

15 Years of BRICs

This November will mark 15 years since Jim O'Neill, the Chairman of Goldman Sachs Asset Management at the time, coined the term BRIC. This collection of Emerging Markets were identified as challengers to the G7's grip on global economic power. All four had large populations with low GDP per capita and economies with significant growth potential that were largely unintegrated with the rest of the world.

Since 2001, despite the BRICs gaining significant ground on the G7, success on an individual level has varied. China and India have grown into two of the largest economies in the world. They have outgrown the G7, spurred by large, vibrant populations and dynamic industries. On the other hand, Brazil and Russia have disappointed as an overreliance on commodities and poor governance has highlighted structural vulnerabilities. This varying progress has led investors to question the validity of the BRICs as a group. On our recent trips to Brazil, China and India, we were interested to evaluate whether the investment case for BRICs was still intact.

Brazil

Since 2010, Brazil has arguably disappointed expectations the most out of the BRICs. We find Brazil today experiencing the worst recession since the 1930s with rising unemployment and stubbornly high inflation that has dampened domestic demand across the country. In part, this is due to the populist policies of the Workers' Party (PT) that came to power in 2003. Instead of utilising Brazil's vast natural resources to add long-term economic value through infrastructure, health services and reforms in the tax and pensions systems, the PT have used government resources for excessive welfare projects. This has resulted in a structural budget deficit that requires radical reform.

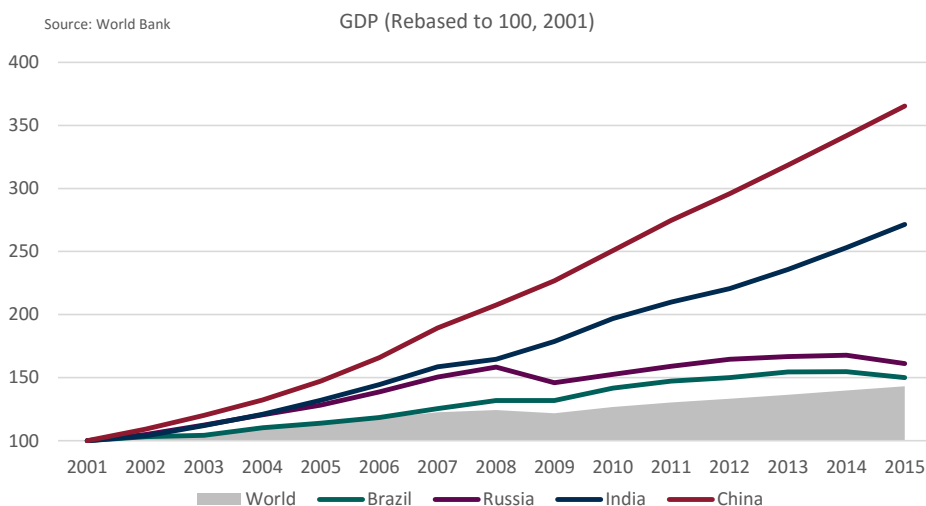
In the short-term, Brazil has a range of risks investors must evaluate. High inflation will take a number of years to subside given automatic inflation-matching adjustments to wages and rents. Distortions in the market fuelled by protectionist measures to prevent imports and complicated tax laws will prevent any recovery occurring within

the next 12 months. We expect heightened volatility during the impeachment process of President Dilma Rousseff that will likely deter FDI until it is resolved. However, if an impeachment does occur and Vice-President Michel Temer assumes office, we expect a reduction in the risk premium and a likely return of foreign capital.

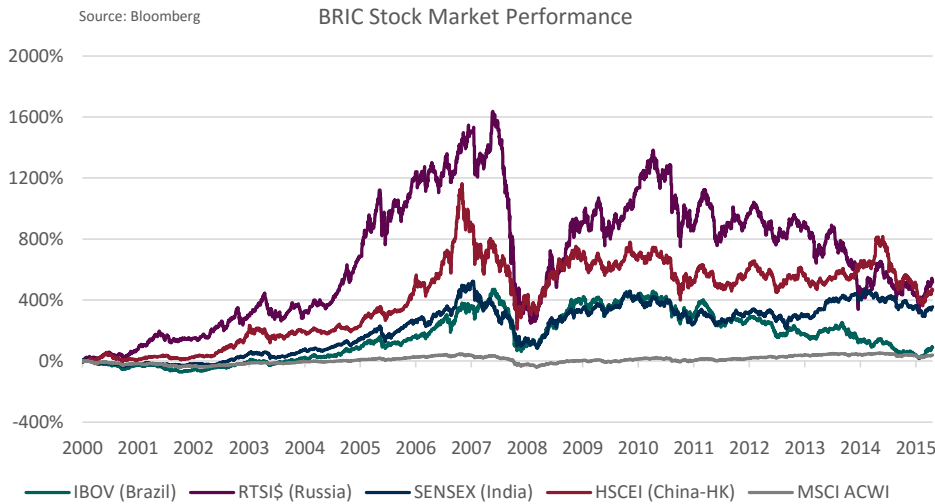
With sufficient FX reserves and limited external debt, the economy is not facing an existential threat that many predict and we remain confident in the long-term prospect of the country. The possible impeachment of Rousseff will trigger much needed political and economic reform. This will support the private sector that has had to adjust to a weaker demand environment during the longest recessionary period in Brazil's history. Without economic support, these companies have strived for greater productivity in order to maintain profitability. This will rebalance the economy away from commodities and direct resources to boosting domestic consumption and the emergence of a middle class. There is significant growth potential in the north of Brazil which remains heavily underpenetrated. Here there is an emerging middle class whose consumption patterns will evolve to resemble that of the southern states of Brazil.

Russia

Similar to Brazil, Russia has incurred a loss of investor confidence due to an overreliance on commodities and widespread government mismanagement. Ongoing political and economic isolation has continued to harm the economy and restricted efforts to react to a low oil price



Since 2001, the growth among BRICs has been varied with China and India the clear outperformers, Brazil and Russia the underperformers.



Since 2000, the BRIC stock markets have all outperformed the world index (MSCI ACWI)

environment. The country requires further fiscal consolidation to address the significant budget deficit.

We are encouraged by small pockets in the economy and recent economic data has beat expectations, notably in industrial production, construction and agriculture. The onset of sanctions has led to the creation of a vibrant SME sector which has replaced the reliance on imports for auto and other manufacturing industries. Sanctions have forced a number of companies to reduce USD-denominated debt, limiting the negative impact of further currency devaluations. The decision to abandon the currency peg in late-2014 means that the country still has significant FX reserves, while the weak RUB has limited the consequence of falling oil prices and supported exporters.

In the long-term, the opportunity to diversify the economy away from a reliance on commodities and need for sensible fiscal policy should be positive. There is an opportunity to improve relations should Russia's presence in the Middle East prove constructive but any escalation of the conflict in Ukraine or further tensions with Western allies such as Turkey

are a risk.

India

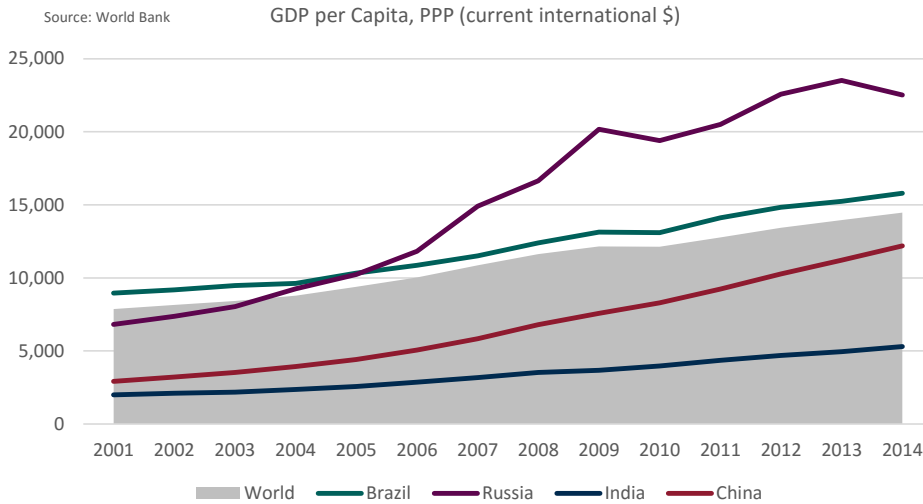
India recently unseated China as the fastest growing major country in the world and has remained resilient to weak global growth. This highlights a dynamic economy that stands out

among EMs with large, globally competitive industries in technology and pharmaceuticals that result in a far broader economy with considerably less reliance on any one GDP source. This has produced a well-diversified economy and increasingly literate population with very low unemployment. India has also had the fastest growing population among the BRICs and is expected to surpass China within the decade.

However, a number of challenges remain embedded in the nation. Excessive bureaucracy and complicated legislation has constrained the efforts of Prime Minister Narendra Modi to introduce sweeping reforms. Yet, it is important to note that any changes will be incrementally positive. The health of the financial sector remains binary. On the one hand, the financial system is an area of substantial growth with an estimated 200 million new bank



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Despite China and India's superior GDP growth rates, Brazil and Russia continue to have higher GDP per Capita in PPP terms.

accounts to be opened within the coming years. On the other hand, the public bank sector is facing significant stress as an estimated 70% of the outstanding loan stock is technically insolvent. There are additional risks with over-gear private banks resulting in a dramatic fall in private sector capex. This poses systemic risks to the economy and must be addressed with appropriate reform.

Despite these threats, we remain confident in the long-term prospects of India. With favourable demographics, increasing literacy levels and an aspirational consumer, India's low base should result in excessive growth rates among most sectors. Consumption should be supported by rising wages, various social welfare programmes and a public worker wage hike that will shift the entire income curve higher. Sustained lower oil prices have allowed the government to unwind crippling subsidies and use the savings to kick-start infrastructure and other projects. These continued efforts to boost public capex and attract FDI will have a positive multiplier on growth.

The lack of reform in India's past presents vast opportunities and

although initial enthusiasm of Modi's appointment has been tempered, there are clear signs of progress. We are particularly enthused with efforts to increase taxes, tackle corruption, reform land acquisition and the power sector, and transform India into a global design and manufacturing hub.

China

As the fastest growing BRIC since 2001, China has leveraged its huge population and proactive government to transform the state of the global economy. Once the factory of the world, China has swiftly shifted its economic structure away from a manufacturing, export-led economy to a services and domestic-led economy that relies on consumption, rather than investment, for growth. Recently, growth concerns and government interference have discouraged investors. Although the vast overcapacity of primary and secondary industries will prolong the readjustment to a tertiary-dominated economy, we find many of these concerns overdone and are confident in China's ongoing transformation.

On a structural level, China's relatively slow effort in financial liberalisation has provided the

government with a range of methods to counter exogenous shocks to the economy. Tight control over FX flows, the lack of a significant international market in RMB and domestic executive power mean that limited pressure can be applied to force a devaluation. Yet, financial repression has discouraged savers with low interest rates. Instead riskier 'wealth management products' and more recently P2P lending allocate according to yield over prudence. Additionally, local stock exchanges are dominated by short-term retail investors which increases volatility. This impedes the development of a

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professional fund management industry and restricts companies' ability to raise money outside the banking sector.

Despite these risks, we continue to find a range of opportunities in China. Healthcare, the internet and tourism remain high growth areas and we expect these industries to support a fast-growing consumer market.

Conclusion

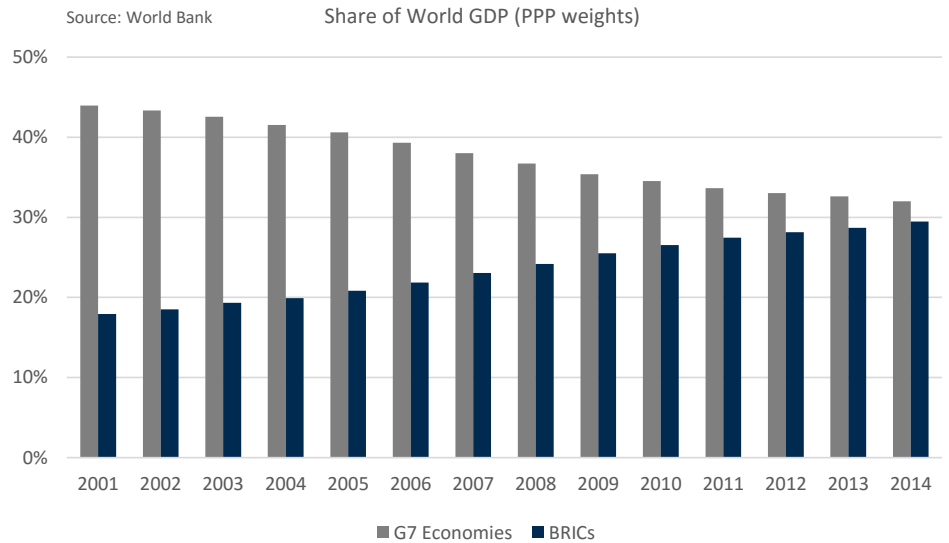
Since 2001, the divergence among the BRICs has been substantial. The larger, more-diversified economies of China and India have continued to outgrow the rest of the world and now find themselves as the second and third largest economies. On the other hand, we find Brazil and Russia today

in recessions as their less-dynamic economies struggle to adjust to a low commodity price environment and suffer the consequences of sustained periods of fiscal mismanagement.

As stock pickers, the companies we find in our investable universe are inevitably products of their environments. The varying success of the BRICs highlights the crucial role governance has in creating environments that enable companies to thrive.

Following Matterhorn’s launch in 2002, we have been fortunate to witness the evolution of each individual BRIC nation and are cautiously optimistic about their prospects as they develop beyond their traditional strengths (manufacturing, outsourcing and commodities). Excellent, well-run companies have emerged not only as domestic leaders, but companies that provide products and services worldwide. We continue to believe that leaders of the future are still emerging and focus much of our effort in finding these.

What has been interesting about the ‘BRIC thesis’ is how despite the diverging fortunes of the four component parts, the grouping has dominated emerging market



Since 2001, the BRICs have experienced strong growth that should soon see them surpass the combined size of the G7 economies

discourse relative to smaller markets in the EM universe. Whilst the divergence between BRICs has come to epitomise the importance of governance and the challenges that all EM countries face in creating environments conducive to growth, these challenges are certainly not confined to the BRICs but inherent to any EM. The divergence between all the various non-BRIC countries has been equally marked, offering up opportunities to invest in markets with supportive policy environments, out of the spotlight so frequently directed towards the BRICs.

The big success of the Jim O’Neill’s concept was creating a lens through which investors could more easily understand the diverse array of countries that comprise emerging markets by focusing on the largest four. The breakdown of that narrative is indicative of the wider EM story as a coherent investible block with shared characteristics and destinies, rather than a collection of disparate nations all pursuing different paths towards economic development. This latter view is something we find far more compelling and relevant today.

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