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STRATEGY

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Truth and Beauty

(... and Russian Finance)

Shadow of the Dragon

Treacherous Waters

Somewhere in the Andaman Sea

While most of our esteemed colleagues and competitors have long since offered their predictions for 2010, T&B feels that they may be jumping the gun – we find that delaying such forward-looking statements only enhances their ultimate accuracy. Each year we push it out a bit further – by mid-decade we shall probably be releasing our full-year forecasts in late November.

That said, we have a healthy respect for the concept of the unknowable – the limitations of our ability to understand our environment and to predict the actions of man and of beast – and especially, in the current context, of political systems which shall be tested to their limits by the imperative necessity of atoning for past folly by taking painful steps to restore some semblance of fiscal equilibrium.

When last we parted company, T&B was generally skittish, moving towards a (for us, most unusual) tactical long USD/EUR position, reversing out of our longstanding longs in NOK, AUD and NZD, although retaining some exposure to the rouble. Although we were (and remain) bullish on Russian equities on a relative basis, in December we were scared of the global markets given the fundamental unsustainability of the current stimulus-driven bull market, rendering us very cautious regards markets equities. Finally, while we were cognizant that our preferred fixed income trades were getting long in the tooth and that spread compression was reaching a mathematical limit, these concerns were counterbalanced by our strongest conviction call: that the G7 economies shall have a hellishly long and painful climb back from the abyss. Thus, we are moderately bullish on rates, as well as very positive on the economic fundamentals of the Emerging universe and have thus retained substantial exposure in bond-land, selectively switching out of those assets which have tightened most, into the few remaining laggards.

While our tactical USD longs have proved rewarding (and we would now move to a more neutral weighting) and we were somewhat awed by the ferocity of the rally in the emerging market debt space, admittedly, the December/January rally in global equities took us by surprise, threatening to make monkeys of us bears – indeed, by mid-January we were close to capitulating and increasing equity exposure. Fortunately, cooler heads prevailed and we remained cautious – as we go to press (someday we will get there) deep-pitched rumblings are once again heard beneath the earth's surface. Markets are blithely discounting a V-shaped recovery in the West (*which just ain't gonna happen*!), political systems are showing the strain, sovereign deficits are rightly being viewed with fear and loathing – and in an unprecedented recognition of the shift in the global economic centre of gravity, as the PBC shows signs of tightening earlier than expected, global markets are gyrating to the news from Beijing, not from New York. While we have long experience reading the runes in Fed statements, neither T&B nor anyone else we know has much of a clue about how to read the Central Bank's Chinese calligraphy.

Whilst in 2008-2009 China proved to be the salvation of global markets, the Chinese are motivated by something other than the altruistic desire to pull other folks' chestnuts from the fire – if appropriate domestic monetary policy requires that they upset the global apple-cart, then upset it they shall. Chinese stimulus has been wildly successful to date, and they shall cut back as and when it suits their needs. Those Western commentators who have been gnashing their teeth as regards China's coming collapse will end up, as per usual, gnawing their bleeding gums upon a string of financial collapses almost anywhere else.

Meanwhile, our American friends appear intent upon confirming our most dire predictions as regards their political process, most benevolently described as "dangerously dysfunctional"; if watching the political horse-trading about desperately needed medical reforms provides for some bad comedy, recent attempts by the US Congress to restrict the independence of the Fed, or the perception of any such action, would be a more serious matter altogether, threatening the sole anchor for inflationary expectations, a nominally independent Fed. Badly enough managed, this could trigger a panicked retreat from US debt markets, sending Treasury yields ballistic. While this is not our base-case scenario, it could happen – we haven't seen this many black swans since last Zakharova danced Tchaikovsky's masterpiece.

Meanwhile, the emerging fixed-income markets are outperforming even our own very bullish expectations. This is not merely liquidity-driven – there is some of that too, but equally, we are seeing a fundamental shift as investors gradually come to realize that in many cases the emergings are far safer than the developed markets. Simply compare the debt dynamics of AAA-rated UK or Spain (!!!) with BBB-rated Russia…not to mention those of Brazil (BBB-) with Greece (BBB+/A2). Sceptics may snarl that the emergings cannot possibly perform with the G7 in trouble; apparently, no one informed the Chinese (nor, for that matter, the Brazilians and the Indians[1]).

For the first quarter, T&B would concentrate on not losing money, keeping our fingers well clear of the gearing. We are consensus with the expectation that Russian equities will outperform both the emerging and her developed peers this year, however we currently prefer this trade on a relative-value basis, i.e. long RTS/short S&P (or European indices) – those wishing to further refine this one may wish to short US financial stocks, given the cold wind blowing in from Washington.

1 While Russia did get a fair bit of trouble, that was self-inflicted – FM Kudrin had no business trying to piggy-back on the Western banking system! Financial services reform is a must…

Liquidity's Rainbow

A fundamental observation: recent market reaction to the high-frequency data has been unambiguous. Strength in financial assets is being driven by liquidity rather than by any expectations of a dramatic economic rebound. Indeed, the occasional signs of accelerating economic growth are taken as distinctly bearish since the market assumes that they bring forward the day when the Central Banks begin to raise rates; on the other hand, moderately weak data suggest that the party can continue for a while longer. This relationship will hold only for as long as economic numbers do not suggest that the much-feared double-dip is upon us, i.e. it is contingent upon the maintenance of ultimately-unsustainable fiscal stimulus. *Beware the day said stimulus finally ends!*

Of Thin Ice, of Elephants, and of Elevators

If there were an award for the word most abused during the global credit crisis, surely "unprecedented" *would rate very near the top of the list – T&B is sorry to join the braying pack, but verily, this last year has brought us a host of things never before imagined. Unprecedented peacetime government deficits throughout the developed economies are beginning to pose a problem so fearsome that political authorities are doing what men habitually do when confronted with the apparently inextricable – simply ignore it, hoping that it will just go away, or failing that, that the unwind will come on someone else's watch.*

The faith-based economics of the old US administration has given place to the hope-based approach of Obama's team. Desperate attempts to salvage dangerously imperilled political careers may lead to heroic sacrifices of the hard-won economic attainments dating back to the Volker years. Argentina may be exporting something other than just its beef! Our long-standing theme – the Decline of the West – may play out faster than would have seemed possible just a couple of years ago.

*After bird-flu and swine flu, we are perhaps witnessing an outbreak of epidemic cognitive dissonance amongst our bulge-bracket strategist peers. Working through their reams of scholarly, well-researched, and almost invariably irrelevant quantitative analysis, we encounter painstaking assessments of the most recent trends in auto sales (good), industrial production (not bad), real-estate (bad, but could be worse), and commercial property (bad – full stop), leading to learned discussions of precisely when Central Banks will begin hiking rates. It seems that everyone employed by a half-way respectable institution[2] pretends that we live in a normal, sustainable environment – one in which the current macro trends can be safely extrapolated into a future which looks very much like the present…**and no, there are no elephants in this elevator!***

We beg to differ – perhaps it's the peanuts on his breath, maybe it's how crowded it's getting – we're not sure where he got in, nor what precisely he is doing here, but we are truly bewildered that so many of our learned colleagues seem oblivious to his presence!

The Western economies are skating on frightfully thin ice. A couple of points of growth in industrial production more or less, a confirmed downtrend in consumer credit, new car and home sales picked apart for the relative contribution of tax subsidies – none of it makes much damned difference! The essential point is that the much-feared great depression of 2009 was (rightly) forestalled by unprecedented fiscal and monetary stimulus. Alas, a second miracle is now called for – with hope a very poor substitute for policy!

The matter is childishly simple. Hugely procyclical fiscal and monetary policy, encouraged by a triumphalist and spectacularly incompetent Bush administration (leaving European policy makers desperately struggling to "modernize" their finances, so as not to be left behind by the Americans, with their famous magic touch) led to an unprecedented expansion in consumer credit, driving massive overproduction of homes, automobiles, and durables of all descriptions.

Unlike previous housing recessions, triggered by a Fed tightening which caused would-be buyers to await lower mortgage rates, lending rates are currently about as low as they are likely to go; the current crisis is instead the direct consequence of orgiastic mortgage lending, pulling demand forward and driving construction of new properties exceeding any solvent demand. More broadly, while the

[2] *We would make an exception for Soc Gen which has taken to issuing hurricane warnings – but then, having been T&B's first employer in the world of finance – whether they can qualify a entirely "respectable" is a matter of opinion.*

affluent classes were busily capturing an ever-increasing share of GDP, social peace was bought by allowing those in the middle to share in the illusion of wealth thanks to the increasing availability of credit.

US New Home Sales – Strong technical support... at zero

Urban Myths

Given that normal people would have been terrified to carry such huge debt burdens, especially as they move toward retirement age, a series of convenient myths was created – "Equities for the long term", "one-way housing markets", and most irritatingly, the global "savings glut" which the US consumer was selflessly absorbing. The Laffer curve, a convenient fiction invented to justify the fiscal irresponsibility of the Reagan administration, provided a convenient and politically painless means for controlling budget deficits: just cut taxes!

As the issuer of the world's reserve currency, the US could fight several insanely expensive wars while enjoying domestic prosperity – all on credit. Meanwhile, simple logic was exiled from economic discourse with affirmations that "deficits do not matter" and convoluted explanations of the "savings glut," with the convenient assumption that China would have to continue providing unlimited vendor finance for the next couple of decades. Faith-based economics at its best!

What is condemnable is this politico-economic hedonism – not the subsequent response of governments and central banks to the massive black hole opening up under the streets of New York, threatening to suck in the entire visible universe. What else was a poor central banker to do? Allow the banking system to collapse? Some damned fool tried – fortunately on scale just below the critical threshold – when Lehman was pitched to the sharks…Chernobyl! No one is likely to try that again. Does anyone seriously suggest that the Fed should have allowed a cascade of global defaults, with a very real threat of severe political instability and disruption of lives, all in the name of some abstract constructs of personal responsibility and free-market orthodoxy?

This was a serious business. Not only would it have been impossible to single out the guilty for punishment without a horde of innocents being crushed, but the broader political consequences were both unforeseeable and potentially catastrophic; the last Great Depression did not end well. Now, the problem is to exit the rescue mode with minimal damage, while not triggering a resumption of the deleveraging crisis.

The Sound of one Hand Clapping

For once, governments took radical action in time – how unfortunate that they had to come to the brink of disaster before doing so. The poisoned seeds, we repeat, were planted a decade earlier. Looking back, the degree of self-indulgence and political blindness is almost unconceivable. This was not the fiscal/monetary policy of some tin-pot Latin American dictator, some populist fool, some proto-Soviet chinovnik. No, this was the avowed policy of the world's largest, richest, smartest and most responsible remaining superpower. The entire political class, the overwhelming plurality of academics, the deep thinkers at Goldman's…not one half-way respectable institution saw it coming[3]! <u>That</u> was left to the lunatic fringe which been warning about unsustainable debt dynamics and "rolling bubbles" for a decade at least. The debt crisis was not an asteroid coming out of deep space – it was the predictable consequence of a massive failure of democratic political systems and much of the intellectual underpinnings of liberal capitalism. Alas, we suspect that a number of babies will now be pitched out with the bathwater as governments are pressed to take remedial action by a populist backlash against the financial industry.

There are, we will repeat, precisely two plausible outcomes of the sovereign debt bubble: hyperinflation or a lost decade; the beneficent outcome – growing out of it – simply does not seem to be feasible under the circumstances. In short, either The West, Inc. raises taxes, slashing spending (a few armies and billion-dollar fighter jets lost would do no

[3] *The exception is perhaps the sainted David Rosenberg, previously Chief Economist at ML – had his senior management bothered to listen, they might still have jobs today!*

harm), and resigns itself to a long, hard climb back, or they take the low road, providing the stimulus the economy craves, printing enough money to drive growth against the fierce headwinds and devalue the accumulated debts by debasing the currency. *Tercium non est.*

The endgame is not an appropriate matter for economic prognostication – it is a purely political choice and the same approach may well not be adopted by different countries. The Germans, in particular, have a tribal memory of the hyperinflation of the 1930, and its ghastly outcome. The Americans, on the other hand, appear to be more marked by the deflationary Great Depression – and are utterly devoid of that belief in redemption-by-suffering which renders the Russians so willing to accept the occasional disaster with relative equanimity.

That said, as a best-guess, our money goes on the deflationary scenario – with endemic high unemployment, slow growth, and a fundamental change in expectations. As compared with previous episodes of deflation, the worst consequences of this deep recession will be cushioned by an increasing degree of socialization as the US will be forced to move increasingly towards the European model. Already, one out of seven American children is fed only thanks to food stamps (in some areas of New York it is fully one-half), a government program to provide basic staples to the needy; increasing numbers of Americans faced with malnutrition are becoming reliant upon food banks and soup kitchens (*sources: NYT, Washington Post, L.A. Times*).

The popular revulsion against past excesses is typically being directed against colourful but ultimately trivial abuses – banker's salaries and the like – yet whichever party holds power, one should expect the substantial and durable increases in taxation which will be needed to fund social programs.

Rates: Fear, in a Handful of Dust

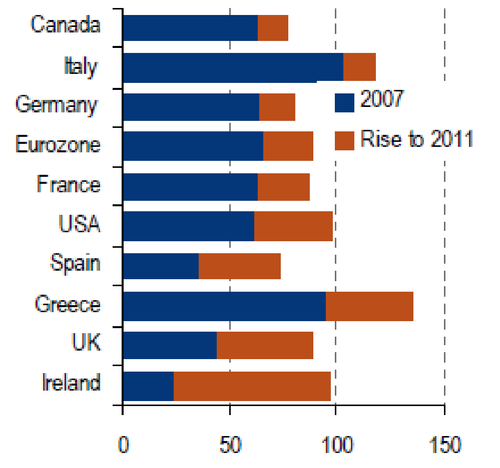
T&B's major theme is once again the widespread cognitive dissonance in the analytical community. The true consequence of the crisis just passed will be a huge increase in debt loads throughout the industrialized world, with several purportedly "serious" G7 countries left with debt/GDP levels of 100% or more. Reinhart and Rogoff demonstrated that this level is associated with a 1% loss of GDP – given that growth rates in the G7 countries are already niggardly, this contractionary force would be associated with severe socio-economic stress.

The first countries to get hit are likely to be European peripheral states, no longer able to print money and increasingly uncompetitive with the core states, notably Germany. While several investment banks, notably the beloved "vampire squid", have minimized the danger of imminent destabilization, given that they were equally dismissive of the risks of a credit crisis in mid-2007, we are not entirely reassured.

All of their pontificating has been purely ex-post facto. *Like sheep, they huddle together for warmth and safety – being wrong along with the consensus is safe – being labelled a maverick is distinctly unsafe. Major systemic disruptions are, by definition, rare events; nevertheless, the ability/willingness of the financial establishment to flag them before they strike is essentially nil.*

In summary, T&B is increasingly concerned with the "denomination risk" of our ill-gotten trading gains. As emerging markets jockeys we're reassured to see the New Paradigm adopted faster than even we could have expected – Hungary can now issue well inside of Greece; Russia is 150 bp inside the great State of California; everyone is on board for the New Chinese Century. The problem is how to align oneself with these howling winds of history, lest one should end up very successfully trading "hard currency" assets in the emerging markets, only to find that the gains become illusory as the reference currencies get trashed. We wonder whether we shall not soon be obliged to urge our readers to swap their entire net worth into Remimbi, Roubles and Reals!

Chart 2: Rise in debt burden



Public debt to GDP 2007 and 2001. Source: EU Commission, IMF, BofAML forecasts, BofA Merrill Lynch Global Research

Rates: How Prolonged is a Period?

As much as T&B is enjoying the ultra-low interest rate environment, and would love to see it extended out towards infinity, given the unpredictability of the economic outturn, excessive complacency in this regard could prove dangerous.

The major theme for the first half of 2010 will be whether unprecedented global expansionary monetary and fiscal policy will result in a growth spurt, and if so, how sustainable this growth will be. Until present we have been sceptical, expecting that the collapse in real-estate, employment, and lending would result in, at worst, a double-dip recession, at best in a prolonged period of flat-lining as both households and governments delever – an environment clearly favourable to long-duration fixed income.

We are ready to revise our views, but not to accept that water can flow uphill. Pump enough stimulus into an economy and one will reliably get a reaction; while this reaction can be confused with self-sustained growth by biased observers, the laws of nature mandate that said stimulus is not sustainable except at the cost of accepting a debt spiral leading to either sovereign default (almost inconceiv-able) or severe inflation. Our bet is that the stress will be taken by fiscal tightening, and the monetary policy will remain accommodative for that "prolonged period." That said, as nervous deflationists, we remain long fixed income, but would keep portfolio durations moderate. No 30-year bonds for us!

How to trade it

The fundamental problem with the consensus is that it is not always wrong!
T&B

The Dollar Death Watch? - Ay, Dolores!

When last we parted company, T&B was moving towards a tactical long USD position, closing our longstanding NOK/Euro, AUD and NZD recommendations, though remaining long the rouble – this latter a matter of some stubbornness on our part, in the face of what seemed like irrational currency weakness.

As it transpires, our long USD position (against almost anything) provided a nice close to the year. The strength has lasted a bit longer than expected, essentially because, for whatever reason, the USD is clearly the other side of the risk trade; the dollar rises on Fear, falls on Greed – and with Greece wobbling and China tightening, Fear is currently the flavour of the month.

That said, we remain fundamental dollar bears, and would now begin to exit long USD positions, going flat while awaiting the next bout of dollar weakness.

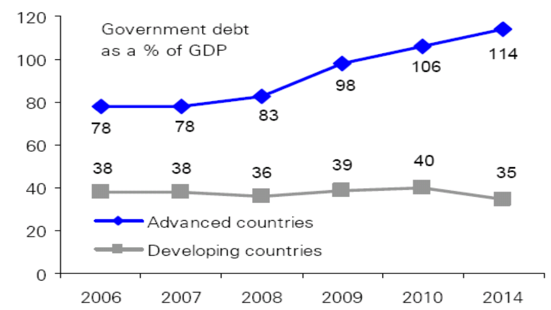
Both the markets and T&B itself may have been a bit too complacent about the risks of an implosion in one of the smaller Euro member states. The fundamental question of whether their domestic political systems are robust enough to take the very hard discipline implied in paying down their bulging debt loads goes well beyond the scope of this report. Although we believe that, in the long run, an exit of one or more of the PIIGS from the Euro would actually strengthen the common currency, in the shorter term, it would trigger panicked downside volatility – an outlier risk, but one to be monitored.

Since when selling the USD one must sell it against something, our top picks would be CAD, AUD, NOK, SGD and perhaps CHF. Again, we are not in any hurry to get short of dollars again until we see a sustained improvement in the mood in the financial markets.

Fixed-Income

T&B still remembers the astonishment we provoked five years ago, writing that Russian bonds were trading inside of that old stalwart, the Ford Motor Company! Subsequent events confirmed the market's risk assessment. The syllogism between risk and emerging markets *is outdated. Over the past decade what has changed fundamentally is that, with precious few exceptions, the emerging countries we know and love – from Ecuador to Kazakhstan, Indonesia to Mongolia, have become paradigms of fiscal probity by comparison with such renegades as the UK, Greece, Portugal…and indeed, that ground-zero for "risk-free" rates – the United States. Even in the most profligate of the emergings – Venezuela, Ukraine and Vietnam, policy seems reasonably sustainable by comparison with the UK! Despite all the ironic warnings against any suggestion that "this time could be different",* ***life is change*** *– and there is good reason to fear that worried investors pulling away from "risky" emerging assets to move back into the safe haven of the G7 markets are rushing back* *<u>into</u>* *a burning building.*

Figure 1: Public debt ratios in advanced and developing economies



Source: Deutsche Bank, IMF

Where does <u>your</u> "safe-money" go?

We retain our bullish calls on Russian, as well as on selected Kazakh and even Ukrainian debt. We can only reiterate our view that the Russian banking sector remains obviously mispriced (though not nearly so much as six months ago!) with virtually a zero-risk of default/restructuring for any of the top 50 banks, and still-generous spreads. Again, we can only repeat our preference for the subs since, in the very unlikely event of a crisis severe enough to cause bank liquidations, subs and senior debt would be worth approximately the same thing – one might as well buy the cheapest.

Wither the Benchmarks?

There is a major caveat to our bullish call: we cannot help worrying about a backup in benchmark rates. Morgan Stanley expects US 10-year yields to break above 5% next year – although Goldman's has them dropping to about 3 ½ % (quite a range!). If the economic recovery is anything like sustainable (which we very much doubt) then rates will indeed rebound, with the longest-duration and narrowest spread assets taking a disproportionate hit; on the other hand, assets with durations of less than five years and trading >500 bp over the treasury curve should be adequately protected.

While we are sceptical about US recovery, short-term visibility is limited, and we would prefer to stay covered – we currently favour high-yield over high-grade, and indeed, would prefer some of the dodgier assets within the high-yield class since the wide spreads provide something of a cushion against increases in the benchmark rates.

In Russia, we would be selling down high-grade positions – RSHB, Gazprom etc; 6% yields are simply not compelling under current circumstances. Even our perennial favourites in the Russian banking sector have relatively little juice left. Alfa 2013 is now yielding around 7.8%, which in absolute terms would seem fairly expensive (though, in spread terms, 550bp over is still decent); we would be prone to leave something on the table and take some profits, or at least, hedge out treasury risk.

The market has belatedly come around to our oft-stated view that the credit risk on the top 50 Russian banks is pretty much uniform, i.e. the large premia for state banks was never justified. Thus, the spread between Bank of Moscow and Alfa has now collapsed – the rating agencies are still drawing artificial distinctions between the default risks, but the market has rightfully chosen to ignore them.

Given the tight spreads at home, T&B has been slumming around in those two EMEA appendages – Kazakhstan and Ukraine. Kazakh has been a turkey shoot. Our two "safe" Kazakh trades, ATF and Bank CenterCredit, have now been recognized as having been totally mispriced and have tightened dramatically; at current levels, we would hold the subordinated issues for cash flow rather than further price appreciation. As regards our riskiest Kazakh call, KKB is now trading down into the high single-digit yields, with the subs (KKB 49s) actually tight to the curve – probably mispriced on scarcity. KKB has paid off all of its 2009 maturities, and the next major payments are not due until 2011. That said, we think that the risk-reward is fairly balanced at current levels, and we would not be buyers.

As for Ukraine – our two recommended bonds, City of Kiev and Alfa Ukraine, have surged, but then, so have most Ukrainian assets. The elections are a bit of a circus, but the prevalent trade seems to be *anyone-but-Yushchenko*, and ultimately, the expectation of a renewed collaboration with the IMF, as well as vastly improved relations with Russia. Spreads are tightening, Nafto has gone ballistic (we totally missed that one...) and along with the two bonds cited above, risk-tolerant investors may consider a bite of Privatbank; a highly-controversial institution owned by some very colourful people, it is nevertheless well capitalized and a likely beneficiary of the current political reshuffle. (disclaimer: *don't try this at home!)*

Further afield – Viva Fidel!

Having become extremely Russo-centric in our debt trading views, not because of a bias against other markets, but simply because the pickings in the EMEA space were so wonderfully rich – we would now be prone to diversify a bit; with Asia characteristically tight, we would begin to position in Latam – in particular Argentina and Venezuela.

As regards Veny, while there is much we find sympathetic about Mr. Chavez, ("populism" is a term usually employed to fustigate governments wasting money feeding the poor) his macroeconomic policy is not really where we would start; the ongoing devaluation of the currency and unorthodox monetary policy are ultimately not sustainable. That said, Venezuela is one of the world's top oil producers, increasingly supplying China with which it enjoys a strengthening relationship, and provided that oil prices stabilize, the PDVSA bonds would appear badly oversold. A constant stream of invective from the bulge-bracket, which tends to treat Venezuela in a fashion reminiscent of the coverage of Iran in the editorial pages of the Wall Street Journal, creates the sort of buying opportunity we have so often seen in Russia. That said, we would treat this as no more than a medium-term trade, carefully monitoring the political situation.

As regards Argentina, it is usually either our favourite long or our favourite short. These days it is neither, but we like it as a yield play – in particular, the Provincia de Buenos Aires, or simply the Discos. A debt deal will ultimately be signed, and Argentina will return to the markets. The macro numbers are improving (including those involving foreign trade which can be independently verified...) and economic orthodoxy has once again become popular. *Someday, down the road, they shall doubtlessly come full-circle, and default again, but there will be plenty of time to get short again...*

Pobre de Mexico! Tan Lejos de Dios...

Since the above trades incur some substantial duration risk (largely but not totally cushioned by the wide spreads) those investors able to do so should consider putting them on as a pairs-trade, shorting long-duration Mexican sovereign assets against Argy/Veny.

Mexico is a very much underappreciated candidate for the next failed state. To call the current spreads – about 130 basis points – "insane" is a gross understatement. Mexico is being hit by collapsing oil production, huge layoffs in the US building and services sectors, as well as a drug trade running totally out of control, and which poses a very real threat to the state. The rating agencies have not yet fully realized that Mexico is "investment grade" like it is Hindu. Despite what must be massive political pressure on the agencies to look the other way, we would expect a series of downgrades, taking it towards lower double-B levels.

In any event, Mexican spreads have only one way to go; tacit a true case of collective madness, they simply cannot tighten inside say, 100bp – on the other hand, they could blow out by a sizeable multiple of that, either as a function of the Mexican news flow, or in the event of a more generalized market sell-off.

The Rating Agencies:
Of Goldfish and Bicycles – What would we do without them?

T&B has heaped abuse on the rating agencies for most of this decade – not simply because of a perverse taste for beating dead horses (and why not? unlike the live ones, they never kick back...) but because of a sense of outrage at the totally inappropriate quasi-official role enshrined by legislation and market practice for these private, for-profit organizations, several of which are owned by diversified financial groups, responsible solely to their shareholders, and who give not a fig for their objectivity or probity. Despite the obvious conflict between their commercial structure and their institutional role, bank holdings, Basel standards, central bank repos of debt paper, the portfolios of pension funds – all are regulated by a trio of agencies *recently demonstrated to be egregiously corrupt in their ratings of structured products.*

Amazingly, despite having been as guilty as the money centre banks for the financial collapse, they have escaped all attempts at regulation or control, while retaining a key role within the international bank regulatory framework – the equivalent to handing over legislative oversight to the only slightly less notorious Moscow Traffic Police!

In recent weeks, S&P helpfully upgraded the outlook for Russia from Negative to Neutral, leaving the underlying BBB country rating unchanged (as Bloomberg might add: *for those who can't count, that is one notch above the lowest investment grade*). Typically, this ratings shift came several months after the CDS spread on Russia began tightening from a panicked high of ~1200 during the worst of the turbulence, to a recent low around 165; for a bit of comic relief, the revision in Russia's outlook was announced shortly after the agency slashed its ratings on Dubai – this several weeks after the market did so for them, as Dubai CDS spreads literally exploded. Once again, the agencies proved to be excellent lagging indicators, predicting the past quite accurately.

Russia is now – we think appropriately – rated higher by the market (i.e. the CDS is narrower) than Brazil or India, although rated lower than China.

Looking beyond our own little corner of the woods, we encounter a few minor anomalies – in particular, despite towering debt pyramids which would become unfinanceable the day that Euro rates are normalized, gaping budget deficits, and dangerously dysfunctional political systems (closing the Greek budget deficit would presuppose divine intervention), the European PIIGS, (Portugal, Italy, Ireland, Greece and Spain) are A/AA-rated, i.e. several notches higher than Russia. We would note that, unlike these pedigree swine, Russia has huge net sovereign savings, responsible (and especially, counter-cyclical) budgetary policy and impressive political stability (the last time Russia was paralyzed by strikes or civil unrest was 1917 – rather more distant than many southern European states...) – along with some very convenient hydrocarbon reserves.

Not surprisingly, the spreads demanded by investors on Russian sovereign assets are now well <u>inside</u> those for Greece; it is only a matter of time before this becomes the case for several of the more desperate Euro hangers-on.

The Euro Trembles – Greek Comedy?

Like the European Union itself, the Euro was essentially a political creation, a voluntary straightjacket designed to rope the European states together in an unbreakable union, so as to finally resolve the great tragedy of Europe since 1861: in the words of AJP Taylor, *Germany was stronger than any of her neighbours taken individually, but weaker than all of them taken together.*

Onto this fundamental imperative was grafted the overriding imperative of the mid-sized European states to maintain their relevance in a multipolar world as the balance of economic gravity shifted rapidly across the Atlantic, and then, from the Atlantic towards the Pacific.

Both France and Britain have long succeeded in punching above their economic weights; they now hope to leverage upon their superior diplomatic skills, benefiting from the sheer size of the European Union. Germany alone has the sufficient weight to be a global player, but – given the Ghosts of Christmases Past – generally seeks to build a European consensus rather than acting alone.

The major limit to German compromise has been the memory of Weimar Republic hyperinflation, and the resultant political havoc. This is very significant: unlike for Americans, for whom the deflationary Great Depression is the dominant historical reference, for Germans, the memory of the debasement of the currency is foremost.

Thus, before signing on for the Euro, Germany demanded the Stability Pact, with hard limitations on public debt and inflation for accession, as well as severe financial sanctions for any deviation from the fiscal criteria. Needless to say, the criteria for adoption of the Euro were fudged for political reasons, Greece provided fraudulent economic data, and with the recent economic crisis enforcement of the Pact was "suspended."

That said, German (and French) public finances have remained relatively virtuous; it is primarily the peripheral countries to have gotten themselves dangerously overextended courtesy of markets that no longer needed to price currency risk, and choose to ignore growing sovereign risks (note that a non-Euro member state, the UK, is running budgetary policies arguably worse than any of the PIIGS.)

Recent selling of the Euro has been widely attributed to the fear of default in the peripheral countries, however since most other currencies have also been falling against a recovering USD, we are not entirely convinced that this is the major factor; if it is, then this would likely represent a buying opportunity.

First of all, the Euro is structured so as to render it particularly difficult for any country to withdraw – and more to the point, any member doing so would be committing economic hara-kiri since they would find themselves forced to borrow at rates several times those they had been paying in Euros, facing severe IMF programs and a harshly deflationary outlook. Germany will not allow fiscal profligacy to be rewarded by continual ECB bailouts, ultimately turning PIIGS risk into Euro risk – thus, what is being seen as a Euro problem is in fact a classical case of the assessment of sovereign debt sustainability.

Indeed, a Euro-zone state could theoretically default on its debts without leaving the bloc – investors are buying the signature of a particular country, not of the ECB. This begs the question of whether any Euro-zone member would be forced out of the bloc for egregious violation of its fiscal requirements. While our base-cases scenario is that market forces, not the European Commission, will enforce sufficient budgetary discipline, one or two of these countries (Portugal? Greece?) may have already found themselves in a debt trap, i.e. where increasing market rates render the funding of the accumulated deficit prohibitively expensive, further aggravating the deficit, while economic growth is crushed by the fiscal burden of debt service.

While we think it unlikely that any of the main member states would wish to assume the political risk of pitching one of the peripheral countries to the sharks, if we are mistaken, or were this to become ineluctable, it would trigger a wave of panicked volatility and flight to quality and the dollar would undoubtedly surge. That said, six months down the road, the Euro would be strengthened – not weakened, as it would become even more the successor currency to the Deutsche Mark, with Germany wedded to the notion of fiscal probity.

With a sunnier view of the human condition, the Americans will remain focused upon the Great Depression and on avoiding the Japanese Scenario. Thus, third-party reserves managers seeking to balance currency reserves will ultimately prefer the currency whose real value is a matter of obsessive importance to its major issuer, and which is sustained by positive real yields, while the US body politic accommodates itself to negative real yields and continued currency debasement.

The Eternal Russia

This month, we will be relatively brief about Russia, instead appending our new piece on an old favourite theme – Russia's New Asian Century, i.e. Russo-Chinese relations. That said, we could not resist taking a swipe at the villainous "reporting" of the Financial Times and the clueless "diplomacy" of the West, Inc.

Regarding the FT, the pernicious incompetence of the FT's editorial treatment of Russia, when compared with their writing as regards any other European country, is simply breathtaking. One could easily imagine that they were writing of some faraway place where no one had ever been, but which they had been reliably informed actually exists.

While the FT continues to employ some very experienced and competent reporters on the ground in Russia, half of the stories they run are editorials-in-disguise. The standard tack is to construct a relatively neutral framework, then solicit the most negative and Russophobic quotes available, providing a fake aura of objectivity, as in – *" I didn't say it – a Russian did...so it must be true!"* Given that, in Russia, one can readily enough find someone happy to be quoted saying almost <u>anything</u> – from the boringly consensus to the wildly outlandish – any half-bright hack can "document" virtually any assertion he wishes.

In a recent hatchet job by Quentin Peel, not ordinarily considered to be a Russia expert, we learn that:

What seems to bind the two themes of security and modernisation together is a desire in the Kremlin to come in from the cold. But what is equally clear is that any return to warmer relations with the West should not do anything to disturb the power structure in Moscow or its regional sphere of influence.

Take Mr Medvedev's modernisation thesis. Andrei Ryabov, editor of the journal World Economy and International Relations, says the Kremlin's strategy seems to have a lot in common with that of Peter the Great or Joseph Stalin. "It means buying foreign technology while maintaining control, stability and law and order. You have a Utopian project which can hardly be realised, because the key actor [in Russia] will remain the state, with structures that are riddled with corruption."

The above statement is prima-facia idiotic. Peter the Great had rather more in common with any other 17th century monarch than with Vladimir Putin. Joseph Stalin was the leader of a fiercely ideological empire – something which no one could assert about modern-day Russia, as devoid of ideology as any nation on earth. As for the rest, it is tautological that every country, developing or developed, seeks to buy in the best available technology, while maintaining stability, law and order! Is Russia expected to seek the most outmoded technology, while courting anarchy? There is nothing remotely "Utopian" about this project, it is strictly about dollars and cents, while the remainder of the quote is nothing more than a statement of personal distaste – and should be quickly consigned to the dust heap by anyone who paused to consider the ongoing modernization of China.

Peel then slips in his own coloration – again, simply a statement of personal tastes, again, with nary a scrap of substantiation.

Another big theme in Russian government circles – on the face of it unrelated – is the proposal for a "new European security architecture". This has been talked about in Moscow for a year or more but nobody wanted to take it seriously in the rest of Europe or in the US.

Whether or not anyone takes it seriously will be a function of a single factor – how much the West thinks it needs Russian cooperation! Previously, and despite all of their protestations of good-neighbourly intentions, NATO has treated Russia's legitimate interests with contempt – thus, the bombing of Serbia and the failed Georgian invasion of South Ossetia. Times have changed, and Mr. Obama has radically modified the diplomatic tone. NATO is soliciting Russian help in Afghanistan and Iran (they will probably get help on the first – certainly not on the second!) and Russian cooperation now seems a goal worthy of considerable attention.

Given that the United States is seriously over-extended and is facing further military burdens (the war in Yemen is just getting underway) and, thus, is obliged to seek more harmonious relations with other major powers, while NATO is thrashing about in search of assistance in Afghanistan (their last tack, outright bribery, smacks of desperation) and has de-facto consigned Georgian/Ukrainian accession to the field of dreams, our betting is that they will be taking Russian security considerations quite seriously indeed.

NATO – More Cognitive Dissonance

NATO sources have recently alternated between relatively macho statements as regards Russia: angry remonstrances concerning the partition of Georgia, and repetition of the myth of Georgian/Ukrainian accession, and increasingly desperate pleas for Russian assistance in Afghanistan.

First, a bit of history: it should be remembered that Russia – in her previous incarnation as a Republic of the Soviet Union – has already "helped out" in Afghanistan – by attempting to occupy that benighted country so as to prevent the sort of instability we are seeing today. They suffered a bloody defeat, in large part thanks to generous support of the Islamic insurgency by the CIA and NATO, who nurtured and armed the Taliban, providing them the Stinger missiles which so effectively chased Soviet helicopters from the skies; thousands of young Russians died, and though the Afghan government held for two years following the Russian withdrawal, ultimately it was overthrown by an extremist Taliban regime which engendered Al Qaeda and recognized the rebel Chechen regime. Little did anyone expect that the World Trade Center would ultimately be part of the collateral damage – and this, perhaps only a down-payment.

To expect the Russians not to see a certain poetic justice in NATO's struggle to undo its own work would be to think them utterly devoid of human failings.

That said, it is clearly in Russia's interests that the Taliban be defeated, and Afghanistan stabilized. Russia may thus well decide to provide assistance within the framework of a more cooperative NATO relationship. It is, however, insane to imagine that NATO officials can simultaneously goad the Bear and expect generous Russian support. For that, there will need to be a broad framework – including measures to address Russian security concerns.

Old habits die hard, but if the West wishes to have Russia as a partner, they will learn to deal with her as such!

Welcome: The Moscow News!

Finally there is some pluralism in the Moscow English-language press. While for years, those unable to savour the long-winded pleasures of Russian newspapers in the original had little alternative but to subject themselves to the amateurish and systematically anti-Russian "journalism" of the Moscow Times (in the mid-1990s, the world's best English-language expat daily; now, under changed management and after being plundered of its best journalists by the top global papers, on a par with your typical high-school rag).

For a quick English read, although it is still only a weekly, the Moscow News provides a more balanced and constructive alternative. Pick up a copy the next time you need a caffeine fix – and tell their advertisers how much you like seeing them there!

Appendix I – Russia's New Asian Century

T&B is occasionally criticized for our purportedly Sinophilic mind-set – nothing could be further from the truth! An avid sailor and diver, we are sickened by the irreparable devastation of the ecology of the oceans by the Chinese taste for shark fin soup. As born-again Buddhists, we are appalled by the rape of Tibet (on the other hand, questions of Chinese domestic policy are strictly up to the Chinese to decide, and we do wish the Western governments would stop moaning about what they cannot possibly influence).

Tacit our purported anti-Americanism, we have more than once warned that when the Chinese rule the roost, we shall all end up rather missing the American Empire. This is a statement of personal tastes – and is neither here nor there; to be of any utility to our readers, T&B must seek to describe the world as it is – not as we would have it.

Queried by clients as to whether China can truly compete with Russia, we regretfully answer that it was self-evident – if the Europeans and the Americans cannot, how could Russia? Fortunately, Russia does not have to compete. There are numerous areas for lucrative cooperation, and all things Chinese – markets, models and money – will be vital determinants for Russia during the coming decade.

Global investors would be well advised to follow our advice to "Buy whatever China needs – selling anything that China makes".

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Russia's New Asian Century

Eric Kraus

At the beginning of this decade, when I first warned that the pernicious and misguided policy toward Russia of the NATO countries would only serve to accelerate Russia's natural drift towards a closer alliance with an ascendant China, these warnings were met with derision; indeed, one noted American academic went as far as to retort that Russia was so afraid of China that she would be compelled to seek a protective military alliance with Washington – under virtually any terms the Americans chose to dictate…

A decade later we have seen not a defensive Russo-American military alliance, but quite the opposite – the rise of the Shanghai Cooperation Organization (SCO) as a major forum for Russo-Chinese diplomatic and military cooperation, a functional Sino-Russian alignment in the UN Security Council, the largest joint military exercises in China's history, an explosion in bilateral trade volumes, substantial Chinese investment in the Russian resource sector, and vitally, the building of a major hydrocarbon export pipeline complex to supply China's growing energy needs (meanwhile, totally unhindered by his unenviable track-record, our American friend has continued his rise in prominence, and is currently advising Mr. Obama on Russian affairs)

Admittedly, there were grounds for scepticism: historically, the relationship between Russia and China has been fraught. Beginning with Peter the Great, Russia looked towards a "civilized West" for role models, rather than towards a backward and impoverished Asia. By the end of the Napoleonic Wars, Russia had come onto the European stage not as an onlooker, but as a full-fledged participant – a bulwark of monarchical conservatism and the preservation of the status quo.

Like her Western peers, the Tsarist Empire saw the lands to the South and the East of Europe as a legitimate field for territorial expansion; as Qing dynasty China weakened, Russia embarked upon a major Eastwards expansion along the Amur River, seizing a large block of Pacific territory under nominal Chinese sovereignty. Consecrated by the Treaties of Aigun and Peking (the only of the "unequal treaties" to have never been abrogated by China), this conquest effectively transferred one million square kilometres of land between the Stanovoy Mountains and the Amur River to the Russian Empire.

Russia assisted Mao during the Chinese revolution, however after a brief period of cooperation between the two leading Communist powers, relations rapidly deteriorated due to the personal animosity between Mao and Khrushchev, as well to the fundamental question of who was to be the elder brother; this culminated in a series of armed confrontations in the late 1960s along a border which had never been properly agreed. By the time the Soviet Union voted itself out of existence in 1991, relations with China ranged between poor and non-existent.

The economic logic behind an enhanced relationship was obvious – Asia needed Russian resources, Russia was desperate for Asian capital – but whilst President Yeltsin made occasional gestures towards the establishment of an active Asia policy with increased trade and the building of export pipelines, there was a characteristic lack of focus or follow-through. Yeltsin was obsessed with rebuilding relations with the West, and both China and Japan soon became disenchanted with an inconsistent and ineffectual Russian policy; diplomatic relations were icy, with tens of thousands of kilometres of border lands still under dispute. The Chinese continued to regard their Western neighbours as barbarians, while Russians told lurid tales of the "Yellow Peril" – two million Chinese illegal immigrants already deeply entrenched in Eastern Siberia, ready to rise up, seizing Russia's Far East.

The assumption of the Russian presidency by Vladimir Putin led to a fundamental recasting of this vital relationship. From the political standpoint, the two countries were united in their vehement opposition to the unilateralism of the Bush administration, seeking to restore their own spheres of influence in a multipolar world. Both are permanent members of the UN Security Council, where the two BRICs are almost systematically aligned. The last Sino-Russian border disputes involving two islands at the mouth of the Amur River were settled in 2004, followed by a major push to improve popular perceptions – the Year of Russia in China, followed by the Year of China in Russia.

The Russo-Chinese diplomatic rapprochement has been impressive – the Shanghai Cooperation Organization, now widened to include all of the main Eurasian countries excluding American-aligned Japan and Australia, has evolved from a talking shop into one of the key levers for Sino-Russian influence in Central Asia. Russia and China are tightly aligned at the UN Security Council, where China – somewhat reticent to antagonize their largest export market – discretely shelters behind a Russian government increasingly willing to assume a more confrontational stance.

Finally, the largest-scale joint military exercises in either country's history have been conducted, and after decades of selling slightly antiquated weaponry, Russia is increasingly willing to export its most recent generation of military technology to China, signifying a new confidence in their long-term relationship.

As China scours the globe for resources – energy, grain, pulp and paper, minerals, metals and ores – to fuel voracious industrial growth, Russo-Chinese trade has surged to more than $60bn/year. Russian railroad and electricity networks are being built out to service Chinese demand, while following a long and tedious hesitation waltz between the rival Japanese and Chinese pipeline routes, China has prevailed; the first phase of the Eastern oil pipeline (ESPO) has been completed, with a parallel gas pipe now in the planning stages. From the strategic standpoint, energy supplies from Russia or the Southern Republics offer China a major security advantage – they are not susceptible to interruption by naval blockade.

During the global economic crisis Chinese capital proved invaluable to Russia, with China offering $25 bn in credits on favourable terms to the Russian oil transport monopoly Transneft and the majority state-owned oil major Rosneft, in return for guaranteed future oil supplies.

The Double-Eagle Finally Looks East

When on December 28, Prime M Vladimir Putin inaugurated Russia's first major oil export facility on the Pacific coast, the Kozmino deep-water oil terminal exporting oil transported by the long-awaited ESPO (East Siberia-Pacific Ocean) pipeline, it marked a fundamental shift in the global energy balance. Mr. Putin's declaration that "this is not just a pipe, but rather, a geopolitical project" can be taken at face value. At a total cost of some $15 bn USD, the Eastern export route has been the most expensive infrastructure project ever undertaken in the Russian energy sector; transport costs will be approximately twice those of the European export routes, a necessary cost for Russia's participation in the Asian growth story, as well as for freeing Russia from dependency upon Western off-takers. While Russia, the world's largest oil producer (10m bbd – compared with Saudi Arabia's 7m), has traditionally looked to Western European markets, with the build-out over the coming decade of the next phase of ESPO, including the spur to China, a substantial share of Russian hydrocarbon exports will flow toward the high-growth Asian markets, especially China.

Russia and the Dragon

By needlessly antagonizing and hectoring Russia, the clumsy, self-righteous, and frequently provocative diplomacy of the Atlantic Alliance has simply served to accelerate this rapprochement. From the Russian standpoint, China is in equal measures a threat and an opportunity and there are multiple areas of strategic competition between the two giants. Nevertheless, one vital point is almost universally overlooked by Western commentators – the Russian government is fully cognizant of the very limited means at its disposal to counter the secular ascendancy of China. Given that this process appears ineluctable, it is in Russian interests to become a net beneficiary of this fundamental shift in the centre of economic gravity.

Chinese chequebook diplomacy has led to a major increase in Chinese influence in the "Stans," previously the Southern flank of the Soviet Union and within Russia's historic sphere of influence. Kazakh President Nazarbayev who had long sought to play off Russia, China and the West against each other now increasingly appears to have placed his bets on China, as Kazakhstan seeks to become a part of the Asian growth story. The huge increase in Chinese project finance and direct investment in Kazakh resources and infrastructure will substantially increase mineral extraction and supply to the Chinese market. Similarly, Chinese investment is the major driving factor in the neighbouring republics of Uzbekistan and Tajikistan, with Chinese manufactured goods having largely displaced Russian manufactures across the region. A Chinese gas pipeline linking Turkmenistan to China via Kazakhstan and Uzbekistan with a capacity of 13 bn m3 per annum has recently been commissioned, further complicating the longstanding negotiations between Russia and China for planned Russian gas exports from Sakhalin; while Russia demands that the gas pricing formula be indexed to Asian crude oil prices, China is doing everything possible to avoid such indexation. While Sakhalin I operator Exxon has repeatedly sought permission to sell gas directly to China, Russia's Gazprom has an undisputed legal monopoly on gas transport within the Russian Federation; thus, we would expect that China will ultimately accept Russian gas deliveries following the standard oil-indexed formula.

Nabucco: of Pipelines and Pipe-dreams

From the European standpoint, the constant threats to diversify energy sources away from Russia are having unintended – if readily foreseeable – consequences: Russia is doing whatever possible to diversify her export markets. While the building of the North Stream and South Stream corridors carrying Russian gas directly to Western Europe locks the two sides into long-term supply contracts, production from new fields will increasingly flow east. The Atlantic Alliance scored an impressive own-goal with loose talk of a proposed Nabucco pipeline, the proposed southern European energy corridor intended to transport Caspian gas to Europe without crossing Russian territory; the threat of Nabucco triggered Russian countermoves to lock in all available Central Asian supplies, as well as to accelerate diversification of her own export routes. While it has been proposed that initial gas be provided by Azerbaijan, Azeri supplies are clearly insufficient to render Nabucco even remotely economic. As China and Russia compete to buy up every available molecule of gas in the region – tacit the obvious problem of how to get Central Asian gas to Europe (all five Caspian states including Russia have veto power over any undersea construction) – the likelihood of Nabucco finding sufficient supplies is approximately nil.

Russia's New Asian Century

Looking forward, we would expect to see increasing cross-border integration of Russian and Chinese processing industries. The Hong Kong listing of Rusal, Russia's aluminium behemoth is a case in point. The manufacture of aluminium, essentially a crystallized form of electricity, makes no sense in energy-short China – it makes a great deal of sense in Russian Siberia, with its enormous hydropower resources. We would expect Chinese state entities to seek to acquire stakes in Rusal and other Russian metals firms, leading to further integration of the supply chain.

Similar development can be expected in other commodity industries, as Chinese industry moves rapidly up the value chain while Beijing seeks to mitigate the growing ecological strains of rapid industrialization, with increasingly severe restrictions on pollution, fresh water supplies, and land use.

Great powers have no permanent friends – only permanent interests; thus China and Russia. The economic logic of further Russian integration with developing Asia is sufficiently compelling to override any cultural or political barriers. While most attention has been given to energy supplies, these are only part of the story – growth markets for Russian exports to China include agricultural products, especially grain and foodstuffs, coking coal, iron ore, PGMs, gold, copper, nickel, aluminium, and forestry. More speculatively, given the environmental havoc caused by increasing population strains and climate change, we would expect to see increased trading in electricity, agriculturals, and even fresh water – an increasingly scarce resource in mainland China.

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