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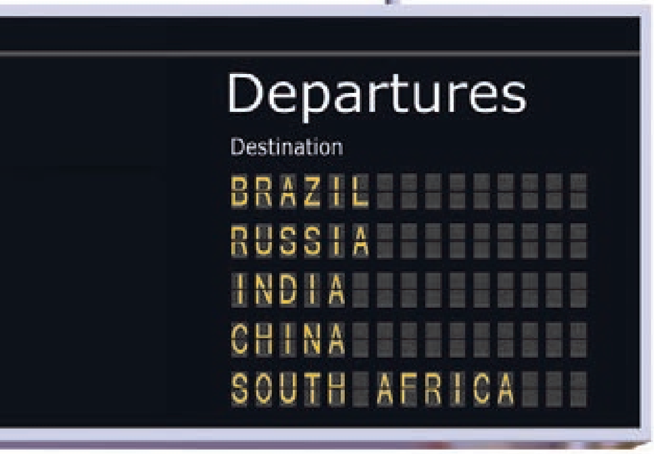

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Flight to safety
exposes cracks in BRICS economies

Snapshot

The past few months have seen investors withdrawing from emerging markets in the expectation the US Federal Reserve would wind back its monetary stimulus. The flight of investment capital back into US and European markets has exposed cracks in some developing economies.

Much of the global liquidity created by the US fiscal stimulus program was subsequently invested in emerging markets. This in turn helped to pull the world out of recession after the global financial crisis. Now the BRICS nations of Brazil, Russia, India, China and South Africa are struggling against an exodus of cash and weakening currencies as investors shift their focus back to developed markets.

Winding back stimulus

There is much uncertainty about when the US Central Bank will start to scale back its massive $85 billion a month bond buying program. Its eventual reduction, however, will stem the flow of US dollars into the global financial system, including emerging markets. But the BRICS nations are not sitting on their hands. At the recent G20 meeting of world leaders in St Petersburg, BRICS nations agreed to create a $109 billion pool of currency reserves to withstand financial shocks and shore up investor confidence.

Some countries more susceptible

AMP Capital head of investment strategy, Shane Oliver, expects India, Indonesia and Brazil will be particularly hard hit. The Indian rupee has reached record lows against the US dollar this year while the Indonesian rupiah and Brazilian real are down more than 17 per cent.

Shares in some developing countries have also been hit hard. The MSCI Emerging Market Index fell almost 6 per cent between January and September while the BRIC Index fell 7.4 per cent against a rise of 14.7 per cent in the world index.

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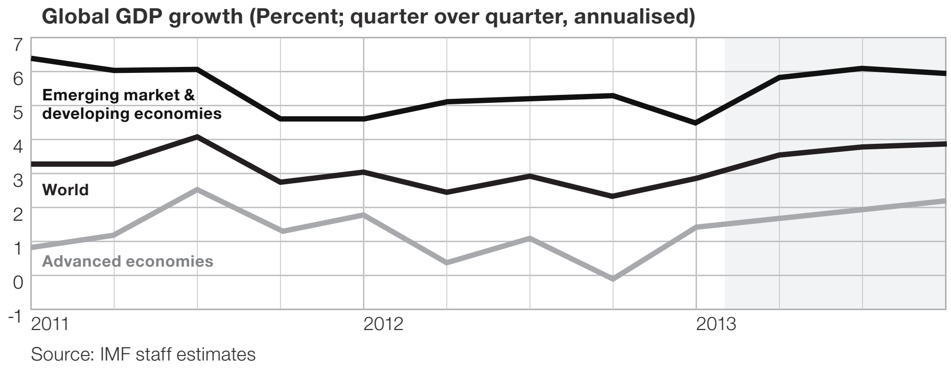

Discretion increasingly important

As the tide of easy money flows out, investors are no longer prepared to gloss over the need for structural reforms. Poor infrastructure, excessive regulation, corruption and restrictive labour laws are viewed as the key problems in India, Indonesia and Brazil.

That's not to say that investors should shy away from the developing world entirely, but discretion is becoming increasingly important. Countries with budget surpluses, such as South Korea and China, are better placed to weather the change in global investor sentiment and could enjoy trade gains as US growth rebounds.

The International Monetary Fund (IMF) expects growth rates in emerging markets to ease slightly this year, but they are still growing at three times the pace of advanced economies as the chart above shows.

Implications for Australia

Australia has been one of the chief beneficiaries of Asia's rapid economic development and one of only a handful of countries to retain its AAA credit rating in the wake of the financial crisis. The IMF expects solid economic growth of 3 per cent this year and 3.3 per cent in 2014. But we are not immune to the global shift in money flows.

The Australian dollar has already fallen from a high of US$1.06 to as low as US88c this year. Despite a recent spike above US95c following the US Federal Reserve's announcement it would continue its fiscal stimulus, slower growth in the Asian region and reduced demand for commodities is likely to act as a drag on the Aussie dollar for some time.

Oliver says the Aussie dollar may suffer collateral damage as investors often sell it as a proxy for less liquid Asian currencies.

Being prepared

Australian shares have not been exempt either, as investors shift their attention to the US and Europe. While Australian shares are up 13 per cent this year, US shares are up more than 22 per cent.

As the tide of global investment sentiment turns, it is important for Australians to understand the likely implications for their investment portfolios.

If you would like to discuss your investment strategy, please don't hesitate to call us.

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