

## Market Wrap-Up

Warwick Economics

Summit Edition

February 15th, 2013



Warwick  
Investment  
Club

## The WIC Market Wrap-Up

The WIC Market Wrap-Up is published fortnightly by the Warwick Finance Societies' (WFS) Warwick Investment Club (WIC) Research Team. Receive the Wrap Up via email newsletter by joining the WFS, or look out for current and archived issues on [www.wfsocieties.com](http://www.wfsocieties.com).

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## FX Strategy

**EUR: A Year of Two Halves**

By Daryl Chia, Editor-in-Chief

Much like 2012 was a year of two halves where risk-off was the order of the day up till July 2012, 2013 is likely to see much of the same dynamics – but in reverse order. The pickup in financial conditions and surprising resilience in global economic data going into H2 2013 meant that some of the riskiest assets were the best performers for 2012. Further still, as financial conditions eased (figure 1 and 2) equity and FX volatility hit 5-year lows while cross-asset correlations as measured via PCA reached pre-crisis levels. With such developments, idiosyncratic differentiation has begun to prevail in FX, with yield differentials and economic fundamentals taking on increasing in importance.

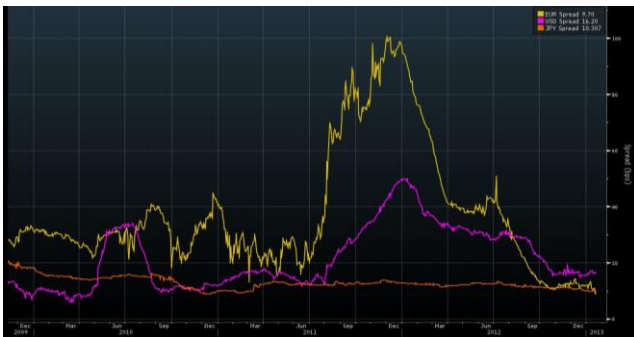


Figure 1: LIBOR-OIS reflects easing financial conditions in H2 2012



Figure 2: The S&P500 and MSCI Europe powering ahead in H2 2012

Still, with extreme positioning in FX majors including the EUR, JPY and AUD, and with significant tail risks on the horizon, FX crosses are highly exposed to headline risk and

will likely see a reversion to risk-off trading as these risks materialise in H2 2013.

**EUR: Short-term bullish, Long-term bearish**

*EURUSD Spot: 1.34, H1 2013 Target: 1.40, 2014 Target: 1.21*

The sharp reduction in EZ break-up risk – from 73% in July to 25% in December 2012 based on Sentix GmbH surveys – and the approximately 300bp narrowing in peripheral spreads over Bunds since Draghi’s ‘whatever it takes’ OMT speech has buoyed the EUR in virtually all crosses and have earned the Greece Athex, German DAX, European financials and peripheral sovereign debt the title of best performing assets in 2012. Given the momentum in portfolio inflows into the EZ that are supporting risk-sentiment in the abovementioned assets, and the sharp correction in Target 2 balances seen since H2 2012, the EUR’s rise from 1.21 to 1.34 against the USD (exhibit 3) from July 2012 to date is likely to carry on in for H1 2013.

Still, poor economic conditions, lack of competitiveness in the periphery worsened by a strong EUR, slow implementation of structural reforms and banking, fiscal and political union in the EZ, along with headline risk of the Italian and German elections in February and September respectively and the political instability of the Greek coalition government could well take the market back to risk-off mode in H2 2013 and serve as a severe hit to the EUR, of which speculative long positioning is already stretched.

**H1 2013: Outlook Benign**

The EUR will likely continue to be supported in the near term. While speculative long positioning in the EUR and short positioning in the JPY remain stretched – the JPY is now an important funding currency for yield pick-up in EUR assets given inflation targeting and Abe’s ‘Rooseveltian Resolve’ – leads to the EUR being vulnerable to headline risk, economic prints and political headline risk is likely to remain supportive in H1 2013.

The February Italian elections are likely to see the Democratic Party and Left Ecology Freedom form a strong majority in Senate, resulting in a pro-EZ and pro-reform government that in fact will include Mario Monti. Still, on the political front, German elections in September promises

to maintain Merkel's support for Greece via bailouts and OSI in the near term in return for relative stability in the EZ. Then, in terms of monetary policy, the ECB's OMT promise promises to maintain Spain and Italy's market access – and the fact that the OMT programme and ESM may not have to expend a single cent – while Draghi's relative hawkishness and lack of desire for currency intervention amid EUR strength is a boost to the EUR and its carry interest differential against DM currencies immersed in ZIRP.

Outside the Eurozone, newly introduced Abenomics in Japan – responsible for powering the EUR/JPY cross into an unabated 30% rise since July 2012 – is responsible for a sizeable amount of portfolio inflows into the EZ as the JPY's increasing status as a carry currency, evident from correlations with high yielding FX and AxJ currencies, further support the flight of capital. Also, partial resolution of the U.S. fiscal cliff and the surprisingly strong manufacturing figures and property market stability despite cliff-uncertainty going into Q4 2012 mean that negative economic surprises will remain less probable in H1 2013. While US Q4 2012 GDP came in at -0.1%, negative for the first time in 3 years, seasonal factors were largely the cause and as such, Q1 and Q2 2013 are expected to deliver GDP growth in the 2-2.4% range. Also, relative stability in Chinese production and property prices point to signs that hard landing potential, well potentially resurgent in H2 2013, will remain subdued for now. Such developments provide positive external traction and a backstop for risk and a EUR correction in the near term.

### H2 2013 - 2014: Tail Risks to Re-emerge

While financial conditions have improved across the board – save for the contraction of credit in the real economy within the periphery – economic conditions have remained weak and are expected to stay so in 2013. With EU unemployment and youth unemployment at 11.8% (figure 4) and 24.4% respectively, the consensus EZ GDP forecast for 2013 stands at -0.2%, with German and French output remaining stagnant and peripheral output continuing its sharp contraction. Amid on-going front-loaded fiscal austerity, poor EZ-wide industrial production figures persisting toward the close of 2012 and the financial market's and core-EZ politicians' little regard for the high fiscal multipliers (which the IMF has warned of when

countries deleverage simultaneously), the risks to consensus forecasts for the year lies to the downside. Such risks are likely to materialise in H2 2013.



Figure 3: The Euro – insufficiently weak

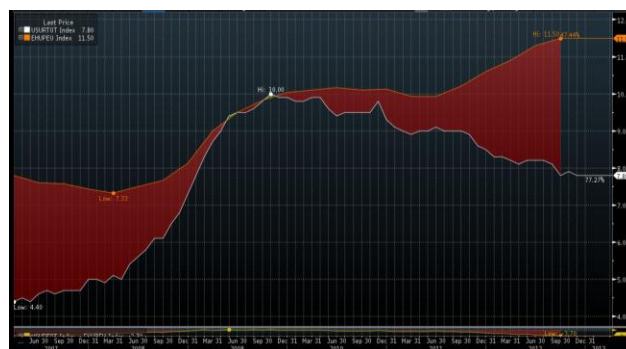


Figure 4: US and EU unemployment diverging  
Source: Bloomberg

Further contributing to the weakness in and lack external competitiveness of the periphery, the strength of the Euro considerably negates the gain in competitiveness achieved albeit at an extremely slow rate via structural reforms. Since the Euro started trading at 1.17 against the USD in 1998, unit labour costs in the periphery have risen approximately 30%, while the Euro has in fact adjusted in the 'wrong' direction, appreciating by 15% to 1.35 today. The Euro hence remains highly overvalued by such analysis and also when seen through a PPP model, hurting EZ exports and accelerating the currency's demise. The strong Euro should hence feed into a further deterioration of EZ-wide conditions later in 2013 and bring to the fore the unresolved structural problems in the EZ, the inability of Greece and Spain to meet its deficit targets for 2013 and 2014 and the instability of the Greek coalition government on one hand vis-à-vis a reduction in the core's willingness to perform OSI on the other as the German elections tides

over. Debt restructuring, OSI and PSI are likely to take centre stage again come H2 2013, during which market confidence will be exposed to the vagaries of politicians and their electorate, increasing the likelihood of a disorderly breakup or loss in market access.

In the longer run still, as the EZ crisis unfolds and promises to remain durable, the EUR shall continue to lose backing from currency reserve managers. At present, the EUR share of EM central bank reserves have fallen from 31% to 25%, levels last seen in 2002. Given such mid and long term prospects, attractive long positions against the EUR are the USD and CHF (of which is presently declining against EUR from its SNB imposed cap), and less so the AUD, CAD, and GBP (due to their positive correlation with risk-appetite and carry interest compression in the former). Strategy with regards to these FX Majors will be discussed in future editions of the Warwick Finance Societies' Market Wrap Up. **WIC.**

***About the author:** Daryl is a second year BSc Mathematics, Operations Research, Statistics and Economics (MORSE) student at the University of Warwick. An avid macro investor, Daryl began managing a global macro portfolio in 2007 and has published research in the International Journal of Economics and Finance and the Journal of Finance and Investment Analysis. He has also completed the CAIA, FRM, PRM and IMC professional accreditation exams and runs a finance blog, darylchia.com.*

*As the Editor-in-Chief for the WFS' WIC Research Team, Daryl is the point of contact for those looking to write for Market Wrap Up. Undergraduates and postgraduates with keen interest in the markets may apply to the team's Analyst Programme; candidates with prior research experience will be considered for a Co-Editor role. Do get in touch with him at d.chia@wfsocieties.com if you are keen on contributing.*

## The World Economy

# Global Challenges in 2013

*By Melson Chun*

Let me start off by wishing all our fervent Chinese readers a prosperous lunar new year in the year of snake. Going forward, I do believe we need all the best wishes in the world, both in understanding the intricacies of the challenges facing us in the year ahead and making profits from the financial markets if you are a small-time investor. While we might have started 2013 with an ebullience that have not been witnessed for a long time, I do believe the optimism have lasted way beyond it should have. The fun is almost over and the chickens are coming home to roost.

General business sentiments across the world have propelled the leading equity indices to record levels. The S&P 500 index is just shy of its peak reached in 2007. The Nikkei 225 index weekly buying momentum, as of 8 February, registered an index value of 79, a value that signifies that the equities are generally overbought and that a correction is way overdue. This comes at the back of positive sentiments from numerous fronts – the reduction of tail-risks from the Euro-zone periphery countries, the determination of the new Japan government to bring the country out of its prolonged deflation state of affairs and the US legislators resolving the impending fiscal cliff.

The birds and bees do it when the weather gets warmer. Similarly, when times get better, company leaders often get the urge to merge and acquire. From a purely financial point of view, the cheap credit and huge piles of cash most major corporations are sitting on make it an ideal time for deal-making. Yet things might not be as straight-forward as it initially seems due to growing regulatory risks. For example, European governments seem willing to support national brands, as evidenced by Italy's recent government fund to 'invest' in companies of national interest. China's antitrust arm also reserves the right to review any deal in which the combined Chinese sales exceed USD 63 million. Going forward, we might witness a more subdued economic landscape, in the light of these uncertainties from governments across the world.

That is clearly not all. The mounting tension between Japan and China is also a huge cause for concern. The Japanese

government recently made a statement, saying that it would raise defence spending close to 1% of its annual GDP. While China's defence spending has largely remained at 2% of its GDP, the increase in armament makes it more likely that any future stand-off between these 2 major powers become an armed conflict. To illustrate its impact, Japan has been registering monthly decreases in trade balances ever since the disagreement with China got more heated. It is clearly not in either or the world's interest for the tension to escalate, especially when growth in China is picking up and Japan has its own share of domestic issues to tackle.

In the United States, the start of the new year have saw how the country narrowly escaped a series of automatic tax increases and spending cuts that would almost certain plunge the country back into recession. Yet, the short amount of time that Tax Reform Act has bought is unlikely to be sufficient for any meaningful long-term reduction to be made. The Republicans in the House know that they are a defeated force and only keep the appearance of poking and prodding for more deficit reduction. The CBO forecast that the average monthly decrease in federal spending between March and September of USD 6 billion a month would show itself almost immediately by shaving off close to 1% of the quarterly economic growth. It is indeed time for the politicians to muster political courage to put in place a long-term budget that would put the country back onto a sustainable path of growth. The press have reported the perpetual impasse to death.

For the average investor, all these headlines mean that the financial markets might constantly be flung into a topsy-turvy state of affairs. While the liquidity central banks across the world have kept the financial markets relatively afloat, it is unsure how events might unfold when this sugar-high is removed. It is also uncertain how central banks around the world are going to get rid of the massive balance sheets that they have accumulated as a consequence.

The indirect devaluation of the Japanese yen has accumulated massive criticisms from Germany and other major economies around the world, and while it is likely that the pace of depreciation might decrease as we approach the G20 meeting, it is also uncertain how events might prevail subsequently. Of course, investing is always

done with a horizon in mind, but given the plethora of challenges that are still unresolved, I definitely still favour a shorter term investing horizon.

I will leave the political challenges in the Euro-zone aside for now. Have a great year ahead. **WIC.**

***About the author:** Prior to university, Melson was working in an upstart hedge fund with USD 10 million worth of AUM. Having passed 2 of the PRM qualification, he specialised in bottom-up fundamental equity analysis and helped refine the firm's trading strategies. In 2012, he was one of the six selected to represent the United Kingdom in the Deloitte international consulting case competition in Athens. His other experiences include a research stint at Singapore's nano-science laboratory, which hauled a Gold medal at a regional science competition. In his free time, Melson trades in the financial markets, mainly focusing on global currencies and futures, and reads broadly.*

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## The US Economy

# How can America respond to the Fiscal Crisis?

*By Andrei Damaschin, Co-Editor*

Washington's gamesmanship over the fiscal cliff raises a critical question: does the US have budget rules and processes that are adequate for the nation's looming crisis? The 16th amendment, which blessed the taxation of income, opened a fiscal Pandora's box. From that emerged a small but hungry federal government, initially taking no more than 7% of the annual income of multi-millionaires. One hundred years later, it is taking 40% from the incomes of citizens who will never be millionaires.

### Budgets, deficits and debt

Today's budget debate should raise important concerns about fairness, too. High and rising national debt levels will sap future economic growth and portend sharply rising tax burdens and/or reductions in basic public goods such as defense, infrastructure, and scientific research. The

budget rules don't account for short-sighted politicians, an omission that can easily be fixed.

Economists have long worried about unbalanced budgets. These warnings, coupled with countless plans to fix the budget, have been ignored while debt has piled up. A decade from now, under the Congressional Budget Office's alternative (i.e. realistic) scenario, the debt-to-gross domestic product ratio is set to rise above its second world war level. And what the CBO calls the "explosive path of federal spending" will add the equivalent of 3% of GDP to the national debt each year this decade, followed by 4 - 5% in the next.

The federal government has resolved six major debt build-ups over the course of the nation's history. Putting aside the Great Depression, debt spikes were driven by war – the revolutionary war, war of 1812, American civil war, and the two world wars. In contrast, today's debt has been building up for decades and cannot be pinned on a singular event. The US is facing is an entitlement crisis, which strains its out-of-date budget processes and raises serious questions of inter-generational fairness.

### Entitlements

In 1973, the federal government spent 17.6% of the nation's GDP. Of these funds, 3.7% of GDP went to Social Security spending, 1.1% was for health care, leaving 9.9% for discretionary spending (including defence). This year will be quite a contrast. The federal government is projected to spend 21% of the nation's GDP, not counting interest payments on the debt. Of that spending, 5.1 percent of GDP will go to Social Security, 5.6 percent will be for health care entitlements, leaving only 7.8% for discretionary spending.

This trend – entitlements crowding out other government responsibilities – is projected to continue. The rising cost of Washington relative to nation's economy darkens the debt picture considerably. While on this much nearly everyone agrees, Washington has not made serious progress towards bridging the fiscal gap. Making progress is essential, and it requires rethinking the rules; not simply the policies.

### Revenue generation

While my preference would be for budget imbalance to be addressed entirely by reducing the growth of federal spending, a consumption tax does provide a means for raising additional revenue if the political process supports a larger government. A democracy should not be constrained in its use of revenue increases or spending reductions to achieve balance. But the use of the consumption tax ensures that all Americans know they are paying for the rising cost of broad-based entitlement programs. As with the case made for the 16th amendment, the US Congress could retain a modest wage tax for high earners to promote fairness.

The use of a consumption tax would not imply that the US Congress is required to support higher rates of consumption taxation to pay for rising entitlement spending. On the contrary, the US Congress – and by extension the public at large – would be compelled to choose among reducing entitlement spending (say, by slowing benefit growth for more affluent households), reducing discretionary spending (say, on defence and education), or increasing taxes in response to higher projected spending. The adjustments could take place over several years to avoid amplifying the business cycle. And Congress would have to decide whether to initiate the new process at current levels of federal deficits and debt or, in addition, to reduce the debt-to-GDP ratio from its present level. The roots of the income tax as a revenue raiser and tool to increase fairness could be better met with a reformed tax code raising the bulk of federal revenue from consumption taxation, while imposing a progressive labor income tax on high earners for fairness.

But this discussion should not crowd out as even more important one of how to restore budget discipline before both economic growth and fairness to future generations are irrevocably compromised. The combination of a revised budget process and the introduction of a broad-based tax as an instrument offer a way to reset the nation's fiscal course while there is still time to do so. **WIC.**

## UK Monetary Policy

# Wind of Change

By Wodzik Kicinski

Just as a mutation of a deadly virus, which cannot be cured with existing medicine, the financial crisis has shaken pillars of the economic system forcing policy makers to go beyond conventional responses for downturns. With interest rates cut to the historic lows, monetary policy makers fell into a liquidity trap, and even repeated series of quantitative easing (QE) by major central banks could not restore pre-crisis growth levels. To fight the crisis central bankers started not only to use innovative policy tools but also begun to change the framework according to which monetary policy has been conducted so far.

In December, Fed for the first time in its history tied its rate setting decision not only to inflation level but also to the unemployment rate. Ben Bernanke, Fed's Chairman, announced that until unemployment falls to 6.5% and inflation does not exceed 2.5% (2% is Fed's long run target) Fed will keep the interest rates near zero. In Japan, newly elected Prime Minister Shinzo Abe influenced the Bank of Japan to adopt a higher inflation target, hoping to spur Japanese growth, which has stalled for decades now. And finally also in Britain, Mark Carney who will replace Sir Mervyn King as the Governor of the Bank of England (BoE), is expected to revolutionise the way monetary policy is conducted.

### Monetary policy framework: principle and reality clash

Monetary policy has two objectives: the first is to stabilise inflation and second to try to eliminate the output gap. Views on relative importance of these two vary. In Britain, for instance, the emphasis is put on the first one, in contrast to the United States where the mandate of the Federal Reserve covers both. This is because so far Britain adopted "flexible inflation targeting", which reconciles both principles. Trying to hit the inflation target in two years, which is how the BoE interprets flexible targeting, implies that when the inflation target level is achieved it will also lead to closing the output gap, because stable inflation is related to zero output gap.

However recent British experience demonstrates incompleteness of this view. For the past four years inflation was above BoE's 2% target and output stayed below its sustainable level. The failure of monetary policy to match its objectives with reality indicates a need for change of the current system.

There are high market expectations for policy change for the incoming BoE's Governor, who so far has held the position of the Governor of the Bank of Canada. With an extraordinarily severe fiscal squeeze, interest rate at a record 0.5% low, and less scope to increase asset purchases from already high £375 billion level, because of inflation above 2% target it might seem that Mark Carney has a limited scope for action. But the Canadian is regarded as a banker with an initiative and a supporter of an active role of the central bank to reinvigorate the economy. Not yet in the new seat, Mr Carney has already begun a debate on reforming monetary policy by series of recent public speeches.

### New cures?

Saying in a speech in Toronto in December that targeting nominal domestic output is potentially a "more powerful" tool for central bankers in a liquidity trap, Carney implied that he gives thought to NGDP growth targeting. A 4.5% NGDP target would imply central bank creating money by variety of methods, such as purchasing bonds, until nominal GDP hits the target, with no particular emphasis on what share of the number is generated by real growth and how much is due to inflation. According to proponents of such measure like Christina Romer, chairwoman of President Obama's Council of Economic Advisors or Paul Krugman, Economics Nobel Laureate, NGDP target would increase expectations of future growth and induce economic agents to spend more.

However, NGDP targeting opponents draw attention to the fact that it undermines the mandate of preserving price stability, because with a nominal output growth target it is harder to determine how much of the future growth will be in fact real. It might hence result in less central bank credibility and more volatile inflation expectations. Key criticism is that Britain might be suffering from a permanent loss of output and productivity (labour productivity is still around 2% below its pre-crisis level).

Such an explanation of the crisis rather than a cyclical lack of demand implies that the UK economy is more prone to inflation at weaker growth rates than before so NGDP target will most likely result in little real growth and more inflation.

Indeed, speaking before a parliamentary committee last week, Carney refrained from his support of NGDP targeting, admitting that he is far from convinced of its merits as a monetary policy tool, however he repeated importance of “escape velocity” a term he first used at the World Economic Forum in Davos in January. Although the catchy phrase was not really explained, analysing Carney’s responses at the meeting, we can expect the governor to follow Fed’s path of increasing the importance of central bank signalling through measures such as: conditional commitments to keeping interest rates low for a certain period of time or announcing Fed-like thresholds for inflation and unemployment that have to be met before tightening of the monetary policy. So the BoE power shift implies more dovish monetary policy, expectations of which have already decreased the value of sterling compared to other major currencies.

The biggest challenge for Carney is not really reform of BoE’s proceedings but gaining market confidence in his actions. Instead of a new cure British economy might just need a placebo to start believing in a recovery and to finally grow. With a change of the BoE’s discourse thorough an initiative for bolder actions the first foreign Governor of the Bank of England might be on the right track to achieve that. **WIC.**

*About the author: After reading Wodzik’s article you might also see him during the weekend among members of the Warwick Economics Summit Talks Team. These two functions reconcile his passion for economics and debating. He enjoys discovering complexity of financial markets as an Analyst of the Warwick Investment Club and mastering public speaking skills in debating tournaments, like World Universities Debating Championship in Berlin. In his little free time Wodzik trains fencing and prepares for his first marathon.*

## The Future of Financial Regulation New Rules, New Game

*By Elliott Anderson, Co-Editor*

Despite conflicting data suggesting the US economy was simultaneously shrinking and forging ahead at the end of 2012, regulators are pushing ahead with drafts and proposals to curb risk in the financial industry. Institutions are preparing to play a new game, one where the Eurozone would net €35bn from financial transaction and cheating will be punished. Let’s look at the two key regulatory works in progress and conclude with issues facing regulators.

### *Solvency II*

Solvency II is a new solvency regime (*the ability to meet maturing obligations as they come due*) for all EU insurers to be implemented by 2012. It is a directive aimed at harmonising rules on the minimum levels of solvency, or financial resources, that insurers and reinsurers must have to cover their risk exposure, and has a three-pillar structure covering quantities requirements, supervisory review and market disclosure.

In the 2009 Investment Management Association survey, *insurance assets accounted for 23% of the total assets managed in the UK*, hence its relevance to the finance industry. Investment managers owned by large insurance companies are beginning to be engaged in their Solvency II implementation projects and are identifying a number of key impacts on their investment impact operations. However, it does not seem as though many other investment managers have started assessing the potential impact on their business. Investment managers will have to re-assess their strategy with respect to the insurance market.

The new piece of regulation has significant implications for how risks are evaluated, how capital efficiency is judged and how and where insurers choose to compete. This includes potentially higher capital charges for policies with volatile or uncertain risk profiles such as guaranteed life products and long tail casualty business, and highlighting

capital tied up in discontinued business. In addition Solvency II is driving companies to reconsider how they structure their operations, for example moving to branch structures for EU business. Solvency II is driving greater integration of risk management and business decision-making.

(More analysis on the integrate implications of the reform available from: PWC/Deloitte)

**CRD IV/Basel III**

Note: Basel III is constantly being reviewed and revised, so certain aspects may be overlooked or no longer relevant.

According to the Basel Committee on Banking Supervision (BCBS), the Basel III proposals have two main objectives:

- To strengthen global capital and liquidity regulations with the goal of promoting a more resilient banking sector
- To improve the banking sector’s ability to absorb shocks arising from financial and economic stress, which, in turn, would reduce the risk of a spill over from the financial sector to the real economy.

**Breakdown of the Basel III proposals**

	Basel III	
Capital reform	Liquidity standards	Systemic risk and interconnectedness
Quality, consistency, and transparency of capital base	Short-term: Liquidity Coverage Ratio (LCR)	Capital incentives for using CCPs for OTC
Capturing of all risks	Long-term: Net Stable Funding Ratio (NSFR)	Higher capital for systemic derivatives
Controlling leverage		Higher capital for inter-financial exposures
Buffers		Contingent capital
		Capital surcharge for systemic banks

Source: KPMG

An excellent interactive flash by PWC explaining in greater detail the formulas and ratios that are to be implemented.

**Limitations**

On key difficulty is ensuring the regulation is adhered by all key countries to avoid havens and imbalances. Governments on both sides of the Atlantic are also looking

to strengthen their investor protection efforts. Enforcement against mis-selling, insider dealing and fraud has also been stepped up across the globe, from Hong Kong to London and the US. In 2010, Congress duly passed the Dodd-Frank Act, which included the requirement for higher capital for foreign banks in the US – mainly hitting Barclays and, above all, Deutsche. An additional \$20bn of capital would have to be injected into DB’s US business – an expensive one-off bill followed by a permanently less efficient balance sheet. The worry is that short deadline will mean banks will rush for assets whilst taking a permanent hit on their balance sheet and profitability.

Furthermore, top bankers and lawyers are already finding loopholes within regulations. US banks led by JPMorgan Chase are offering a new type of debt product that will help them to skirt new rules requiring them to hold war chests of liquid asset. Thus far, co-operation seems to have been achieved as certain rations and deadlines have been pushed back as institutions spend considerable resources to adapt their organizations and operations to the new game. WIC.



*About the author: Elliott is a 3rd year management student, currently co-editor and writer for the wrap-up. With experience on both the buy and sell side of the finance industry, Elliott uses a finance 101 approaches to tackle obscure and dynamic issues. Whilst worried about inflation and currency wars, he believes that there is still great potential for innovation and creativity in the finance industry. Elliott hopes you liked our articles, and recommends you sign up to receive the bi-weekly editions to quench your curiosity for the markets.*

## BRICS

# Dreaming with the BRICS: The Revised Path to 2050

By Swasti Gupta

Back then, in a bold move to pin down growth in emerging markets, O'Neill predicted that the combined economies of Brazil, Russia, India and China would overtake the G-8 countries by 2039, offering huge growth opportunities for investments. With 40% of the world's population and 25% output, is this dream the pathway to reality?

In its first decade, the prophecy appeared to be correct when the BRIC bloc grew twice as fast as the world economy, at 6.6% (per IMF). Now this gap has been closed down to 1%, with emerging market funds withdrawing investment from the BRIC bloc as a consequence of their slowdown.

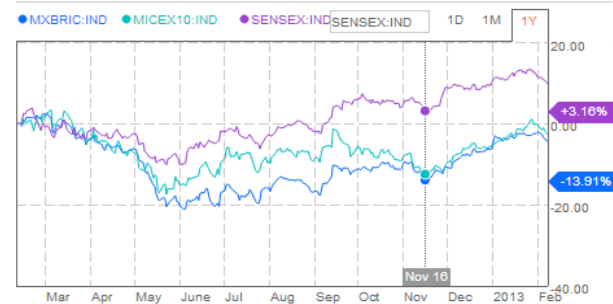
## MSCI BRIC

The MSCI BRIC index, a free float weighted equity index combining components each of the respective country equity indices, has failed to keep up with other emerging market economies for a third consecutive year, falling 9.2% over the period. The biggest setback for BRIC exponential growth came with the 2008 financial crisis. The contraction in world demand and effects of the global recession were hard hitting even for the BRICs, a consequence of their integration into the global economy. However, some export focused countries such as China suffered more, while others such as Brazil with comparatively less developed financial systems and trade, and more reliance on the domestic demand for growth were less exposed to the crisis.

Moreover, the crisis did highlight the growing cracks in the BRIC foundation. In particular, the indices for each respective country which once moved in tandem with each other, no longer seem to do so. Certain countries, like India, have continued to grow at the pace highlighted by

O'Neill whereas others, like China and Russia have slowed down (as shown by the graph below). Data from Bloomberg supports this, showing that the SHCOMP's 30 day correlation with the MSCI BRIC index dropped from 0.8 at the start of 2012 to 0.2 earlier in January. This recent turn has put into question as to how long such exceptional growth can be sustained for.

Index Chart for MXBRIC >>



Interactive MXBRIC Chart >>

Index Chart for MXBRIC >>



Interactive MXBRIC Chart >>

In essence, investors looking for exposure to the emerging markets for active or passive managements, ETFs and custom indices may improve performance by zoning in on individual growth countries rather than BRIC denominated benchmarks.

## So, where is the growth?

EPFR Global data records a \$70 billion inflow into emerging market economies, however since 2010 BRIC funds have recorded a net outflow of \$8.3 billion. There is strong investor sentiment around growth opportunities in emerging markets, but this is not restricted to the BRIC bracket. Two countries comparable to but not included in the BRIC status were South Korea and Mexico, now

forming part of O'Neill's new MIST acronym alongside Indonesia and Turkey, each comprising 1% of world GDP. With better financial systems, and membership of the OECD, they were considered too well developed to be comparable to the BRICs.

MIST accounts for 73% of the output of the wider the N11 (next eleven) countries. Indonesia grew by a staggering 6.1% in 2012, outperforming India (5.3%). Although though this level of output cannot match that of China (7.9%), some predict MIST countries are starting their period of growth whereas BRIC countries have started cooling down. The prophecy of the BRICs overtaking the G-8, may yet need to be revised again, in particular growth opportunities in emerging markets are now better than ever. **WIC.**

*About the Author: Swasti Gupta is a second year economics student at Warwick university, with specific interest in equities and global macro. Thoughts and comments are welcome.*

## Renminbi

### China: at it again?

By John Peter Ong

It is no secret that China's "currency management" has been a key driver of its economic growth over the past decade. To its credit, the CNY has appreciated more than 9% against the USD since floating in 2010, and is only undervalued by about 25 basis points in comparison to the offshore Yuan market in Hong Kong, where it floats freely. However, with the People's Bank of China's latest reduction of its central parity rate to 6.2881, one begins to wonder if old habits truly do die hard.

#### Depreciation appreciation

Currency devaluation is frowned upon as it benefits a single country at the expense of its trading partners. As exchange rates fall, exports become cheaper relative to foreign goods and imports become dearer relative to local

products, boosting net exports and thus encouraging GDP growth. This effect is especially pronounced for China, which manufactures goods that have relatively price elastic demand. In addition, with \$1.1 trillion worth of dollar-denominated US debt on its balance sheet, China has a significant incentive to depress its currency to minimize exchange rate losses.

However, before prematurely condemning China of competitive devaluation, there are several extenuating factors that deserve consideration. First, this measure has been largely reactionary, reflecting the need to mitigate the Yuan's steep 15% ascent against the Japanese yen over the past 4 months, due mainly to Shinzo Abe's aggressive stance on monetary easing. Second, a weaker target rate for the Yuan might reflect an expected appreciation of the USD, where the recent slew of generally positive US economic data has led to capital inflows that have driven up equity indexes to multiyear highs. With the backstory of its largest two trading partners in perspective, the PBOC's decision to weaken the Yuan is understandable, if not justifiable.

#### Time for change

Yet, China should resist the temptation to begin a race to the bottom. Doing so would not only force Mario Draghi's hand, compelling him to reverse the recent rise of the euro, but also harm China's economy in the long run, detracting its efforts to restructure its economy toward consumption-led growth. Currency devaluation promotes export-oriented industries, while discouraging foreign investment directed at internal commerce, since profits are reduced during exchange rate conversion. Furthermore, a weak currency impedes China's movement up the value chain, as producers of lower value products, which tend to have greater price elasticity of demand, gain more from reduced export prices.

Notably, economic restructuring has become an increasingly pressing issue for China. With average annual wages in China rising more than 200% over the past decade and its working-age population shrinking by 0.4% in 2012, the demographic dividends from its baby boomers are quickly giving way to the consequences of its one child policy. As the size of its labor force teeters into inevitable decline, China has to improve labor productivity if it is to

maintain its standard of living and remain globally competitive, underlining the need to transition into higher value sectors. Already, China has managed explosive growth in the automotive industry, but it must continue to pursue economic upgrading if it is to remain ahead of other low cost countries, such as Vietnam.

### **Striking a balance**

While there is an economic case for allowing a modest appreciation of the yuan, the political anxieties that are perpetually entangled with international policies demand attention. To turn a blind eye to a neighbor engaging in currency devaluation could signal indifference, or worse, acceptance that the yuan has been intrinsically undervalued over the last decade. Also, with the recent transition of power in the Chinese government, its officials might not wish for rapid sectorial shifts, which are often accompanied by economic recession and structural unemployment. Whether China manages to address its

numerous conflicting interests coherently is likely to be a primary determinant in its prospects for economic development.

Traditional Chinese medicine focuses on preserving harmony between bodily functions and the outside world. Similarly, China must work out an exchange rate policy that allows its economic mechanisms to interface effectively with other nations, facilitating internal rejuvenation and growth. Medicine is often bitter, but also often necessary. **WIC.**

*About the author: John is a 1st year BSc Economics and Industrial Organization undergraduate at the University of Warwick. He has managed a personal equities portfolio since 2010 and is an analyst on the WIC Market Wrap up team.*

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