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BRICs Lead the Global Recovery

Tetsufumi Yamakawa
tetsufumi.yamakawa@gs.com
+44 (0)20 7774 5061

Swarnali Ahmed
swarnali.ahmed@gs.com
+44 (0)20 7051 4009

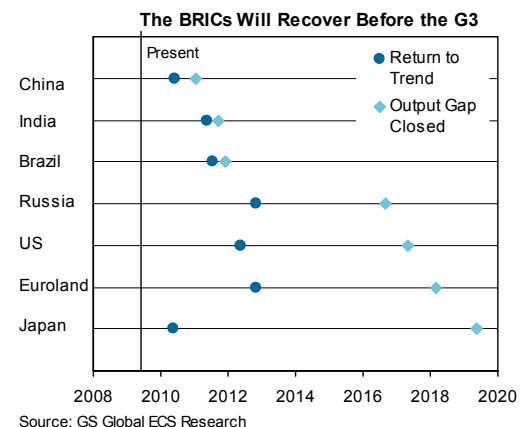
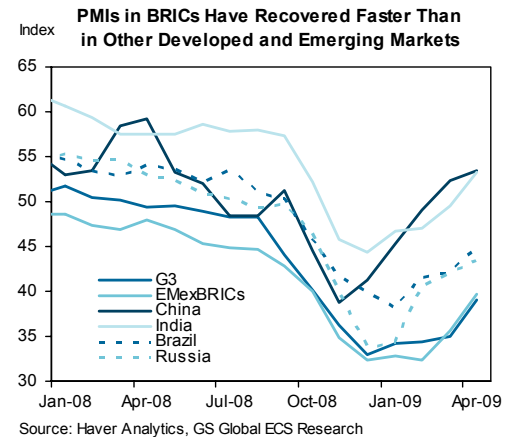
Alex Kelston
alex.kelston@gs.com
+1 212 855 0684

There is growing evidence that the global business cycle has begun to stabilise. Positive signs have been apparent in most headline PMI indices, as well as in their 'guts'. The BRICs have led both the advanced economies and the rest of the emerging world in this process. We expect resilient domestic demand growth from emerging markets, particularly the BRICs, to be one of the driving forces of an export-driven recovery in advanced economies over the next couple of years.

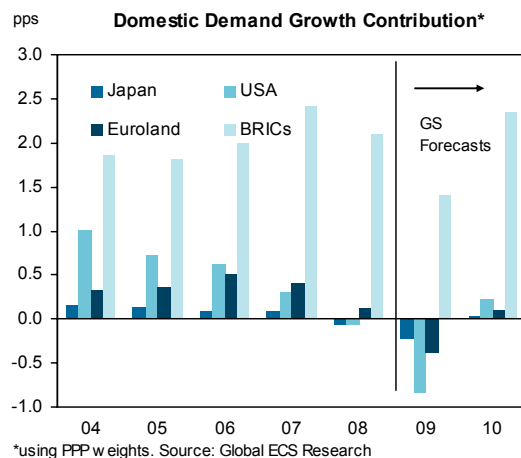
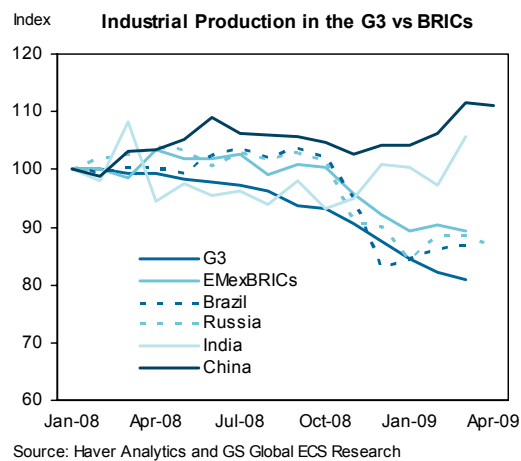
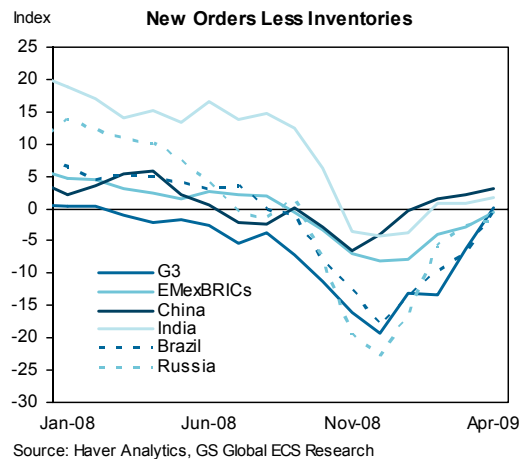
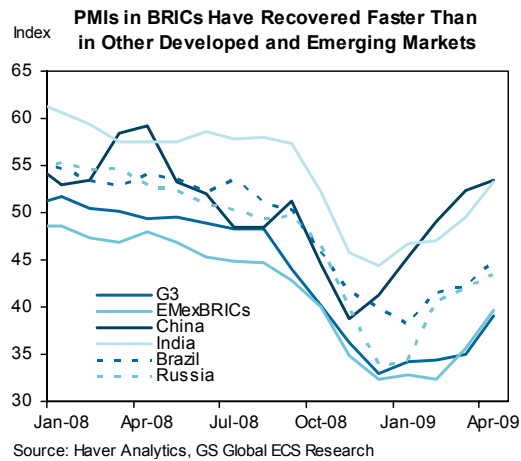
As we have discussed in various publications, most recently *Global Economics Weekly 09/19* 'The Race to Trend Growth', there is growing evidence that the global business cycle has started to stabilise. Most headline PMI indices, as well as the underlying components, have shown signs of stabilisation, with the BRICs leading both the advanced economies and the rest of the emerging world in this process.

We expect China to lead the global recovery, returning to trend growth by mid-2010, much earlier than any other country. India and Brazil should return to trend in 2011, also more rapidly than most other emerging markets. In addition, while the momentum is strongest in China, all three countries are poised to close their output gaps quickly. This rapid narrowing of output gaps is due to recent above-trend growth as well as the relatively quick return to trend growth forecast for these countries. Russia lags the other BRICs as it is set to return to trend growth in 2012, close its output gap much later in 2016.

We expect resilient domestic demand growth from emerging markets, and in particular the BRICs, to be one of the driving forces of an export-driven recovery in advanced economies over the next couple of years. As we begin the recovery phase, how quickly individual countries return to trend growth and close their output gaps is likely to be an important factor in the market.



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BRICs' PMI Recovery has Outpaced Rest of the World

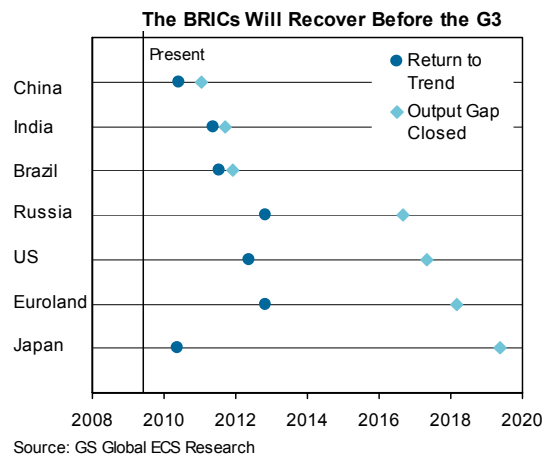
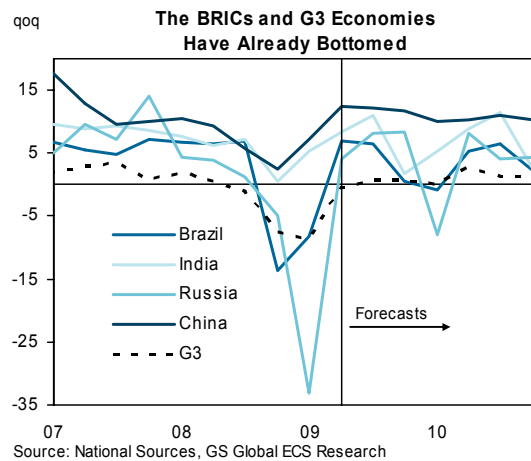
- As we have discussed in various publications, most recently the *Global Economics Weekly 09/19* 'The Race to Trend Growth', there is growing evidence that the global business cycle has begun to stabilise. Positive signs have been apparent in most headline PMI indices, as well as in their 'guts'.
- The BRICs have led the way. China's PMI bottomed in November, earlier or as early as any other economy, and has seen a strong recovery since. While the bottom in the PMI for Brazil and Russia lagged those in India and China, the rebound in each of the BRICs has outpaced that in other emerging markets and in the advanced economies.
- Consistent with the improvement in headline, BRICs' new orders less inventories also bottomed earlier than in the G3. In particular, new orders less inventories rebounded strongly in April, as the small increase in inventories was substantially outweighed by the increase in new orders.
- This improvement in headline PMIs and their underlying components has also translated into signs of stabilisation in the industrial production sector in emerging markets. IP in China improved dramatically in March to 8.3%yoy from 3.8%yoy in February. Although the 7.3%yoy IP growth in April was lower than the March figure, the latter had an exceptionally high base and April's growth level is still significantly higher than the level in 1Q2009 as a whole (5.1%). We believe China's growth recovery remains intact and that the dip in April is likely to be temporary.
- For the other BRICs, the industrial production number is mixed: Brazil is showing signs of stabilisation, while India and Russia continue to fall. However, we expect an uptick in the next release (April print) in India, as well as an upward revision of the March number.

Domestic Demand from BRICs/EM Key in the Recovery Process

- We expect the resilient domestic demand growth from emerging markets, and in particular the BRICs, to be one of the driving forces of an export-driven recovery in advanced economies in the next couple of years. This is especially important because our economists envisage a contraction of -3.0%yoy in domestic demand growth in the advanced economies in 2009.
- With the key advanced economies contributing negatively towards domestic demand growth in 2009 and barely positively in 2010, the contribution from the BRICs, mainly China, will be instrumental in maintaining world domestic demand growth at -0.8% in 2009, better than the severity of the global recession would imply. In the same way, world domestic demand is likely to return to a healthy growth rate of 3.4%yoy in 2010, mainly on the back of a significant contribution from the BRICs.

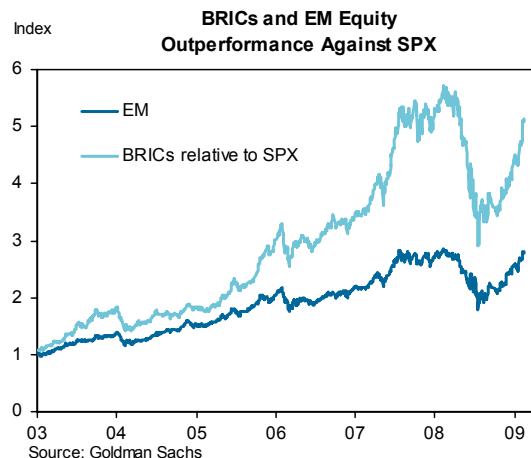
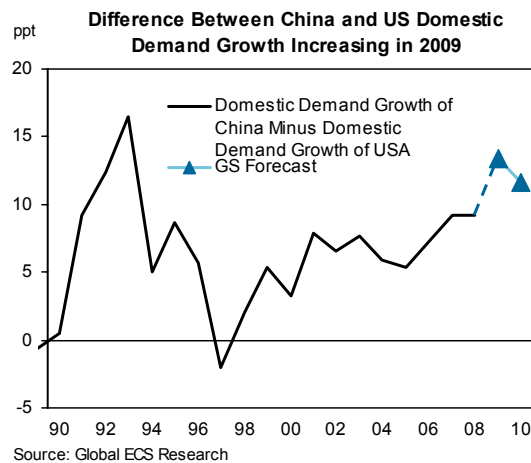
BRICs Lead Developed World on the Road to Recovery

- The BRICs and the G3 economies have already bottomed, either in 2008Q4 or 2009Q1. In any economy, two important milestones on the road to recovery are the return to trend growth and closure of the output gap. On average, emerging markets as an aggregate are likely to see a return to trend growth about six months before advanced economies. EMs should close their output gaps almost two years on average before advanced economies.
- Of the BRICs, we expect China to lead the way, returning to trend growth by mid-2010, much earlier than any other country. India and Brazil should return to trend in 2011, also more rapidly than most other emerging markets. In addition, while the momentum is strongest in China, all three countries are poised to close their output gaps quickly. This rapid narrowing of output gaps is due to recent above-trend growth as well as the relatively quick return to trend growth forecast for these countries. Russia lags the other BRICs as it is set to return to trend growth in 2012, close its output gap much later in 2016.
- Estimates of the timing of this process (especially the narrowing of output gaps) are subject to a wide margin of error. So we are more confident about the relative rankings of these transitions than about absolute timings. The relative rankings indicate that the BRICs will both return to trend growth and close output gaps ahead of the developed world.



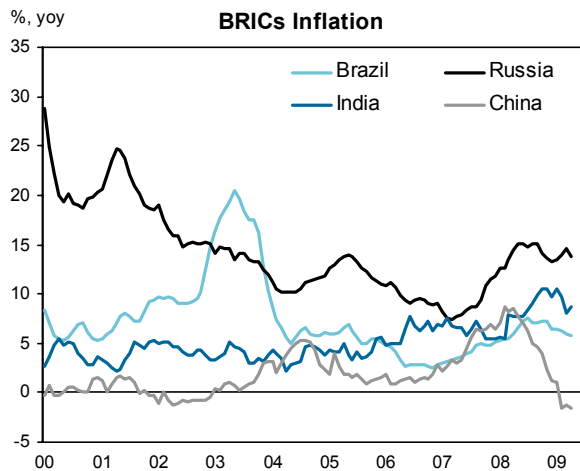
Domestic Demand Growth and Output Gap Recovery Story Supports our Recommended CHICON Trade

- We have recently added long China Cyclical, short US Consumer Cyclical (CHICON) to our recommended Top Trades for clients. Our strategists' view that Chinese demand growth is likely to be both stronger and more sustainable than the US consumer growth recovery drives this trade. This is consistent with our finding that China will lead in the race to trend growth, and the US will probably lag in the recovery phase. Domestic demand growth is likely to be stronger for countries that are closer to bridging the output gap than countries that are lagging behind.
- As we begin the recovery phase, the lack of synchronicity in how quickly individual countries return to trend growth and close their output gaps is likely to be an important factor in the market. A number of stockmarkets, especially in the BRICs, have already seen large moves this year. After falling since the middle of last year, EM equity market outperformance has again risen significantly, and BRICs equity markets have taken the lead here.
- However, we are also conscious that a number of stockmarkets—especially within the EM space—have already seen large moves this year and we would recommend a more discriminating stance going forward. Among the BRICs, our portfolio strategists are overweight in China and neutral in India.

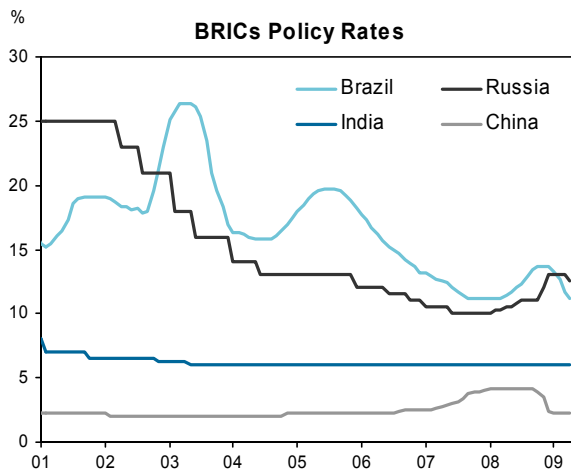


Economic Activity in the BRICs

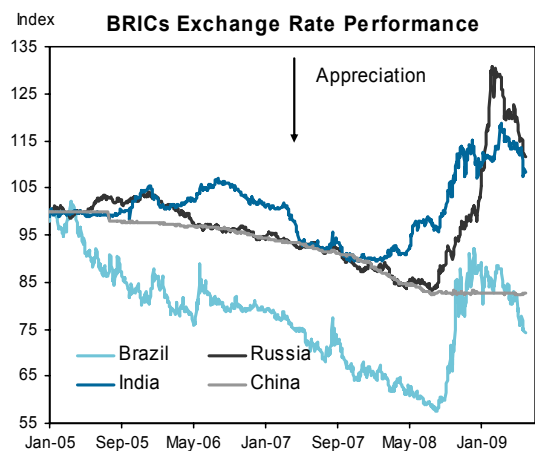
Headline CPI in China has remained negative for the last few months. Meanwhile, inflation in Brazil has slowly but steadily declined the last six months.



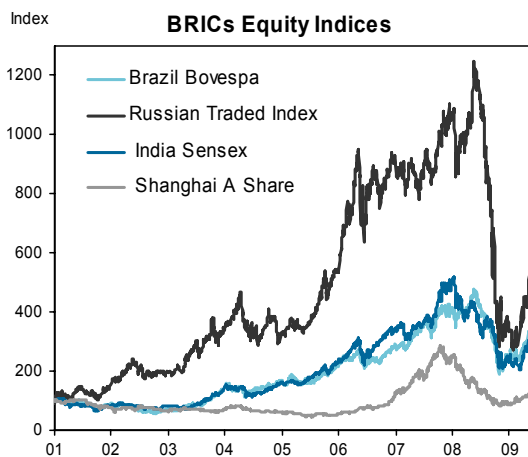
The Central Bank of Russia cut rates on April 24th by 50 bps and more recently cut by another 50 bps in May as inflation decelerated in April.



The recent rally in commodities and risky assets has been supportive of the Ruble. Similarly, the BRL has and INR have also appreciated this month.



Since the unexpected big victory for the Congress-led UPA government in India, the India Sensex has surged over 17%.



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