Weekly Report

GRIFF INVESTMENT FUND

Macroeconomic Analysis

Does the World Cup 2014 have a positive impact on the Brazilian economy?

The current World Cup in Brazil has almost reached its half way stage as the group phases have been completed. The World Cup has undoubtedly been a commercial success, which it was bound to be when the host country has football culture so deeply integrated within society. However, the more interesting question is if it will bring any economic success to the Brazilian economy.

Euler Hermes Economic Research released a report on the 6th June 2014, this described a main consequence of the World Cup – there will be more inflation than growth in the Brazilian economy. They expect growth to be as low as +1.8% this year, and +2.1% in 2015. Taking into account the increased inflationary pressures due to the massive spending of 25.50 billion Brazilian Real (BRL) (the equivalent of 6.76 billion GBP) on the football tournament, the real growth will indeed be limited. In fact, the expected inflation rate this year is +6.3% and +6.1% in 2015. However, the unique scenario for Brazil could explain the increased inflation, as they are not only hosting the world's largest sporting tournament, but also the Olympic Games in 2016, which obviously significantly increases spending.

However, according to EY, there will be certain sectors that will be positively affected by the World Cup. Amongst the business services, real estate services, retail, finance and tourism sector, there is one main sector that has benefitted the most, which is unsurprisingly the construction sector. Whilst the Brazilian government has faced political critiques lately about building stadiums in the middle of the Amazon where not even a local football club exists, which alone cost $300 million (666 million BRL), the construction sector has cheerfully enjoyed billions of BRL from both the public and private sector. This is expected to have a direct impact on the Brazilian GDP by +7000 million BRL, and indirect impact by +1000 million BRL.

The World Cup as well as the upcoming Olympic Games, are therefore expected to cause a disproportionate increase in inflation due to the increased spending on the two gigantic tournaments in such a short time frame. It could be unhealthy for the Brazilian economy, as the impact on the employment will be small and short term. This is mainly because the jobs created during the tournaments in tourism services and hotel industries are by nature only seasonal.

It should therefore be strongly highlighted that the World Cup is not necessarily a long-term economic investment for the Brazilian economy, which the government frequently justifies the tournament to be. Instead, it could lead to overspending; the budgets are being underestimated as always for countries hosting global tournaments and the long-term usage of the investment products will not necessarily be reaching the expected or desired level. However, what keeps the World Cup popular and politically justified is more than a positive economic impact. Its main purpose is not to bring economic prosperity, but to unite the world to enjoy a sport which has been a global tradition for decades previous. Additionally, social issues such as the campaigns against racism, which has for long been an important issue in Brazil, are also reasons for Brazil to host these tournaments. It is by having the global audience following the country for one month during a grand tournament, that political influence will grow, and that is exactly what a strong emerging market like Brazil wants and needs now. So although the economy might not experience a positive impact, the political capacity in Brazil sure will.

Argentina: Debt Problem?

On the 16th of June, the U.S. Supreme Court ruled under a *pari passu* (equal footing) order that Argentina must pay "hold-out" bondholders. Argentina must deal with this debt, or risk defaulting on all of its debt. The deadline set is the 30th of June.

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The background to the situation is that following Argentina's 2001 default on $95bn of debt, a number of investors bought up distressed Argentinian bonds. Argentina restructured its debt with 93% of these creditors in both 2005 and 2010 to 25-30% of their value. The remaining 7% held out. Led by NML Capital, the "hold-outs" have pursued the country for the payment of all principal plus outstanding interest on these bonds in US courts (the bonds were governed by New York law). The Supreme Court ruled in favour of NML Capitol, ordering Argentina to pay the full $1.3bn it claims. This could open Argentina up to similar claims by other hold-out bondholders, who were not involved in the litigation. Valuation of these has ranged from Argentina's estimate of $15bn to that of NML's $6bn. Regardless, the situation Argentina is faced with is that it must repay this $1.3bn or face defaulting on all of its restructured debt.

The initial reaction from Argentina appeared to be one of defiance. President Cristina Fernandez initially lambasted these "vulture" funds and insisted they would not "submit to extortion". Fernandez's weak domestic position negates that she cannot be seen to lose this crisis. Following this address, steps were taken by Economics Minister Axel Kicillof to begin a new debt swap in order to service the country's restructured debt under Argentinean law. This move realistically would seem to be political maneuvering; in all feasibility it is likely to be too complex and unlikely to receive the 85% of necessary creditor approval. A negotiated settlement appears to be the more likely outcome. Despite Fernandez's populist rhetoric in her initial reaction, she was careful not to rule out negotiation. The end of the week seemed to signal a pang of realism from the Argentinean government; Fernandez stated that her government would negotiate with all the country's creditors. Though this may have settled nerves of a default, considerable hurdles remain. Among these challenges include: a possible threat of a Rights Upon Future Offers clause in the exchange bonds; Fernandez's tight political corner; Argentina's constrained finances; and the fact that the holdout creditors seem to have the upper hand following the court ruling. The ability to extract concessions will be limited. Political brinkmanship would appear on the cards.

A bond default could trigger another major currency devaluation, higher inflation and economic stagnation for Argentina. Furthermore, a default would likely result in exclusion from the global capital markets for a further 10-15 years. This would undo Argentina's recent work to return to the global capital markets, for example when they agreed with the Paris Club in May to begin repaying $9.7bn in debts unpaid since 2001. It would seem in Argentina's interests to blink first.

Equity Analysis

For how much longer can American Apparel Struggle?

Controversial clothing retailer American Apparel Inc. is continuing to struggle with finances as Lion Capital demanded repayment of its $10 million loan. This comes as the Board of Directors fired the founder and CEO Dov Charney this week after even more allegations of misconduct. With $250 million debt and falling earnings, American Apparel has been struggling for some years now. The retailer has been closing stores in recent years due to falling revenues; they are struggling to keep up with interest repayments on outstanding debt and in addition the auditors resigned in 2010 after concerns about financial disclosure. In 2005 the company went public selling shares at $5, but in 2011 they announced the possibility of bankruptcy and ever since the stock price has been fluctuating around the $1 mark. They tried to restructure last year, but this resulted in increased costs of production and complications with the new distribution centre which caused revenues to fall even further.

Mr Charney is the biggest shareholder and currently owns 27.2% of shares, he has liaised with Standard General to try and buy more stock in an attempt to takeover, but American Apparel has retaliated by introducing its plans for a "poison pill" to avoid this. The plan states that if anyone tries to buy more than 15% of existing stock then current shareholders will be given the ability to buy more shares at $2.75 in an attempt to dilute the shares. Mr Charney's lawyers have already started to take legal action against American Apparel saying that Mr Charney's departure was unlawful which is causing even more concerns for investors. Although some think that Charney's departure from American Apparel will help the business recover revenue, it will take considerable work and time for the retailer to recover 2007 profit levels.

Investment Anaylsis

The dangers of Penny stocks.

Many funds and investment firms avoid penny stocks for various reasons. The first reason is the companies that are deemed as penny stocks are extremely small in comparison to larger blue chips companies. This means they are riskier than blue chips as they are more likely to go into administration for far more reasons than blue chips. For example, a small cap miner that operates in an emerging market that only has one mining license may list on a small cap market (such as the FTSE AIM) to raise capital to fund the pre-feasibility study. If this capital isn't raised, the company may not be able to continue operations and so any capital

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that operates in an emerging market that only has one mining license may list on a small cap market (such as the FTSE AIM) to raise capital to fund the pre-feasibility study. If this capital isn't raised, the company may not be able to continue operations and so any capital previously provided by investors may be lost.

The next reason is small cap markets tend to have a lot less regulation than larger cap markets. This allows for share manipulation that is unseen in larger cap markets. One of these schemes is known as 'pump and dump'. The famous Jordan Belfort, whose life as a stock broker was shown in a recent blockbuster film, funded a lavish lifestyle through using this scheme on U.S. small cap stocks. This scheme means investors will buy shares at a low price, push for other investors to invest in that stock (most of the time on a specific day) that makes the share price sky-rocket which allows the original investor to sell their shares at a much higher price whilst other investors have bought shares at an excessively high price that they can't sell without making a huge loss.

Another reason they are avoided is because of their small size - if a fund or investment firm, that manages millions of pounds (or other currency), invests quite a few thousand pound into a small cap stock (which would be a small portion of their investment portfolio), it would cause the share price to increase rapidly or decrease rapidly if they sold. This is purely because the companies market cap tends to be only a few million compared to more than £100m that medium companies are valued at.

With this in mind, it's easy to see why funds and investment firms avoid small cap companies and leave them for small individual investors. Even then, it's good for these investors to know the risks too so they don't fall into the trap of investing in a not-so-good company or get caught up in fraudulent scheme that they regret later.

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Weekly Report | 30th June, 2014