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ECONOTE No. 27 **23/1/2015**

Some weak links : Russia, Brazil and Greece, and a glance at China

Summary

It is customary to start the year with the outlook for 2015, but as we have already done so in Econote 26, we start here with some of the weak links in the global economy, Russia, Brazil and Greece and a sideways glance at China, not because it is a weak link but because of misleading statistical releases as to its GDP growth.

Brazil is a victim of some poor economic policies and, recently, falling soft and hard commodity prices, while Russia pays the price of a one- product economy, oil, and total absence of diversification. Greece is faced with more political uncertainty but no “Grexit”.

Investment Conclusions

Investment advice consists of three parts, buy, sell and hold (the latter misleading as it applies only to portfolios which contain the asset). We prefer a “buy, sell and keep out “ advice ! All the three economies considered here are, of course, “keep out” meaning that there are no strong reasons to buy them now, selling them will be too late and, hence, “keeping out” is the logical advice. China’s case is more complex as the performance of equities has completely decoupled from that of GDP as long and short term performances have shown. Hence the misleading “hold “advice holds

A picture is worth a 1000 words..as they say

Greece’s govies yields exploded after September 2014 when it became obvious that the country would go for elections where the party likely to win was also preparing for, yet another, debt negotiation. With elections now set for the 25th January, yields eased a little but not enough to show that the markets have relaxed.

The Fact Box outlines strong arguments which have been made recently as to why Greece’s debt burden is consistently overestimated and, hence, pressure for more austerity is misplaced. This might sound as cheap let-out for Greece, but there is a great deal of value in the argument. Our take has always been that the ratio (Debt/GDP) is worse than misleading in gauging a country’s debt burden. It is actually irrelevant and meaningless. It divides a flow concept, GDP which is the value of goods and services produced per annum, with a “timeless” concept, the size of debt, which has no time flow element. What is far more relevant, but is never quoted is the sum necessary to service the debt as percent of GDP.This ratio shows two flows of incomes and expenditures and makes a great more sense. Under the so-called IPSAS approach, Greece’s debt to GDP (never mind my objections..) comes down to 60% from nearly 175%.But all this is of no importance as the troika will not change accounting conventions to suit Greece !

Brazil’s curent woes are partialy man-made following years of state intervention in various sectors which led to poor investments, a deteriorating fiscal and current account balance caused by falling commodity prices which led to a deprecaition of real (green in Chart 1) which added to inflation.Hikes in interest rates added to these pressures.To add to problems, the newly elected Rousseff administration has been plagued by scandals .

Chart 1: Greek 10Y bonds(blue),Real(green),Ruble (red) forex rates, 2013-15

Source: Bloomberg

Common issues, common problems

Brazil's main soft commodity exports such as soybeans and coffee are under the pressures of falling prices, as are its hard commodity exports of iron ore.Falling oil prices added to the problems of Petrobras, the state oil producer.

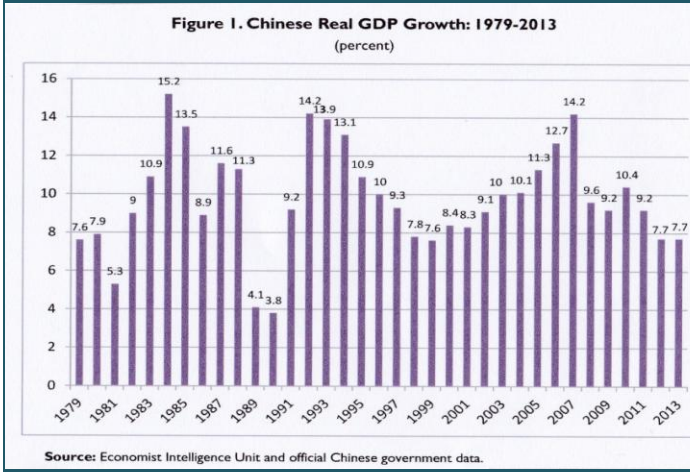
The oil price declines are of major importance for **Russia.**The ruble crisis (Chart 1 red) led to 650 bps rate hikes as well as adding pressures on the fiscal balance.The Ukraine crisis sanctions on Russia by the EU and the US have made life even more difficult by shutting off access to international financial markets.Russia is facing the prospect of negative GDP growth in 2015 as well accelerating inflation because of the fall of the ruble.The explosive mixture of politics with a looming financial crisis has made Russia an added risk to the global economy at the time that there is no clear relief on oil prices. Russia has, so far, made no use of its control of gas supplies to Europe as a political or economic bargaining chip.

FACT BOX : IPSAS approach

Economics of Debt Three cash flow streams interest stream, Interest on interest stream, and principal stream. The economic value of debt is the present value of future cash flows discounted at most comparable market rates. The current **Maastricht (EDP)** definition used by the EU is a legal definition designed to support a debt covenant by reporting debt at par value .Of the three streams of debt, interest, interest on interest and principal, Maastricht considers only principal ignoring the existence of either the time value of money or market interest rates, requiring a zero coupon bond be measured at the principal amount due at maturity. (Intl Pub Sector Accounting Standard, Japonica Partners)

Although not seeming relevant or even connected, the CHF crisis (man-made to boot) came at a time that nothing seemed to have been going right in Europe and Latin America (we have not included here the dire straits of Venezuela and Argentina!).All of which has left Asia as the bright light, bar the concerns over China's growth. At least India is now cutting rates and keeping the INR stable, an unusual mixture.

Chart 2: China, GDP growth 1979-2013



Summing up and China

Headlines have announced that China's GDP growth for 2014 stood at 7.4%, the lowest rate in 24 years. Yes correct (look at the Chart 2), but the lowest in 34 years was 3.8% in 1990, while the highest was in 1992 and 2007 at 14.2 %.In other words it all depends which year you choose! Also: Does it really makes that much difference if one looks at 1998 at 7.8%, 1999 at 7.6% and 2012 and 2013 at 7.7%? Would it REALLY be upsetting if we had to choose between 7.8% and 7.4%? Bottom line: China is still growing faster than any other Asian economy, more than twice that of the US, never mind the near zero rate of the EU, etc. Investment- wise the Chinese equities may need more monetary boost, less state interference and more institutional investors (over 60% Shanghai's turnover is volatile retail trade) in an effectively closed market. Stay out for now. India is a better bargain till the February budget. The equity markets of Brazil and Russia will likely continue to be under the macro and financial pressures to be of serious considerations now. Those with very strong stomach may look at Greece after the elections. If the new administration does not go for extremes, a strong "relief" rally could follow.

Andrew Freris (writing completed on 22/1/2015)