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2010 BRIC Outlook Remains Strong

BRICs economies were hit by the financial crisis and global recession but, by and large, they suffered collateral not intrinsic damage. They are not left with the same aftermath issues to deal with that the economies at the “epicenter” of the financial crisis are. Of course, the external environment of them has changed, perhaps permanently. China, for example, will need to rely more on domestic demand growth and less on export growth. With reference to Nomura’s report, this article discusses the outlook of BRIC in this year.

China

Barring an aggressive policy tightening, 2010 will likely prove one of the best years in decades for the Chinese economy, characterized by strong GDP growth and mild CPI inflation. Real GDP growth should rise to 10.5% in 2010. Investment should continue to be the main driver – contributing 6.8% percentage points (pp) to real GDP growth – as public investment remains strong and private investment picks up. The contribution of private consumption to GDP growth should rise to 4.6pp from 4.0pp in 2009, as the credit boom boosts household’s real purchasing power in a low-inflation environment and the government strikes further to boost consumption through income transfer and fiscal subsidies. We expect exports to return to double-digit growth (more than 10%), on a low base created by massive global destocking in 2009. We expect import growth to be even stronger (around 20%), due to strong domestic demand from investment and consumption booms.

As for inflation, we expect significant PPI inflation of 6.0% - mainly due to strong demand for raw materials and capital goods from the investment boom – but mild CPI inflation of 2.5% in 2010. In our view, the existence of overcapacity in the manufacturing sectors and rapid growth in labor productivity should prevent high PPI inflation from being transmitted into CPI inflation.

We expect tightening policies to be introduced gradually in early 2010, in response to signs of economic overheating. Without a real CPI inflation threat, policy tightening will be mild (highly probable) – we expect to see only 81bp of rate hikes, 100bp of reserve ratio requirement (RRR) hikes and window guidance.

However, there is a chance that, having delayed tightening for too long, policymakers over-react to some signs of overheating in 2010. If this happens, the economy could face a hard landing. The development of an asset price bubble is another risk, as abundant liquidity could ignite inflation expectations and a benign economic environment may boost investor confidence to unreasonable levels.

India

A rebound in private demand, rising inflationary pressures and a surge in capital inflows have set the stage for policy reversal in 2010, but managing the fiscal deficit will remain a challenge. India has weathered not just the global crisis, but also weak monsoon, and is likely to post 6.5% y-o-y GDP growth in 2009. Buoyed by loose macro policies, we expect growth to rebound to 8% in 2010, and 8.2% in 2011. Domestic private consumption is picking up due to lower interest costs, rising confidence and better job prospects. As consumer demand rebounds and the global economy stabilizes, increased business confidence should propel greenfield investments.

Food inflation is a concern. We believe that food prices could remain high in 2010 due to hoarding ahead of the next monsoons. Non-food inflationary pressures are also building due to higher oil prices, and the economy recovery could soon lead to demand-side price pressures. High input prices and rising demand are likely to prompt firms to gradually pass on more of their increased costs to consumers. Therefore, the fundamental driver of inflation is likely to shift from the supply side to the demand side in coming quarters.

With both growth and inflation heading towards 8%, we expect the Reserve Bank of India (RBI) to start normalizing its policy rates in January, and hike its repo and reserve repo rates by 125bp each in 2010. We expect rupee to appreciate due to rising net capital inflows and the RBI's inflationary concerns. However, weak external demand suggests that the RBI will continue to intervene in order to prevent too sharp INR appreciation, and to mop up the resulting excess liquidity through cash reserve ratio hikes and market stabilization schemes. On the fiscal side, we are skeptical about any public expenditure cuts and instead expect higher revenue buoyancy, a reversal of tax cuts and disinvestment to lower the fiscal deficit. Still, gross borrowings are likely to be substantial and combined with higher inflation and rising policy rates, are likely to put upward pressure on long-term yields.

Higher oil prices, a double-dip and global financial instability are the key downside risks, while strong net capital inflows and a sharp rebound in investment are the key upside risks.

Russia

After the marked slowdown in 2009, Russia is poised to return to stable, if somewhat subdued, growth in 2010, supported by the benign oil price outlook and pent-up domestic demand. The country was disproportionately affected by the global financial crisis because of a confluence of adverse shocks – unwinding terms-of-trade gains, disappearing external demand and drying up capital flows. However, the faster-than-expected recovery in oil prices and the very proactive fiscal policy have paved the way for an improving output performance, starting from the second half of 2009. We expect the growth momentum to continue through this year, with GDP recovering strongly from -7.5% in 2009 to 3.5% in 2010. Growth should be primarily driven by domestic demand, with consumption and investment contributing 1% and 1.4% to growth, respectively.

After the temporary boom in inflation in Q1 2009, reflecting the ruble devaluation, price growth has been steadily decelerating ever since, falling to single y-o-y digits in October 2009. We see inflation continuing to drop over the next year from an average of 11.7% in 2009 to 8.9% in 2010 as subdued wage growth and loosening capacity constraints weigh on price pressures.

Fiscal policy will likely be consolidated, but should continue to support growth as the federal budget should improve from a deficit of 6.8% of GDP in 2009 to a deficit of 5% in 2010. The central bank navigated well the abrupt currency movements at the start of 2009, although this was greatly facilitated by the loss of a third of foreign reserves. Importantly, monetary policy move from exchange rate targeting to inflation targeting. Besides, the upward pressure of the currency may intensify in 2010 should oil prices continue to rise and GDP surprise on the upside.

Brazil

Strongly pro-cyclical monetary and fiscal policy, buoyant capital markets and strengthened labor markets should make Brazil one of the strongest growth stories in Latin America in 2010. The recession seems to have ended in the country. While the main drivers of growth have so far been personal consumption and government spending, we expect business fixed investments to take up the slack, pushed higher by buoyant capital markets and an appreciating currency. This powerful combination should put 2009 GDP just north of zero – at 0.1%. For 2010, we forecast a return to very strong growth of 5.4%. However, we expect a retrenchment in 2011 as interest rates rise and a newly elected government potentially reins in spending. Higher consumption and investment by both the private and public sector should push the trade balance into deficit in 2010 for the first time since 2000, with the current account deficit widening further. Nonetheless, ample portfolio and investment flows should more than cover the growing current account deficit, allowing real to appreciate.

Inflation, as represented by the central-bank-targeted IPCA index, looks likely to close below the central bank's 4.5% target in 2009, but not in 2010. At the beginning of 2010, the effects of currency appreciation and wholesale price deflation should provide a strong anchor for inflation, but a rapid closing output gap and electoral-year spending should drive inflation higher, to 4.7% by end 2010, even if the central bank hikes rates.

Given concrete signs of a strong, board based growth in Brazil, we expect the central bank to begin to tighten rates in June, though an earlier hike in March is also possible. An earlier start to the tightening cycle is unlikely, as the near-term inflation outlook is positive even as the output gap is set to close. Strong private-sector growth and loose fiscal policy in an election year will likely push inflation expectations higher for the end of 2010 and 2011, eliciting tighter monetary policy. We see rates rising by 375bp into March of 2010, taking the policy rate to

12.5%. We also expect the fiscal policy will be substantially higher in 2011 after the recent deterioration.

The very loose fiscal policy looks set to continue into the 2010 election year. This could lead to above-potential growth, putting steady pressure on inflation and the current account deficit. We assume the central bank will be able to execute monetary policy without overt intervention and political pressure to control demand. We also assume that whoever wins the October 2010 presidential election will rein in spending at the beginning of 2011 from the current unsustainable pace. Any disappointments on these fronts could lead to higher inflation, a higher current account deficit and more volatile financial markets.

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