. By comparison, the framework we use suggests that BRICs are relatively expensive when compared with advanced equity markets.

GSAM's Valuation Framework

The framework GSAM uses is based on calculations of equity risk premiums (ERP), which measure the difference between the expected equity return in a country and the associated risk-free rate.[6] Using this framework, GSAM's calculations show the implied ERP for the BRICs to be nearly twice the average level for the advanced markets (Figure 3), which according to GSAM implies they are relatively cheap: "When the ERP is high and above its long-term average, it is likely to decline through a favorable performance of equities. Similarly when it is low, it is likely to recover through a less favorable performance."

The methodology that GSAM utilizes, however, incorporates some underlying assumptions, which in our view biases the results in favor of the BRICs over advanced markets. GSAM's model, for example, assumes there is a direct 1:1 relation between the real GDP growth trend and real earnings growth. That is, the higher the projected rate of economic growth, the higher the growth in earnings in real terms. Based on several empirical studies, however, it is questionable whether such a relationship holds. For example, a recent analysis by Societe Generale[7] makes the following observation: "Several commentators have shown that in the long run – and contrary to common belief – there is no relation between a country's stock market returns and its overall economic growth. If there were to be a relationship, it tends to be negative."

Another limitation of GSAM's methodology is that it compares equity markets on the basis of their risk premium *relative to the country's bond market,* rather than by directly comparing equity valuations across countries. One way of making direct comparisons with other equity markets is to compare calculations of implied discount rates for the various markets. When we do these calculations we find that implied discount rates for the BRICs are low relative to historic trends. This suggests these markets no longer are cheap and appear to be more fully valued.

On this score, I concur with the following statement that appears in the May 20, 2010 issue of BRICs Monthly:

> "In the past decade, BRIC equity markets outperformed significantly because the strong growth of these economies surprised many and BRICs themselves came into focus. At the same time, valuations were low relative to many major markets in 2000. *Now that the BRICs story is better known, expectations are higher and the valuation gap is much smaller, the same degree of outperformance seems much less likely, even if the BRICs deliver solid returns.*" (note: italics added).

[6] *See "The ERP in the BRIC-dominated World," February 2011*
[7] *See Societe Generale, Cross Asset Research, "Country selection, GDP Growth is Irrelevant"*

Figure 3: GSAM's ERP Valuation Framework

	Real GDP Growth Trend	Real Earnings Growth	+	Dividend Yield	=	Expected Real Return	–	Real Bond Yield	=	Implied ERP	Expected Inflation	Expected Nominal Return
US	3.0	3.0		1.8		1.8		1.1		3.6	2.0	6.8
UK	2.8	2.8		2.7		5.5		0.2		5.4	2.0	7.5
Europe	2.3	2.3		2.7		5.0		1.4		3.6	2.0	7.0
Japan	1.5	1.5		1.9		3.4		1.3		2.0	0.5	3.9
Brazil	5.0	5.0		2.7		7.7		8.3		-0.6	4.5	12.2
China	8.0	8.0		2.5		10.5		1.0		9.5	3.0	13.5
India	8.0	8.0		0.9		8.9		4.2		4.8	4.0	12.9
Russia	5.0	5.0		1.8		6.8		2.0		4.8	6.0	12.8
Advanced*	2.5	2.5		2.2		4.7		1.2		3.5	1.8	6.5
BRICs*	7.3	7.3		2.1		9.4		2.6		6.8	3.7	13.2
World*	4.4	4.4		2.1		6.5		1.7		4.8	2.5	9.0

**PPP-Weighted*
Source: GSAM — As of 02 February 2011

Conclusions

The BRIC concept that was created ten years ago has served the purpose of bringing attention to some of the largest and most dynamic economies of the world, as well as attracting investors to their markets. The leaders of these countries have embraced the concept, as it highlights the progress they have achieved and also has helped to create a forum for them and other emerging economies to discuss issues of mutual interest.

At the same time, I find the BRIC concept to be less useful as an investment theme. The principal reason is that the four economies are more heterogeneous than they are homogeneous (see Figure 4.). China's emergence as a global power over the last decade is, by far, the most important story, and how it plays out will have repercussions for the other three countries: *China's economy, which is now the second largest in the world, is greater than that of India, Russia, and Brazil combined.* Over the past decade, its share of the world economy has nearly doubled to 14%, while India's has increased from 4% to 5%, and Brazil's and Russia's have held steady at about 3% each. Hence, it is misleading to combine the four economies into an aggregate figure and presume that they have shared a common experience.

These four economies also face diverse challenges. The over-riding challenge for China is transitioning away from an export and invest-led model of development to one based on domestic consumption. The potential problems in implementing a new strategy should not be minimized, especially considering the difficulties Japan has encountered. For India, the ongoing challenge is to keep the reform process going, reduce bureaucratic red tape, and improve productivity. Finally, in the case of Brazil and Russia, it remains to be seen how they will perform when confronted with an external environment that is less favorable to raw materials. Russia's economy, for example, suffered a steep decline of nearly 8% in 2009, when oil prices plummeted, while Brazil's economy stagnated in the face of falling raw material prices.

For these reasons, there is no easy shortcut for investors who are considering these countries other than to do extensive research on the risks, as well as opportunities, each of them affords.

Figure 4: Key Economic Performance Indicators

	2000 -2004 Average	2005 – 2009 Average	2010	2011F
Brazil:				
GDP ($2.2 trillion) Growth	3.0%	3.5%	7.5%	4.5%
Investment (% of GDP)	17.1%	17.7%	19.2%	19.7%
Inflation (CPI)	8.7%	5.1%	5.0%	6.3%
Current Acct (% of GDP)	-1.4%	0.0%	-2.3%	-2.6%
Russia:				
GDP ($2.2 trillion) Growth	6.9%	4.1%	4.0%	4.8%
Investment (% of GDP)	20.1%	21.4%	19.8%	23.9%
Inflation (CPI)	16.5%	11.4%	6.8%	9.3%
Current Acct (% of GDP)	11.2%	7.4%	4.9%	5.6%
India:				
GDP ($4 trillion) Growth	5.6%	35.7%	10.4%	8.2%
Investment (% of GDP)	25.6%	7.2%	37.9%	39.2%
Inflation (CPI)	3.9%	0.5%	13.2%	7.5%
Current Acct (% of GDP)	8.3%	-1.6%	-3.2%	-3.7%
China:				
GDP ($10 trillion) Growth	9.2%	11.4%	10.3%	9.6%
Investment (% of GDP)	31.7%	43.8%	48.8%	48.6%
Inflation (CPI)	1.1%	2.6%	3.3%	5.0%
Current Acct (% of GDP)	2.4%	8.5%	5.2%	5.7%

Source: IMF, World Economic Outlook Database, April 2011

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