Newton

For most, the lesson is taught some time in middle school. The name of the instructor may have faded, and the method of learning will almost certainly be lost to memory. The lesson is still remembered by almost everyone, in one form or another. For every action there is always an equal and opposite reaction. It may sound terribly familiar, and it should, as a lighter and easily remembered version of Newton's third law of motion. Action, reaction. But what is true in physics may not always hold true in politics or in economics.

The people of Ukraine had spoken, wishing to form a partnership with the European Union; the government sought closer ties with Russia. For a month, revolts in the Ukraine raged, and ultimately the government fell. Seeing a vacuum in power, Russian forces swept into Crimea, and in a week seized a land-mass nearly the size of Vancouver Island. The international reaction was far from equal, and not overly opposite. European nations, dependent on natural gas from Russia, took limited action. The members of the G8 moved their scheduled meeting in May from Sochi to Brussels, and will be meeting as the G7, excluding Russia. "So be it", said Russian foreign minister Sergei Lavrov. That reaction was also not equal, or opposite, but was instead distinctly Russian.

This attitude may be one that the Russian Government can afford. While their equity market, the MICEX, tumbled twenty percent as foreign investors removed capital, the fact remains that Russia retains a stranglehold on the supply side of the European natural gas market. With so many natural, and captive, customers in Western Europe, the need to tread carefully politically rests with the consumer and not the supplier. This may be the new normal going forward, with a shift in economic power from the old established First World nations, to the new power players, the BRICS. The BRICS bloc is a group of nations, Brazil, Russia, India, China, and newest member South Africa, whose economic scale has yet to equal their potential based on the size of their population. The G7 nations remain leaders, economically, but that gap is shrinking every day.

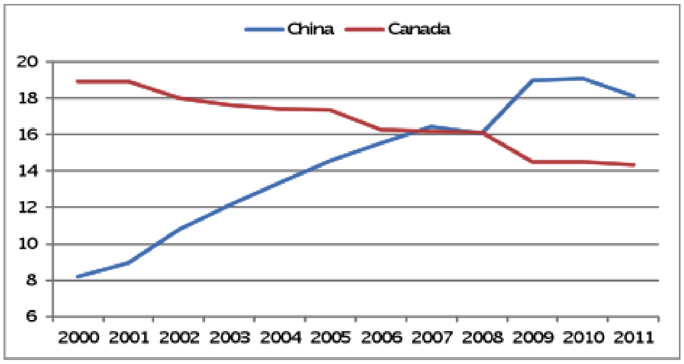
Lost in the fray of the last six years, comprising the American mortgage mess, subsequent questions surrounding bank solvency, the European debt crisis, and massive increases in American, Japanese, and European money supply, has been growth in the second-tier economies that make up the BRICS nations, a collective of now nearly three billion people. Population growth in the BRIC nations was 124 million people, a gain of 4.1%. Far more profound was their growth in Gross Domestic Product, which grew at 43.4%, led by China and India. With gains so large, how did these economies stay under the radar for six years? In no small part, it is because the returns from those markets have ranged from sideways to positively dismal. The performance of the equity markets belied the strength of the growing economies.

	Pop 2007	Pop 2012	Change	GDP 2007	GDP 2012	Change
	(millions)	(millions)		(trillions)	(trillions)	
China	1317.9	1350.7	2.49%	3.494	8.227	135.46%
India	1159	1237	6.69%	1.238	1.841	48.71%
Brazil	189	198.7	5.11%	1.653	2.252	36.24%
Russia	142	143.5	1.01%	1.66	2.014	21.33%
S.Africa	48.2	51.2	6.08%	0.273	0.384	40.72%
Canada	32.9	34.9	5.93%	1.502	1.821	21.24%
USA	304	314	3.23%	14.72	16.244	10.35%

Source: data.worldbank.org

The Russian economy was keenly in focus during the Winter Olympics, the eyes of the World descending for two weeks of theatre. Those Olympics were held at an estimated cost of $51 billion (US), roughly six times the outlay for Vancouver's Olympics in 2010, with graft, corruption, bribery, and a need for totalitarian security estimated at eighty percent of that cost. The figures seem shocking on their face, but are simply an associated cost of doing business in Russia. The long shadow of 2003's seizure of Russian energy complex Yukos through ever-growing tax bills and the jailing of Mikhail Khodorkovsky - its outspoken CEO, hang over the business environment of 2014, making any form of capital investment in Russia a costly – and risky – proposition. Russian capital markets have suffered from this distrust. Action, reaction.

Collectively the BRIC markets represent both risk and opportunity, while large gains in Gross Domestic Product have been made, the gap between emerging and developed economies remains considerable, witness China's forty times Canada's population, but only producing five times the economic value. The growth in these economies makes them too important to ignore, but that same growth makes them vulnerable.



China's impact on Canada's share of U.S. merchandise imports, per cent

Source : Conference Board of Canada

With rapid growth can come a loss of control, inflationary pressures can build, control over currency values and social harmony can be lost, and capacity can be built in anticipation of economic expansion that never arrives; China has factories, ports, and even cities that have been built, waiting for the American and European economies to recover, that currently sit idle. While expansion in China has been brisk, it has gotten ahead of global demand for Chinese-made products, and investors have been carefully watching - for several years now – whether or not their economy will have a hard landing. By necessity, Chinese rates of growth will slow, normalizing to developed economy standards, but whether that comes as a gradual decline or an arresting halt remains unclear. Of late, a number of low-quality borrowers have defaulted, sending ripples through the Chinese shadow-banking system; the slowing economy has begun to impact borrowers at the extreme margin. Growth assets, in particular materials like copper, have been under pressure as a result.

And the reaction does not stop there. The Canadian market, which is itself a peripheral market for Global investors, has been a relative laggard over the last few years. Materials represent more than twelve percent of the market capitalization the SPTSX, and energy more than twenty six percent. The action of slowing growth abroad has had the reaction in our stock market here at home. But that leverage works both ways, a soft landing in China, the building of stadia for Brazil's World Cup, the growth of the auto industry in India, all bode well for Canadian companies. A stable banking sector with low leverage, mining expertise, oil and gas production, all are likely to benefit in both the short and long run alongside the BRICS, a Canadian investor need not look beyond our borders to profit from growth.

Developing markets are notoriously hard to work in, with corruption, graft, and bureaucracy aplenty. Direct investment can be extremely difficult, the World Bank ranking China, India, Russia, and Brazil 96th 134th, 92nd, and 116th respectively out of 185 nations in terms of ease of doing business. These markets have a long way to go before they can be treated equally with developed G7 nations. Fortunately, Newton also had a law governing inertia. Simply put, an object in motion will want to stay in motion; the BRICS nations are not fully developed markets today, but every new day is one day closer to the BRICS having the economic impact their populations warrant.