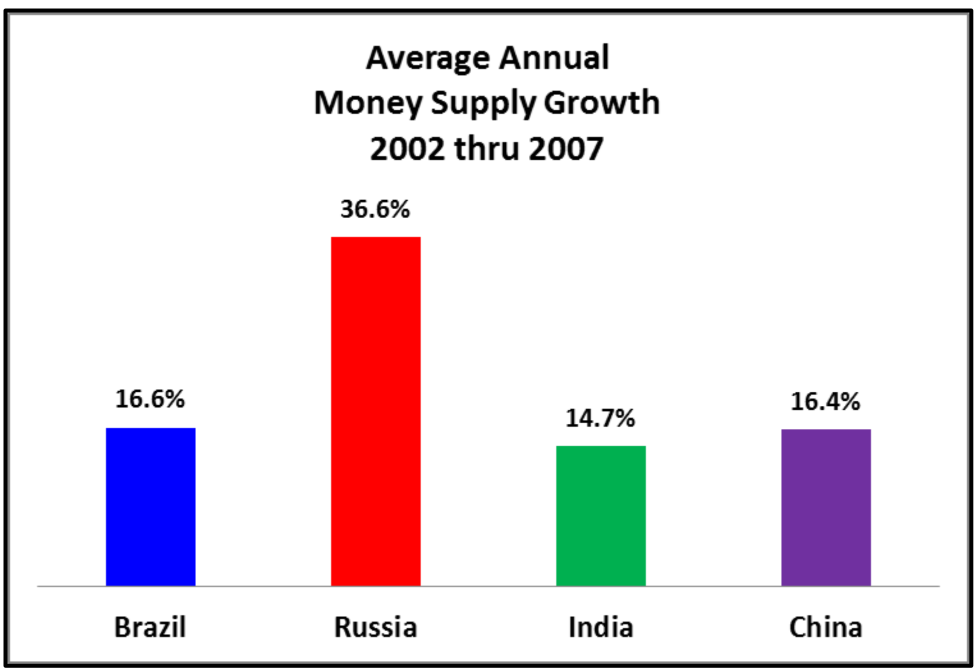
BRIC Markets Results = Lower Commodity Prices

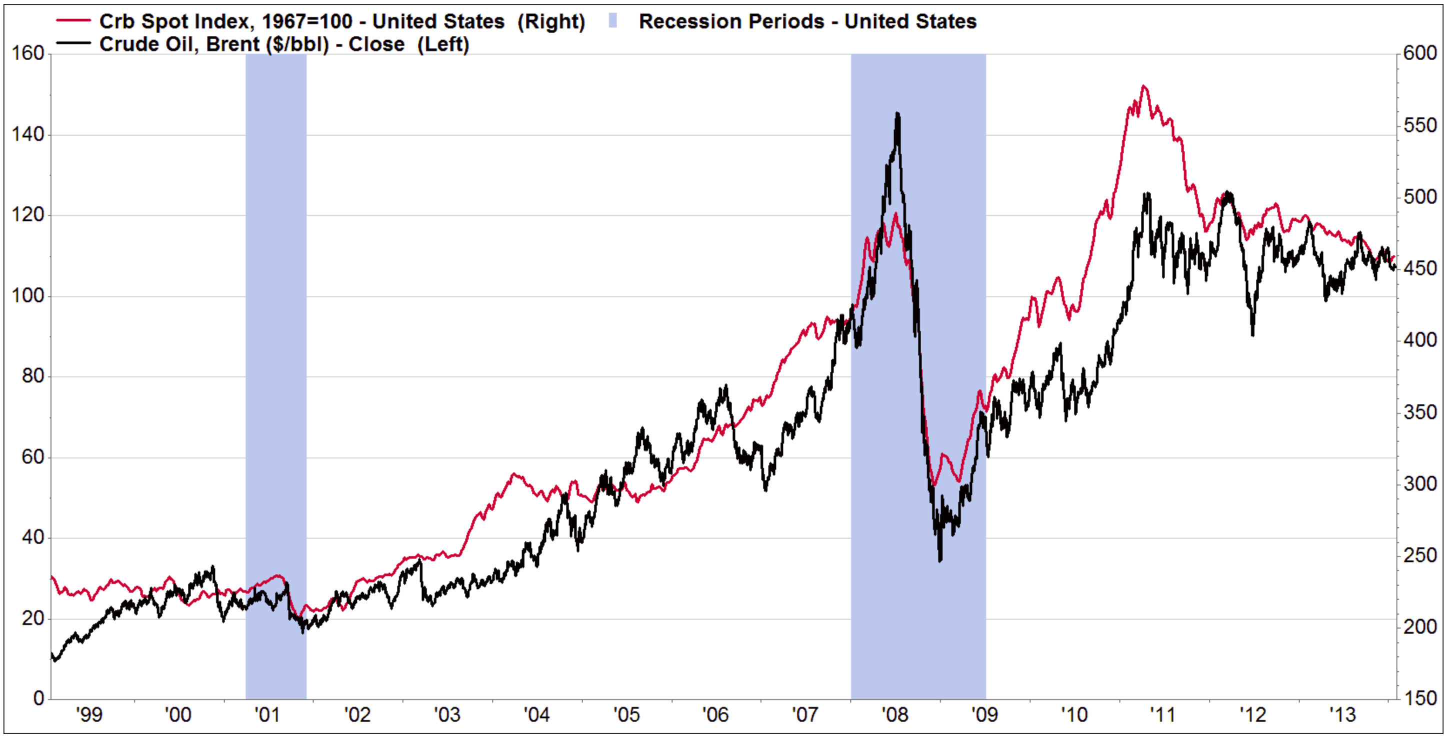
During the economic expansion between late 2001 and the end of 2007, one of the dominant investment themes was the "coming of age" of the emerging markets. Following previous cycles of surging but unsustainable growth, it was finally time for many of the "developing" (i.e. emerging) countries to mature and experience rapid and extended economic growth. The poster children for this movement were Brazil, Russia, India and China (BRICs).

This period of economic growth in the emerging markets was supported by rapid money supply growth. In the chart below is the year-over-year growth of money supply for each BRIC country.



Source: FactSet

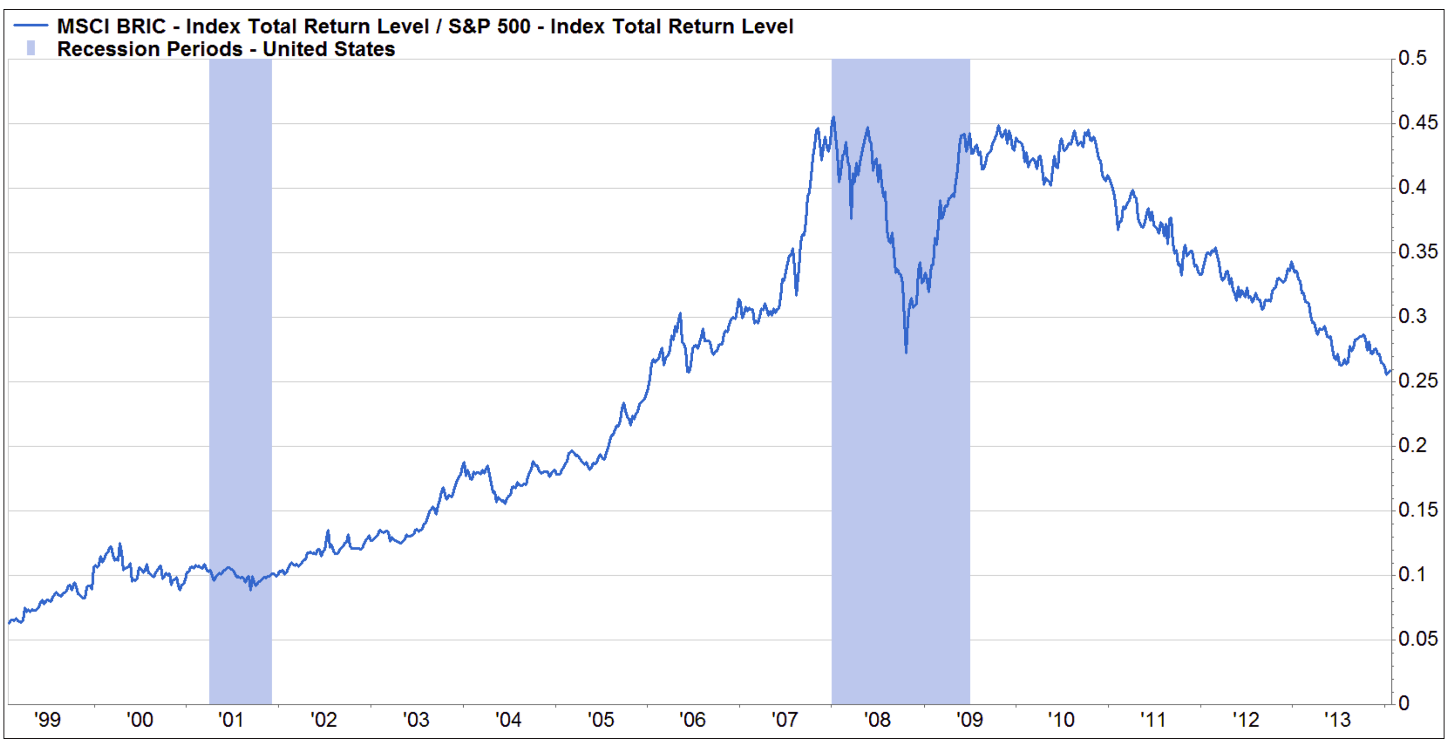
Between late 2001 and the end of 2007, money growth in the BRICs increased typically between 10% and 25% annually. This money growth helped prolong economic growth. Importantly, this growth created enough incremental global demand (particularly in China) to drive up commodity prices.



Source: FactSet

From the end of 2001 to the peak in mid-2008, commodity prices (as measured by the CRB Spot Index) experienced an extended bull market averaging about a 13% annual increase. Leading the commodity charge was the price of oil which increased from about $20 per barrel to a peak of $145 per barrel.

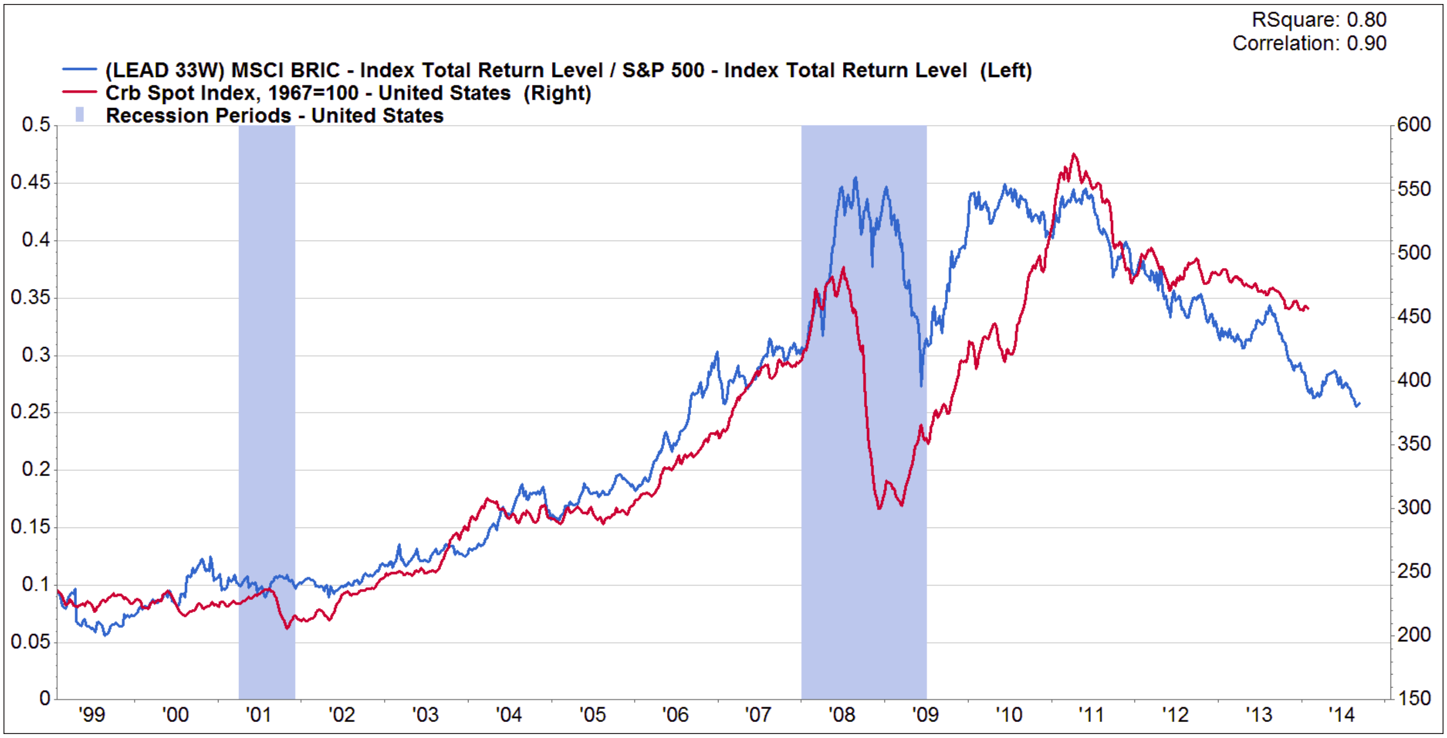
Not surprising, financial markets rewarded this extended growth period with strong stock market appreciation. When measured on a relative basis, the BRIC markets consistently outperformed the rising prices of the S&P 500, during this period.



Source: FactSet

Since the end of the last recession in mid-2009, the BRIC markets (and many emerging markets) have underperformed the S&P 500 on a fairly consistent basis. *Slowing economic conditions and rising inflationary pressures are prevalent in many emerging countries and are creating some political and policy problems. As long as these stagflation-like conditions persist, investors will likely continue to prefer the more stable and low-inflation conditions of the U.S. economy and, therefore, the S&P 500 will likely continue to outperform.*

Interestingly, the underperformance of the BRIC stock markets relative to the S&P 500 has tended to precede the direction of commodity prices.



Source: FactSet

Presented above is the relative price of the BRIC markets to the S&P 500 (blue line) and the CRB Spot Index (red line) with the relative performance line shifted ahead 33 weeks. Over this period, there has been a very strong relationship (90% correlation).

This is significant because (as we presented in last month's *Market Commentary*) commodity prices and the S&P 500 P/E* tend to move in opposite directions over time. Therefore, if underperforming BRIC markets lead to lower commodity prices this would be supportive of higher S&P 500 P/Es*. Likewise, such conditions would suggest further price appreciation.

We remain focused on understanding the current trends in fundamentals because it gives us the best probability for success.

* P/E is price/next twelve months earnings