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Inflation pressure remains in Brazil, India, and China and more monetary policy tightening will come. Inverted yield curve in Brazil and India—could PIMCO and CIC shorting U.S. Treasuries be contributing factors? *As I have argued, the inflation pressures in the BRICs are still quite strong and CBs will continue to tighten. But shorting U.S. treasuries could also put downward pressure on long bonds in India and Brazil.*

Bill Gross of PIMCO has been sounding warnings on U.S. debt. His point is well taken, the U.S. may not default, but treasury yields are too low to hold. Gross has repeatedly stated that PIMCO has found substitutes. CIC (China's sovereign wealth fund) has been making similar remarks about the risk/reward problems around holding too many U.S. treasuries. I have absolutely no proof of what I am about to suggest, but the behavior of EM yield curves could be indicating that foreign investors are holding more EM debt at a longer duration than we have seen in the past. PIMCO's short of U.S. treasuries is a lot of extra cash, looking for duration and liquidity. EM bonds are probably benefiting.

In the western press, some experts have compared the inverted yield curves to those in Europe's problem member countries. Portugal's yield curve issues reflect investor concerns as to whether the country may not be able to pay its debt because of falling tax revenues, crippled banks, and no economic growth. In Brazil, the inverted curve surely does not reflect any of these same

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concerns. Brazil has savings, healthy banks, growth, and energy self-sufficiency. It's politically stable and has a young population with a dynamic diversified economy and rising tax revenues. India' economy is relatively healthy and diversified; though headline inflation indicates that there will be further tightening from the RBI, the government has benefited from higher revenues. Given that Brazil and India have such comparatively strong economic profiles compared to Europe's problem periphery, the inversion of their yield curves must be explained by different drivers.

There are significant inflation pressures in India, China, Russia, and Brazil. With the exception of Russia, all of the central banks are in serious "tightening" mode and higher interest rates are expected in these countries. This too could be adding to the dynamics of inverted curves for Brazil and India. Russia just completed its annual IMF Article IV and the fund indicated that loose monetary policy was contributing to inflation troubles. Moreover, the banking sector remained vulnerable and required more balance sheet repair. China's inflation at a 34-month high is not politically acceptable (though similar inflation rates in U.S. headline inflation are not considered a real problem), and China's PBOC responded by raising bank reserve requirements to a record high of 21.5%!

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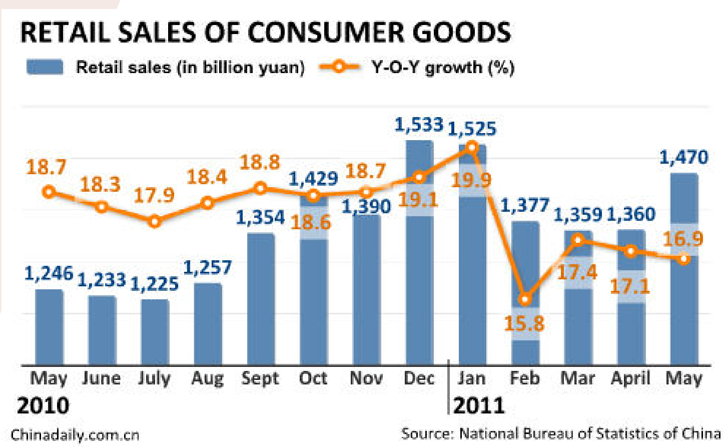

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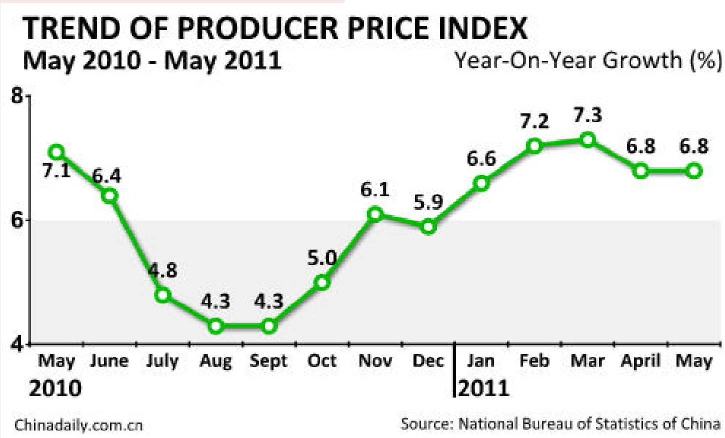

China's banks on a short leash: Monthly enforcement of loan-to-deposit ratios are now in effect. *The PBoC will enforce a mandatory limit on loan-to-deposit ratios at 75%.*

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In March, the PBoC informed the commercial banks that their lending would be subjected to new constraints. As of June 1, the banks have to report their loan-to-deposit ratios to the PBoC on a daily basis; they are required to conform to the official ratio of 75% every month. Before, this process occurred every 90 days! According to local reports, the small- and medium-size banks (who have benefited from lower reserve requirements) will have trouble meeting the ratio and their lending will have to slow. China Argicultural Bank had a very low ratio in March—below 60%. The PBoC is moving to smooth out lending so that preemptive, quarterly, and annual surges in lending are reduced. Loan allocation by quarter led to significant increases in short-term lending and front-loading loans, as did annual loan targets. The PBoC has been removing such targets from bank lenders so that "work arounds" to the allocation rules will be reduced.

Turkey's elections: As expected—and best outcome for investors—an AK single party majority, but without a super majority. *This is the best possible result for investors and also for progress on political and economic reform in Turkey. The government will continue to favor export competitiveness with a weaker currency and thwart market expectations for a return to monetary orthodoxy. Kurdish political involvement and strong showing is a positive signal that Kurds are more willing to engage in a civil and political relationship with Ankara.*

I was worried that PM Erdogan might get his way—a recipe for disaster for most politicians. But fortunately the small MHP and the Kurdish independents did better than expected, and Erdogan was denied the super majority. Since the AK has fewer than 330 seats, they cannot send their

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planned constitutional reforms to referendum without the support of the opposition. So PM Erdogan will have to work with the opposition. To my mind, this is very desirable. There are several bad ideas for constitutional reform that involve taking Turkey along the French Presidential path where the president would become exceedingly strong and the PM more of a speaker. We have seen this happen in the Ukraine, where a powerful PM tried to set up a move to the presidency with more power and fewer checks on executive authority. I, for one, am happy that this will be difficult for PM Erdogan to achive.

As expected, Turkey's economic recovery is cooling, like that of nearly every other emerging market country. As the uncertainty in Europe deepens, Turkey will need to focus on the economy. The positive election results against a relatively healthy economy should facilitate a responsible political and economic transtion. But the hard work is just beginning. Turkey has relied on unorthodox monetary policies to keep the lyra and its exports competitive. But the CAD is rising quickly. Some experts are arguing that credit growth is too fast and inflation pressures are building.

The fact that the Kurdish independents made such a strong showing in the national elections is a sign that the AK party plans for economic development in the Kurdish regions has actually worked. High turnout and a willingness by the Kurdish population to send political representatives to Ankara is a step toward political intgration and empowerment. I am cautiously hopeful that the Kurds will choose civil and political engagement with Ankara over terrorism.

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China's economic "Monroe Doctrine" for its near neighbors and ASEAN Trade: Taiwan, Vietnam, Kazakhstan, and North Korea. *Note the recent currency swap agreement between Kazakhstan and China, Chinese tourism to North Korea and establishing JVs with the pariah state. These issues, along with confrontations with Vietnam over oil rights, and calls for a more formal institutionalization of cross-straits economic ties with Taiwan all point to a more developed strategy of regional hegemony in China's neighbors, who feel the deepening noose of economic interdependency.*

Recently, focus has been on China's big investments and projects in Africa. But this is not news. The Shanghai Cooperation Organization (SCO) used to get front-page headlines before the global crisis when pundits were sure that Russia was using gas-pipeline terrorism and expansionism to check the EU's ever widening expansion. A good deal of fear mongering has been promoted in the West regarding China's new international role. Like Warren Buffet, China understands that cash is king. The aftermath of the global economic crisis has been a boon for all those fortunate enough to have cash instead of excess leverage. But for China's near neighbors—who may have abundant natural resources and excessive supplies of cheap labor (North Korea)—China will be more influential than ever.

Secretary of State Hillary Clinton might be picking the wrong battle. Certainly African nations need FDI and infrastructure. And to be sure, many governments in Africa are weak and corrupt. But the United States and the European Union may be focused on the diplomatic issue of Africa

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because China's massive and increasing regional interests in Asia cannot be addressed or solved. The U.S. neither has the cash or the influence to protect Vietnam or prevent Kazakhstan from "facing" East. Vietnam might ask the U.S. for help. But the U.S. will not be able to do much to help ease tensions.

Natural resources in the region will be the continued focus for more Chinese expansion and economic "co-opting." The projection of China's military force vis-à-vis its first aircraft carrier certainly generated a great deal of worry in military circles. But foreign investors should be aware that Chinese economic incorporation of its near neighbors would mean a loss of western influence.

Peru: Humala names transition team of Felix Jimenez and Kurt Burneo. *Political and policy risk remains high with the nominations of the transition team. Only the bonds remain attractive at this point.*

The transition team does little to inspire confidence. The fact that the main author of Humala's plan for government Felix Jimenez got his PhD at the New School is truly troublesome. Some of his ideas: nationalizing natural resources, giving money to municipalities to foster "local markets" and small businesses, changing the political system so that the people control the constitution and government, investigations and audits of national infrastructure and transportation for possible reworking of contracts, and many rehashed ideas from inward-looking

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development. His ideas sound very much like Correa's ideas in Ecuador. Kurt Burneo, is his interviews, has a confrontational style that is also troubling. Burneo wants to return control and ownership of ports and airports to the state.

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