HAMILTON POINT
Investment Advisors, LLC
CHAPEL HILL, NC

ANDREW C. BURNS
President/Chief Investment Officer

RICHARD S. WOODS, CFA, CPWA®
Chief Operating Officer

September 2015

Which BRICs Bounce?

*Our 2003 Newsletter **"Hey Queen, This America Thing Could Be Huge"** hazarded a guess at what Columbus may have blurted to Spain's Queen Isabella upon returning from America. We drew an analogy that China's growth would also change the world – and it has. In this Newsletter, we more broadly document the status of the acronymic BRIC emerging market countries of **B**razil, **R**ussia, **I**ndia and **C**hina, and reflect on how recent market turmoil marks a critical inflection point in the ongoing emerging market story.*

We should not lose sight of the fact that roughly 25 years ago—in the short five-year period of 1989 through 1994—amazing politics happened in the world including the fall of the Berlin Wall, the dissolution of the Soviet Union, and reforms which allowed privatizations and capitalistic models to thrive in China. These three events incubated further reforms and opportunities in India and Latin America that have, together, caused the global economy to grow, which has lifted more than a billion humans out of poverty[1].

At the same time, wild swings in commodities (prices rose until recently, largely to feed China), offsetting deflationary pressures from nearly unlimited availability of labor, and benefits from technology have been driving markets. Taken together, this elixir generated annual economic growth over the last 15 years in emerging/developing markets of about 8%, or more than *double* that of major advanced economies[2].

There is evidence though, that internal governance improvement in BRIC countries has not kept pace with economic prosperity. In short, economic liberalization with little political reform exposes extant corruption when growth slows. Most countries realize this, but tough medicine can be disruptive. Let's take each country individually and summarize where it resides on what we call a "governance inflection path."

Watch Your Wallet (Brazil)

Although in recession now, Brazil had exemplary GDP growth due to commodity exports to China and improved labor conditions. The recent slowdown in exports and lower oil prices contributed to the discovery of major corruption at the largest private/public oil company and elsewhere. Anti-corruption demonstrations are routine, President Rousseff's approval rating sits at 8%, and one credit rating agency recently downgraded Brazil to "junk" status.

Vladimir's Kool-Aid (Russia)

This energy rich land has yet to transition away from an oil and gas export economy, instead turning inward and hostile to the West. Putin's response to sanctions following his annexation of Ukraine's Crimea Peninsula has included the banning of many Western products. He has bulldozed mountains of illegally imported cheese and routinely hassles the local McDonalds (a Big Vlad attack?). Though nowhere near as dramatic, Putin's behavior is similar to Russia in 1961 when Khrushchev's anger at two 21-year-olds who smuggled foreign currency and fashionable western-made blue jeans into the country led to their execution by a firing squad. We expect the status quo for continued Russian corruption as they reverse economic liberalization and increasingly cozy up to China.

1) "Towards the End of Poverty." *The Economist.* June 1, 2013.
2) "World Economic Outlook Database." International Monetary Fund. April 2015.

CONTINUED ON REVERSE >

There You Are (India)

Unlike Russia and Brazil, who rely on commodity exports, India is a substantial *importer* of these materials and therefore low commodity prices benefit their economy. The world's largest democracy (1.25 billion people) is messy, but under the fairly new leadership of Mr. Narendra Modi things appear to be improving on the corruption front. One significant logistical project reducing fraud and abuse—the Universal Account Number (UAN)—uses technology to issue every Indian a tax and benefits number. Over 900 million people have been identified, allowing the tracking of all manner of government payments. Having the technology to stop fraud does not mean that culturally imbedded poor habits have disappeared, but our guess is that India sees vast improvement on the corruption scale and steady growth in the coming years.

Get To Work (China)

China's growth has been driven by government spending and an export driven manufacturing bias. In an effort to encourage consumer spending—thus creating a more self-propelled economy—bank lending was relaxed. Unfortunately, this encouraged grand stock market speculation which promptly unwound this year and led to both currency devaluation and desperate "propping up" of stock prices by the government. Fortunately, China has reserves of over $3.0 trillion to support such endeavors. On the corruption front, significant progress has been made including both military and communist party leaders being prosecuted. In order to stay in power, however, most assume that Communist Party leaders must keep domestic employment strong, so we can expect every lever to be used to stimulate growth.

Taken together, we have an inflection point where the news from emerging economies is no longer just about how many dams and airports are built and citizens helped by modernization—but also how these governments are handling the slowdown in global growth and the governance problems it exposes.

Hey Queen, Asia is Still Huge

At Hamilton Point, all of the companies we invest in on an individual stock basis are currently headquartered in developed countries. Some such as **TJ Maxx, CVS** and **HanesBrands** have no emerging market revenue exposure (but source goods there) while most others like **Colgate Palmolive** and **Unilever** do huge business in emerging countries[3]. Accordingly we expect to see slower growth from the latter as those economies adjust. The outside managers we use for direct emerging market equity exposure, generally speaking, have negligible Russian exposure and have reduced their Brazilian equity holdings relative to a few years ago. Interestingly, these managers continue to favor solid exposure to both China and India—something we do not question for long-term investors.

Despite their presumed excitement in the late 1400's, little could Columbus or Queen Isabella have known how America would one day dominate the global landscape. Also unknown was how bumpy our path would be—a Civil and two World Wars, to go with countless financial panics, recessions and outright depressions as our country moved forward with development. In the case of emerging economies, they are only a few decades into their economic odyssey. Bumps in the road are to be expected, and we believe that better times lie ahead for those that are patient, yet thoughtful in their investment selections.

Andrew C. Burns
ABurns@HamiltonPoint.com

Richard S. Woods, CFA, CPWA®
RWoods@HamiltonPoint.com

Hamilton Point Investment Advisors, LLC is an independent and independent-minded wealth advisory firm. Please contact us for a complimentary review of your portfolio. In addition, visitors to the firm's website, www.HamiltonPoint.com, can read past investment newsletters.

3) For a free list of all recommendations made by Hamilton Point during the last year, please contact us.