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TRUTH & BEAUTY
[...AND RUSSIAN FINANCE]

Gazing Into the Abyss

The Khodorkovsky Death Watch

We have repeatedly thought we had spoken our last of the Yukos story, and that – like for the Orange Revolution, or the Georgian invasion of So. Ossetia – the world had begrudgingly come around to a more realistic assessment of the events. This was, of course, to neglect the huge power of PR in our world – money still cannot buy your happiness, but it can, apparently, buy you "Truth"! Khodorkovsky – a murderous thug whose comeuppance was well earned – has corrupted the Anglo-Saxon media much as he corrupted the Russian Duma in the late 90s… and it shall do him about as much good… the following e-mail exchange between T&B and one of the best New York investigative journalists, summarizes our view:

Readers are Reminded that they are welcome to forward T&B to any party they choose.

Dear Eric,

I picked up New Yorker today and read a lead editorial by its editor David Remnick stating as a fact that the charges in the Yukos case were entirely trumped up. David states that K(hodorkovsky) did nothing wrong other than offending Putin.

Didn't the authorities have specific charges about Yukos? As I recall, the Yukos owners were found to have siphoned off $24 billion or so through Cyprus dummy companies?

Is this case better reported in Moscow? In the US, every editorial starts with it as a frame-up and does not discuss any of the actual charges.

David

Dear David,

The main charges against Yukos are so obviously true that only someone who had never lived in Russia during the 1990s could harbour any doubt as to their veracity.

The only possible defense is that "*everyone else was doing it too*"… And of course, they were. Yukos went down because Khodorkovsky refused to stop playing that game when the umpire, Vladimir Putin, called time. The game had changed and Khodorkovsky massively overplayed his hand, believing that he and his brethren still owned the Kremlin outright, and could continue to dictate Russian economic policy.

The problem, of course, with the "*everyone else*" argument is that it has no judicial validity – the fact that other folk were running pyramid schemes was not considered exculpatory for Madoff, nor before him for Boesky, Milken, Cornfield, et al. All of them are guilty of far less criminal behavior than was the Russian Godfather.

To put it very simply, in the 1990s there was one game in town – natural resources. The privatized successors to the Soviet extraction industries all played the same game. They all "sold" their output to captive offshore entities, including both the foreign-domiciled structures you refer to, and to the notorious "onshore-offshores", i.e. postbox entities domiciled in the most far-flung and impoverished areas of the Russian Federation, which had been granted special tax treatment, especially if they hired the handicapped. Every one of them had an office cripple or two, who did nothing but sit, drink tea and watch the tele. (Abuse of these same structures is what brought Browder to grief.)

These dummy trading companies then resold the commodities onto the global markets at market prices, banking the proceeds abroad.

The Russian budget was starved for taxes as the main Russian entities officially made no profits. Substantially all of the gains from the sale of Russian export commodities accrued to the foreign bank accounts of the owners - direct or indirect. Ultimately, this eventuated in the financial crisis of 1998.

What is truly outrageous here is that all of this was **public knowledge** in the 1990s! Every hack, every investment banker, every investor knew the score. No one even bothered to keep it particularly secret – since the oligarchs owned the State outright, they had little reason to fear its wrath. It is amazing how selective memories are – just do a Google search and see what was being written about Khodorkovsky at the time!

The Russian market went from a floating craps game to a real (if still very imperfect) market when the exporters - oil, fertilizers, minerals, metals - were forced to buy in their trading vehicles and repatriate their cash flows. I should know – I was involved in several such transformations in the early part of the decade.

It was the high taxation of oil exports that rebalanced the Russian budget – and set Russia on the path towards fiscal stabilization. Needless to say, the oligarchs did not look favourably upon this massive increase in taxation.

Khodorkovsky went down for blocking the mineral extraction tax and similar legislative/fiscal changes in the Duma (Russian Parliament). Yukos owned outright a block of Duma voters who, in conjunction with the various "opposition parties" (from the Communists to the liberal splinter groups - most of which were funded by other oligarchs), could block any legislation not to Khodorkovsky's liking… It was not a challenge Putin could ignore, and the Alfa bull took him out.

And, as old Ezra put it – "All the rest is litr'tur".

Eric

Muzzled no Longer!

Seven years ago, T&B enjoyed our 15 minutes of fame in the "Bandits*" scandal. During a stint as Chief Strategist for a Russian bank, we had initially referred to the management of a prominent and somewhat sulphurous Russian oil company as "*former bandits" **–** *actually intending it as a compliment! Investors tend to be forgiving animals, and like Yukos, the company in question briefly appeared to have seen the light, evolving from an ugly, oligarchic past towards greater transparency and investor-friendliness – perhaps not the sort of institution you'd trust your adolescent daughter with, but at least one not likely to mug you in the parking lot.*

Alas, it was not meant to be – in the absence of adequate regulation, the temptation to revert to type proved irresistible, and within a few months they were back to some of the ugliest corporate governance abuses witnessed since Yukos/Menatep stole itself – lock-stock and barrel – in the aftermath of the 1998 crisis.

*The ugly truth soon became known, investors were outraged, and with typically Russian logic a conference call (reminiscent of Ionesco's theatre of the absurd) was quickly organized in which the beleaguered company steadfastly declined to give any concrete information, nor to answer any questions. Responding to the angry cries of our long-only clients, T&B banged out a quick desk-note, essentially a retraction – we apologized for just a single word: "*former*"…*

The constructive accusation of banditry was promptly headlined by The Moscow Times (in those days still a paper one could take seriously), the errant oil company management took it very personally indeed, and T&B's life briefly became intensely interesting!

A dead-man walking – and confined to writing about Latin America – we nevertheless had the chutzpah to show up for our employer's annual Christmas party, where our then-boss, Cormac Lynch, pointing to a trained bear – muzzled and on a leash – grinning about the similarity between us.
"Yes, Cormac," came T&B's reply - "but next week my muzzle comes off…"

Ten years later and – having left Zakritie – it has once more...

T&B – Gazing Into the Abyss

Shame on you, T&B!

In a recent issue, T&B quite controversially termed The Economist journalists covering Russia "*a pack of whores".*

A sincere apology is now in order… to the whores!

Indeed, prostitutes constitute an old and venerable profession, providing a highly-skilled service for a freely negotiated price. Whatever one's moral qualms, it is an essentially transparent transaction - no sane person goes to a prostitute expecting to find "true love." Readers of The Economist, on the other hand, have been promised "truth" – objective, erudite, and not dictated by hidden economic or political interests. Instead, what is actually delivered is a well-written compendium of intentional disinformation, carefully selected half-truths, and the occasional outright lie.

This week, T&B has received at least 15 copies of the most recent Economist propaganda piece on Russia, with indignant readers demanding that we pen an instant refutation. For God's sake, why must we bother? Their track record speaks for itself! A magazine which happily rented itself to the US Neocons during the openly fraudulent run up to the Iraq invasion, which hailed the corrupt Timoshenko as Ukraine's saviour, which knowingly retold Saakashvilli's obvious lies during the Ossetian war, and which has been systematically wrong about Russia since the mid-1990s (without even once having the dignity of acknowledging the repeated failure of their predictions) dishonours the venerable old courtesan profession... and we see little upside in debating with them.

Investors following their advice since 1998 would have missed the Russian recovery (world's top performing debt and equity markets for most of the decade), while getting lured in to the Baltic, Ukrainian and Georgian bubbles – with predictable results. Frankly, they have only themselves to blame…

The BBC hardly does much better…

Always compassionate towards dumb animals, watching NATO Secretary General Rasmussen being mauled by Stephen Sackur on BBC Hard Talk, T&B felt like calling the SPCA! Seeing that poor, dumb, plodding bureaucrat savaged by the smug, clever Sackur was reminiscent of bear-baiting or bull-fighting (but against a cow). As Rasmussen stumbled from trap to trap, the most painful episode occurred when the discussion turned to NATO relations with Russia. The poor Dane struggled to maintain the obvious fiction (akin to Turkey's joining the EU, or, T&B the Holy Synod…) of Georgian and Ukrainian accession to the military bloc, all the while affirming what great friends Russia and NATO had become! Cognitive dissonance is apparently part and parcel of his job description – but what possessed him to venture onto Hard Talk, we shall never understand.

The dishonesty of the snide, snarling Sackur was palpable - tormenting Rasmussen over NATO's closer relationship with Russia, he trotted out the disinformation initially broadcast by the BBC regarding Russia's partition of "peaceful little Georgia" in the 2007 war – but which, to the BBC's credit, they subsequently disowned, at least in part, when the European Union report was released.

Anyone watching the BBC during this time – as T&B did – assisted to a transformation reminiscent of the Miracle of the Loaves and the Fishes. For the first 36 hours following the murderous Georgian assault on South Ossetia, the BBC maintained a carefully balanced line, reporting statements by both sides, while rendering it fairly obvious that it was Georgia which had initiated the military hostilities. Then suddenly – their chain yanked by their political masters – the BBC switched to slavish adherence to the Saakashvilli/Cheney line, unabashedly presenting Georgian PR releases as "news."[1]

Strikingly, a year later the BBC published a belated *mea culpa*, wherein they admitted that their coverage of the story had been unbalanced – it had been clearly established that, whatever the provocation, Saakashvilli had ordered an artillery attack on a sleeping civilian population. A subsequent report by the European commission demonstrated very much the same thing (see: *http://news.bbc.co.uk/2/hi/europe/8281990.stm*), although apportioning blame between Georgia and Russia for the gradual rise in tension preceding the Georgian artillery attack.

It is striking that this retraction has now been conveniently forgotten, with Sackur reverting to the initial disinformation – claiming it was Russia which had attacked Georgia, forcing a partition, and conveniently omitting the fact that, whether or not foreign countries recognize them, the newly independent Republics of Abkhazia and South Ossetia had been de-facto independent for almost a decade before the Georgians attempted their forcible Anschluss.

In short, a decade after the collapse of a Yeltsin regime largely subservient to the West, the propaganda machine, funded in part with black Yukos-Menatep money, continues to work overtime. But does it matter?

[1] *Interestingly, Wikileaks showed that the information flowing back to Washington was supplied largely by the Georgian embassy in Rome, as well as directly by the Ministry in Tbilisi – straight propaganda from Saakashvilli's office with no attempt at verification on the ground…*

'Batman' Scores another Goal!

- HURRAY FOR VLADIMIR VLADIMIROVICH!
(… and shame on you, T&B!)

Dragging ourselves out of bed at 4:30 a.m. to pick up the only Singapore-Bangkok plane connecting to our Aeroflot Moscow flight, T&B turned on the TV to silence the din of a world-class hangover – and was utterly flummoxed to learn that RUSSIA HAD BEEN CHOOSEN TO HOST THE 2018 WORLD CUP!

Not, mind you, that T&B gives a tinker's damn for the chance to watch 22 grown men, grossly overpaid, chasing a ball in their underwear. We are informed that the "Beautiful Game" has peacefully substituted for the Great Game; quite frankly, we find trench warfare a great deal more dignified than watching hordes of drunken louts manfully affirming the greatness of their respective nations as two clutches of economic migrants run up and down the lawn.

No, we unreservedly share the joy of our Russian friends at another affirmation of Russia's newfound role in the world – indeed, what we find frankly embarrassing is the fact that we were so amazed! T&B must confess to having stupidly stumbled into the very trap about which we constantly warn our readers.

Distractedly watching the networks' efforts to whip up some excitement during the build-up to the announcement of who would host the World Cup (ever watch CNBC on a dull Friday, 45 minutes before the *non-farm*?), we were repeatedly assured that Russia stood nary the chance of a snowball in hell. Ugly, corrupt, cold, dysfunctional, speaking an incomprehensible language written in a suspicious alphabet, spying on those kindly Americans (who never spy on anyone), cruelly partitioning peaceful, democratic Georgia, jailing innocent oligarchs and building bridges to China, how could anyone award the World Cup to THEM?

The point is, of course, that the shrill, self-referential coterie of the Western Press – The Economist, the BBC, The Washington Post – does not speak for "Mankind" *– they speak for themselves… and for their political masters, and their global irrelevance is in rapid decline. If the reader wishes to know what the "world" thinks of Russia, turn off the TV set, hop onto Aeroflot, and speak to the good folk of Jakarta, of Rio,*

<u>*In Praise of Aeroflot*</u>

When T&B is not totally at sea we are up in the air – spending an embarrassingly large proportion of our time hurled between points a) and b) in a pressurized cigar tube. Inevitably we have endured all the insults the airlines can dish up. British Airways – an institution so profoundly miserable that the term "crimes against humanity" does not seem entirely inappropriate, stands out from the pack – but the others are certainly no picnic.

Air-travel seems to have become a point of crystallization for human idiocy. From the life-jackets under your seat (in the history of civil aviation, no one has ever swum away from a ditched jetliner wearing a life jacket!), to the prohibition of mobile phones (on the average US flight, there are six mobiles left on – though it does tend to run down the batteries…). Indeed, there must be a law stating that once a particular bit of idiocy becomes enshrined in aviation practice, it shall never again be re-assessed. Thus, our all-time favourite – the prohibition of liquids and gels (if you wanna blow your own plane out of the air, it is far more convenient to make it at home, then just pack it in your suitcase!)

Amidst all the uncalled for misery, there is frankly one airline that stands out – a welcome exception to the rule: believe it or not – Aeroflot!

For starters, the ultimate airborne rip-off is intra-European "business-class". Costing about as much as a flight into earth orbit, the business class on BA Moscow-to-London or Air France to Paris gives you exactly the same seat as in Economy, plus a meal you wouldn't dare offer to your Labrador. On one recent flight, Lufthansa didn't even suppress the middle-seat; T&B migrated to the back of the plane where there was more room…

Aeroflot, on the other hand, offers a real business class on European routes… not lie-flat beds of course, but wide, comfortable seats, ample legroom, and meals quite suitable for internal consumption. Should one require sedation there is a very decent collection of wines and alcohols, and the new Aeroflot Sheremetyevo terminal is easily up to European standards, but far less crowded (anyone who has been subjected to Heathrow or other African airports should appreciate).

Their intercontinental service is excellent (the current bit of puffery is being written on the flight back from Bangkok to Moscow), with surprisingly good cuisine (better than we got on either Singapore or Thai), their Airbuses spotless and comfortable, the stewardesses – maternal, kindly, and anxious to please – and our Russian neighbours have the delightful habit of not talking their neighbour's ear off, uninvited.

of Delhi, of Buenos Aires, of Beijing (where, admittedly, like all whites, Russians are classed as barbarians – but privileged barbarians, certainly more worthy of respect than their smug Western peers, who are widely seen as contemptible, self-satisfied, sanctimonious losers).

The English got two votes – the Americans hardly not even that – Spain-Portugal and Belgium-Holland were the runners up (where on earth were they to find the money? Does the IMF sponsor World Cups?). Russian growth will receive a huge boost from the build-out of infrastructure needed to host the games, tourism will boom, and people will see a country totally unlike what they had been led to believe; even the visa regime will be softened… if only they could do something about the weather…
In short, it is an unmitigated blessing – a silver lining without a cloud. T&B shall undoubtedly watch with rapt interest – from our ocean fastness in Raja Ampat (http://www.diverajaampat.org) – far, far from the madding crowds…

Markets - Mayhem and Madness

In Praise of Older Bubbles

The Oracle Marc Faber, in his mountain stronghold of Chang Mai, recently opined that bubbles are, by definition, a profoundly negative phenomenon, almost theologically evil. As a trader – and thus, an essentially amoral mammal – T&B must beg to differ, arguing that, like sex, bubbles are best right before the end[2]*.*

Yes, the long rising phase of bubbles is always and everywhere accompanied by a wretched deterioration in the standards of good taste and manners – latter day peasants flogging real-estate acquire a profoundly irritating sense of entitlement to go with their BMWs. Entire societies shift their collective focus to land transactions and the foibles of the newly ennobled. Donald Trump becomes a cultural hero.

The violent downward phase is even more obviously socially destructive – broken dreams, sudden impoverishment, fractured families and a decline in the voluntary adherence to social codes and conventions – resulting in all manner of mayhem, from the abuse of the wrong kinds of recreational pharmaceuticals to street crime. Like many aspects of the free-markets system, bubbles are clearly a social ill.

Where we disagree with Marc is with his assertion that these natural phenomena are particularly difficult to trade. With a combination of rolling stops and proper hedges, along with a healthy degree of short-termism, strongly trending markets are an absolute lark!

This is neither an ethical nor a non-ethical viewpoint – we are descriptive, not prescriptive. In the unlikely event that T&B were to find ourselves in a position of supreme political power, we would embrace the biblical seven lean years, *paying down deficits, allowing bubbles to deflate, slashing the size of the financial sector (which currently employs us), perhaps leading to the return of some modest measure of sanity, to society in general, and to the financial markets.*

As flagged in a recent, very insightful year-end report by Jim Reed et al. of Deutsche Bank, the grotesquely hypertrophic financial markets – which have come to serve no useful purposes other than their own, while increasing the risk of catastrophe – need downsizing (hyperbole our own, not DB's...).

Fortunately for us, there is little likelihood of this happening. We are but another molecule of water in the rushing stream – and shall thus confine ourselves to trading the bubble, which – like life itself – is ultimately unsustainable. We believe that the combination of political paralysis in Washington, monetary stimulus by the Fed, and almost certainly the need to monetize European debt will drive a further increase in asset prices across global financial markets. Perhaps fortunately, there is one major countervailing force – the festering debt crisis in Europe, which is likely to moderate the momentum while not fundamentally changing the direction or the ultimate magnitude.

Angry Dragon Keeps Smoking

While T&B is surprised by the rapidity with which Chinese ascendancy has become the accepted wisdom in the West – including among Americans, who could be expected to most stubbornly resist acknowledging the loss

[2] This is, of course, a typically male viewpoint – we are all products of our biology; this fundamental difference may go some way towards explaining the preponderance of males in the fast trading world – as opposed to asset management, an increasingly feminized profession.

of their pre-eminence (in Europe, we were forced to do so in the 1950s) – at least one segment of the financial chattering classes remains firmly in denial, and each week T&B continues to receive a half-dozen forwarded papers breathlessly warning us of the impending implosion.

Warnings of the coming Chinese crash apparently increase in direct proportion to the rise in Chinese power. One such article hyped an asset manager for having successfully predicted the unwind of the US subprime bubble[3] (as if this had any relevance to his ability to foresee events in China), noting that he was ready to endure a cash burn rate of 20% per annum until the inevitable crash came (application forms can be downloaded…). Another financial wizard, queried about how he was expressing his bearish view on China, replied that since shorting the Chinese market was risky, and shorting the currency almost impossible, he would instead short… Japanese blue-chip industrials!

Meanwhile, uniquely among the major economies, China shrugged off the financial crisis, has climbed to the top of an increasing number of industrial league tables (most recently, alternative energies) and is set to invest some $1.5 trillion in strategic areas – essentially technology and infrastructure. Although there is inevitably some misallocation of investment, a quick trip to China will show just how much of it has <u>not</u> been misallocated.

T&B remains fundamentally long China; virtually the entire spectrum of emerging markets assets are ultimately China plays. Our two favourites in Asia - the Indonesian and Thai markets, have performed strongly this year. As regards Russian oil and commodities, directly or indirectly, Chinese demand is an essential driver. Talk of a bubble seems to be motivated largely by jealousy – as US public infrastructure rots, and Western educational standards lag, the Shanghai school district has just been ranked the world's top for literacy and numeracy of 15-year olds.

The Dragon Burns His Bridges?

That said, the Chinese government now appears to be making a very dangerous miscalculation. Until recently, Chinese foreign policy had been one of *softly-softly*, promoting galloping economic development without awakening the hostility of their neighbours.

T&B had long warned that someday, as the Dragon graduated from the vendor-finance-of-Walmart model to a better balance between domestic consumption and exports, China would have less need to appease the US and its foreign policy would likely become less compliant – we had not however expected this for a decade at least.

The extraordinary deterioration in the international prestige and "soft power" of the United States under the Bush administration, along with the ensuing economic crisis and the perceived inability of the US to address major economic problems in anything but a hedonistic, short-term fashion, has replaced the erstwhile begrudging Chinese admiration with ill-disguised scorn. A hegemonic power can inspire fear, anger or envy with relative impunity – it cannot long survive pity or scorn.

The economic miracle has apparently gone to Chinese heads – the inevitability of the "New Chinese Century" is taken pretty much for granted, and a nationalistic fever has swept through the populace, informing foreign policy. Memories are long, and apparently the humiliations of the 19th century still rankle. Chinese policy has become needlessly touchy and domineering – especially viz their Asian neighbours. The entire region is apparently seen as sacred Chinese territory, and understandably, the fear of Chinese domination is driving Asian countries to seek alliances where they can, in particular with the United States. Japan, Korea, India, Vietnam and of course Taiwan are all entering into a web of military coalitions vaguely reminiscent of late 19th century Europe – a web of alliances which, of course, eventuated in the First World War.

Perhaps the greatest diplomatic challenge of the coming century will be to accommodate the hand-over of power, and the rise of an Asian country to a position of *primus inter pares* in a multi-polar world. China could do much to facilitate this by seeking to soothe the fears of its neighbours – both close and distant. We see little evidence for any great cultural sensitivity on their part, and fear that the inevitable conflict may be badly mishandled, with a threat of severe disruption to the commonweal.

[3] *Rarely has any outlier event been as well sign-posted as that particular meltdown. CLSA's Chris Wood warned of it, as well as of the bankruptcy of the US housing agencies and banks, years before it became fashionable to do so…*

Le Declin de l'Empire Americaine – A Rant

Our many American readers need not waste time and effort enquiring why T&B thinks as we do, nor whether we are "pro"- or "anti-American" (a question we have addressed repeatedly in the past). The only question which need concern them is whether we are "right" or "wrong." The rest is no more than an issue of personal preferences…

It is a platitude to declare that we are living in an "unprecedented period" of human history. Every period of history is unprecedented – and many of the purported singularities of each era are no more than the reflection of our own inflated sense of self-importance. That said, the present era is entirely unique, not because we are witnessing (yet another) hand-off from a declining to a rising power, but rather, given the speed at which this process is unfolding. History has accelerated into a mad rush; phenomena which would have occurred over centuries are now compressed into decades; perhaps as we approach the ultimate asymptote, the film will accelerate into incomprehensibility as everything becomes near-simultaneous.

The secular decline of the West in general, the United States in particular, is probably inevitable; however, what we find striking is how the increasingly dysfunctional US political system seems to be hell-bent upon accelerating the process. Perhaps, History is a more personal force than is widely recognized in our agnostic era. Perhaps as an empire loses its historic momentum, History which had always smiled upon it, averts her eyes and turns away. The virtually suicidal policies inaugurating the declines of the Spanish Hapsburg, Austrian and the Turkish empires seem to us almost incomprehensible in retrospect. Had these great empires grown weary of supporting the dome of heaven? Did they secretly long for an end to the constant strife? Was it a political incarnation of what Freud described as man's profound longing for personal extinction?[4]

More concretely, viewing the US from abroad, one is struck by the loss of focus upon the essential; an unwillingness to sacrifice short-term comfort for long-term sustainability which has become so culturally ingrained as to be almost a political given; despite thumping proclamations of loyalty to the flag, politics have become brutally partisan, focused primarily upon victories over internal opponents; there is a frightening deterioration in the level of political discourse, particularly dangerous in a democracy; equally dangerous, the inability to recognize and accept limitations – fiscal, military, economic – leads to catastrophic miscalculations.

Enter the Dragon

The self-indulgent sense of historical superiority and entitlement in the West is based upon little more than historical ignorance. While China was indeed an impoverished, overpopulated peasant backwater in the 19th and early-20th centuries, it was not always thus. Indeed, in the 1400s China was far more advanced than Europe, boasting several cities of more than one million inhabitants – this at a time when London housed barely 50,000 souls, Paris about as many, and Rome perhaps 30,000, the majority living in squalor.

China built civil works – 1000 km-long canals and the Great Wall – unmatched in man's history, and was far more advanced in metallurgy, textiles, shipbuilding and navigation – the Chinese treasure fleet sailed around much of the globe, a half-century before Columbus stumbled upon the New World. China evolved a bureaucratic system of government which has maintained rough continuity of the political-administrative system for some 2000 years – a duration matched only by the Old Kingdom of the Nile Valley.

Over the ensuing centuries, China slipped into a prolonged decline, climaxing in the Opium Wars and the "Unequal Treaties" of the 19th century[5] ; we would suggest that these are of seminal importance for understanding the current mindset, accounting for both the erstwhile misperception of Chinese prowess in the West, as well as the deep sense of anger and national humiliation of the Chinese – a very dangerous mix.

[4] *Civilization and its Discontents.*

[5] *Humiliations at the hands of the West, respectively the imposition of an Opium monopoly by the British whom, lacking any goods the Chinese wished to purchase, forced upon them opium, a drug which tends to create its own market, and the loss of territorial integrity to the dominant colonial powers.*

China's extraordinary rise of the past twenty years should not be interpreted as Chinese "modernization" or its embracing of Western values. China remains profoundly different, and convinced of the superiority of its own values. The tributary system placing China at the centre of the universe, with concentric circles of barbarians bowing before the emperor, remains deeply imbued in the national mind-set. Given the equal sense of self-assurance of the Atlantic Alliance, there is a real possibility of miscalculation and conflict. The history of the century past suggests that the decline of major powers and the rise of others is rarely a peaceful, beneficent process…

The Spendthrift Eagle Keeps On Spending:

The Great Indulgence – Budgetary Madness

One of our readers writes to state that T&B has once again been too cynical, pointing that the US economy is performing rather better than we had expected. Madam – with due respect – did you not notice that the emperor is stark naked?

*T&B – and this despite our best efforts – is not remotely cynical enough! The grotesque reality keeps getting ahead of us… for the record, **if you shoot enough voltage into a corpse it will twitch; crank it up high enough and it will get up and dance**; this does not materially impact the long-term prognosis…*

T&B has repeatedly affirmed that the US political system is broken, perhaps beyond repair, and we were reasonably sceptical that the political courage required to enact painful but much-needed budget cuts could be found. What we frankly never imagined was that the diametrical opposite would occur – even <u>we</u> had assumed that fiscal stimulus had, by necessity, come to an end, and at least some token attempts at taming the deficit would be enacted. We could not have imagined that, with every other highly-indebted country on the planet sweating blood to cut its deficit, the United States would happily continue to grow its own – to the tune of $865bn at last news!

The recent budgetary "negotiations'" in Washington leave us would-be cynics feeling outflanked. All sides got what they wanted – tax cuts for the rich, but also tax cuts for the poor, for gays and blacks and lesbians and dolphins. Businesses got relief, the unemployed were funded, families and singles with children or domestic animals got support, but hedge-fund managers kept theirs too. Any painful adjustments were gently wafted off into the distant future. The contrast with the supposedly-paralysed PIIGS is extraordinary: as Ireland slashes, as Greece cuts, Portugal reforms and Spain prays, only the United States is aggressively widening a gaping deficit. Yes, the reader may object, but the United States is fundamentally different in that it can issue the global reserve currency; as we remember, similar arguments were trotted out to explain the sustainability of the mortgage securitization business in 2006, the gaping trade deficit and the hollowing out of US industrial infrastructure. Long experience has rendered us sceptical of reported repeals of the laws of gravity…

The better-than-expected US economic numbers are thus purely a reflection of the massive fiscal stimulus – an unsustainable budget deficit still widening out as we write, given that no politician wishing to continue in his chosen career can afford the political pain implicit in fiscal prudence. The contrast with Europe, which offers the edifying (and very unusual) spectre of several political leaders jeopardizing their futures with wildly unpopular but desperately-needed reforms and budget cuts, or with the so-called "authoritarian regimes" of Russia and China, which are able to enact reforms by decree, could hardly be more striking.

T&B frankly hasn't much of a clue how long the madness can be sustained – what is obvious is that, as long as the US can maintain a combination of massive fiscal and monetary stimulus, there will be "growth'. Such experiments do not ordinarily end well… but until they do, unlike some of our more prudent peers, we shall enjoy the folly to the fullest. Never fight the Fed…

Europa - The Next Domino to Fall?

There is a palpable sense of fear stalking the markets – the fear that the next phase of the global financial crisis, which began as the US Subprime Crisis with the collapse of Bear Stearns and Lehman's, has now morphed into the Global Sovereign Debt Crisis, this time with Europe taking the lead. While there is ample cause for concern, T&B reiterates our unpopular view that, at least in the near-term[6]

[6] *J.M. Keynes was, of course, right about "the long term".*

there will be no widespread European defaults, for the simple reason that, like the first-use of nuclear weapons, the implications are so totally appalling. A generalized wave of European bank failures would quickly progress into the failure of the international financial system, eventuating in a global economic melt-down of a magnitude comparable to the Great Depression. Our basic assumption remains that a quick glimpse into the abyss focuses minds most wondrously – and that, provided there is a half-functional political system (an important caveat…), the survival instinct generally wins out.

There has been a great deal of misguided moralising about whether or not the banks should have been allowed to fail, sparing the good burghers of Dublin the fruits of a collective national flight of folly, while wiping out the evil bank bond holders. From a purely moral standpoint, perhaps they should indeed have been punished – alas, moral issues make precious little difference when survival is at stake.

In simple terms, had, for instance, the Irish banks been allowed to fail (and the only lawful means of restructuring the senior debt would have been via default) – the major British banks, already seriously weakened, would have been rendered instantly insolvent. Whilst the French banks had limited exposure to Ireland, they are heavily exposed to the UK banks, and would have followed them into the maelstrom. A French banking crisis would have pushed Germany over the edge, and by the end of the week, the European economy would have been grinding to a halt as the payments system and trade finance seized up. We leave it to the reader's imagination what effect this would have had on the US banks, or for that matter, the balance of power between Asia and the West.

In short, the Irish bailout was not a bailout for Ireland – like the TARP, it was a bailout of the global financial system. Regardless of the longer-term implications of using public money to bail out private interests (as if injustice were a new and totally unprecedented aspect of the capitalist- , or for that matter, any other, politico-economic system!), the short-term implications of allowing the entire global financial system to melt down were sufficiently dreadful to justify even the most ideologically unpalatable of measures. While crises do force much-needed reforms, the collateral damage would have been intolerable. T&B would class market fundamentalists who consider to be doomed any attempts to attenuate the rigours of the market economy, limit system risk, or indeed, to protect people from the consequences of their own folly, alongside doctrinaire Marxists, flat-earthers, and Millennialists.

An accident going somewhere to happen?

Figure 27: European Bank Exposures to Peripherals on Ultimate Risk Basis ($mn)

	European Banks	Key Countries Banks				Peripheral Banks				
	Total	France	Germany	Netherlands	UK	Greece	Ireland	Italy	Portugal	Spain
Greece	146,779	57,319	36,840	5,271	12,146	0	7,890	5,256	10,097	871
Ireland	423,023	43,594	138,567	19,153	131,627	449	0	14,616	3,512	13,984
Italy	831,688	424,474	153,721	43,373	66,804	549	40,337	0	3,535	32,911
Portugal	205,742	41,325	37,240	6,349	22,244	126	5,256	4,598	0	77,775
Spain	646,949	164,598	181,648	72,703	104,712	664	26,575	25,864	23,901	0
Total exposures										
Weakest 3 Peripherals	775,544	142,238	212,647	30,773	166,017	575	13,146	24,470	13,609	92,630
All Peripherals	2,254,181	731,310	548,016	146,849	337,533	1,788	80,058	50,334	41,045	125,541
Peripheral Banks Peripheral Exposure	298,766									
Potential Write-Downs										
Weakest 3 Peripherals at 10%	77,554	14,224	21,265	3,077	16,602	58	1,315	2,447	1,361	9,263
All Peripherals at 10%	225,418	73,131	54,802	14,685	33,753	179	8,006	5,033	4,105	12,554
Peripheral Banks	29,877									

Source: Deutsche Bank, BIS

Eve – Get Dressed!

The original sin of the Euro is, in retrospect, glaringly obvious: monetary union in the absence of a common fiscal policy. It thus follows that there are precisely two approaches available to attenuate this defect: either dump the common currency altogether, or increase control over the budgetary policies of the member states.

Theoretically simpler, the first option presents the minor drawback of leading to an implosion of the European banking system, resulting in a global financial crisis of terrifying proportions as the contagion effect ricochets both across the Atlantic, and (to a lesser extent) into Asia. The degree of inter-bank exposure is such that a default by any Eurozone sovereign, or any countrywide banking crisis, would have catastrophic repercussions throughout the system.

In theory, a default triggered by political factors in a single peripheral state could be circumscribed by the ECB (most likely supported by the Fed and even the Central Banks of Japan and China), buying the defaulted paper outright, possibly at some small discount, taking it onto the public balance sheet.

The defaulting country would promptly be crushed by the markets – unable to fund themselves or match their liabilities, its banks would cease to function; the state would be unable to raise funding at any price and would rely upon handouts from its neighbours to maintain basic functions; business would cease to operate; with the payments system breaking down, a barter economy would emerge. There is precedent – this is essentially what occurred in Russia in the aftermath of the 1998 crisis and in Argentina a few years later; unfortunately, and unlike in Russia, continued social stability would not be a likely outcome in a crisis situation in the European periphery – the European states lack the social and psychological coping mechanisms developed over decades of extreme economic hardship in the FSU.

The reader may argue that countries from Russia to Argentina and latterly Iceland have suffered precisely such meltdowns, yet emerged with their statehoods intact. The difference, of course, is that these were isolated, non-systemic events, with contagion effects circumscribed by emergency monetary and fiscal measures taken by the G7 countries. In isolation, a default by Greece would not, in fact, be an earth-shattering event; on the other hand, in the absence of a full bailout by the EU, the contagion effect could amplify it beyond imagination – and there are precious few candidates for bailing out the entire global banking system…

Quite simply then, if as we affirm, a default or exit from the Euro is not manageable, and if the current situation is untenable, then despite the obvious political difficulties, another solution will have to be invented.

Third Time Lucky

When T&B taunted a German friend that *"what you guys failed to accomplish in 1914, and again in 1939, you will finally achieve in 2011…"* we were of course being very unfair – Germany can most certainly not be blamed for the current crisis – what the peripheral states are suffering, they did unto themselves!

Whether or not the error was the creation of the Euro itself, or instead, was the inclusion of countries not yet ready for monetary union on the basis of shoddy or fraudulent evidence, is no longer particularly relevant. What was done is done, and it was far easier to wind than it would be to unwind. Although full linguistic and cultural integration of Europe is, at best, a couple of centuries away, this is not required – what is required is fiscal integration, i.e. that countries live within their means, rather than borrowing based upon the credit of their worthier neighbours.

While the German press has been indignantly portraying Germany as the virtuous victim of the feckless Southern Europeans, the truth is rather more nuanced. By sparing German exporters the endless round of competitive devaluations by their European clients, the Euro has allowed Germany to amass a huge foreign trade surplus, essentially based upon vendor-finance; it has been easily as beneficial to Germany as to Greece. The banking sector aside, an exit of the PIIGS from the Euro would have an effect upon the German economy similar to what a sudden extinction of the United States as an export market would have upon China…

While the ignorance of financial realities by some of the European leadership does not inspire confidence – with Mrs. Merkel dangerously clueless even by the standards of her dim-witted peers – we are not certain that this matters very much, suspecting that The Forces of History may be at work here. Either substantial support will be provided, or the entire system will implode – and since it is a political impossibility to offer such support absent further steps towards fiscal integration, binding restrictions on budgetary hedonism are to be expected.

In order for the Northern Europeans to agree to issue Europe-wide debt, or to provide financial support for their Southern neighbours, they will require iron-clad guarantees that this time the money will not be stolen, spent on luxuries, and that they will not find themselves saddled with crushing obligations run up by the errant PIIGS. This would require both a legislative approach – i.e. binding rules to prevent excessive budget deficits, whether "temporary" or otherwise, as well as market-based steps, e.g. a pan-European financing of moderate national debt loads, with any borrowing above that limit rendered dissuasively expensive by the market. In this model, steps would be taken to prevent this "subordinated" debt from being scooped by yield-starved, systemically-important institutions, i.e. the European banks. Certainly, the ratings agencies have suddenly begun to rate the PIIGS as stand-alone entities[7], rather than as Eurozone members, so no further free-riding will be possible. The outstanding question is now how to deal with the massive legacy issue…

Those sceptical about the outlook for European integration should note that, in fact, Germans could continue to work like Germans – Greeks like Greeks, within a currency union, provided that the Greeks accepted living standards commensurate with the amount of actual work furnished, and that their government was precluded from further debt-funded attempts to support an untenable lifestyle in exchange for voter support.

What if we are wrong?

There is an obvious weak point to all of our arguments – the danger of democratic dysfunctionality. Whilst an authoritarian government could swiftly adopt the necessary measures without the need to sell them to the populace, one can certainly conceive of a situation whereby either one of the PIIGS rejected the necessary austerity and elected a hard-left government, challenging the EU to allow it to default (Greece is one obvious candidate for being the first-to-commit Hara-Kiri), or that a political backlash in the Germanic bloc brought to power a government ideologically unwilling to fund the deficits of their less-virtuous European cousins.

We take the current political disarray of the Europeans at less than face value, as it primarily involves jockeying for position before their electorates, with Merkel increasingly being openly undercut by the German political opposition, while she antagonizes the remainder of the EU with her unique combination of self-avowed economic ignorance and quadruped-like stubbornness.

Having repeatedly allowed the situation to progress to the very brink of the abyss, the EU has each time enacted the necessary bailout measures *in extremis* (and a great deal more expensively than had these been decided before the pressure reached the danger point), but there is always the danger that next time they will procrastinate an instant too long, with the markets snatching matters out of their hands…

In this extreme scenario, we expect that the wraith of a Europe-wide default would be sufficiently terrifying so that a hugely-expensive firewall would be erected *in extremis* around the three little PIIGS, while unlimited, Europe-wide support was provided to Spain and Italy. If we were wrong about that too… then it is finally time for our *canned foods, firearms, and land in New Zealand* trade.

Markets and Mayhem II

Where we got it right – where we got it wrong

It is a rule nearly infallible that, when one hears a trader complaining of the sheer irrationality and gross stupidity of the markets – he is losing money, probably a lot of it! The present rant is one of the rare exceptions – T&B feels a bit like John Travolta in Pulp Fiction, when the punk comes bursting out of the closet spraying bullets. Travolta looks down, and astonished by the lack of bullet holes, plugs the punk and walks away into vita nuova.

Over the past few weeks, global markets have enjoyed yet another episode of wild dislocation: Price action was largely irrational and ultimately insignificant; although the sell-off was triggered by justifiable concerns about the future of the European Union, at the nadir, a gaggle of currencies including the Singapore dollar, Swedish Krona and Swiss Franc – none of them members of the

[7] *Moody's has just cut Ireland by a full 5 notches, the financial equivalent of a geographic shift from Europe to Central Africa. Unlike The Economist, when they get it spectacularly wrong, they are obliged to acknowledge it in print!*

Eurozone – had fallen by at least as much as the beleaguered Euro… As we have noted previously, the market is largely binary - everyone is trading "risk," with short-term price action driven almost entirely by market microstructure, rather than by the fundamentals. Keynes' remark about voting machines/weighing machines remains as relevant as ever.

- Risk On/Risk Off: The Hurricane Season

Trading with the Sharks

In our last issue (Swimming with the Sharks, pages 4 et infra*), issued immediately before T&B sailed off into the wilds of West Papua, we bravely (and perhaps foolishly…) predicted that the Eurozone would survive in its current form, with no wave of systemic defaults for reasons discussed above. Our basic assumption remains that FEAR focuses the mind most admirably, and that, faced with the near-certainty of violent extinction, men will generally take evasive action.*

On that basis, we ran a moderately "risk-on" book, positioning our client accounts primarily in EMEA and Latam fixed income, hedging part of the dollar and Euro currency exposures into selected Asian currencies. Our equity picks in Russia remained pretty much confined to the high-dividend resource plays, and we accessed peripheral Asian markets via ETFs. We have maintained substantial Asian equity risk, with a punt on long Nikkei calls, given our expectation of gradual yen weakening. Our favourite out-of-index[8] pick was uranium mining stocks. We stubbornly held no gold – preferring silver or PGMs in the precious metals, copper and oil among the industrial favourite commodities, and long agriculturals via ETFs.

This past month proved more volatile than expected, as desperately ill-timed statements by typically clueless politicians sparked a minor fire-storm, with a sudden exacerbation of the European debt crisis sending risk-assets briefly sprawling. As we go to press it would appear that it was yet another case of the market scaring itself silly, and most asset classes have recovered quite nicely. As the umpteenth false alarm recedes, markets are nervously reverting to the usual themes – quantitative easing driving liquidity into the system, while Eurozone turbulence suppresses risk appetites. A continued exacerbation of volatility accompanied by a grotesque degree of intercorrelation is the obvious outcome, and we retain our bullish bias.

While some of the peripheral countries may have already fallen into a debt trap (i.e. the cost of financing their debt exceeds any credible budget surplus they might run), the gross amounts are large but not unmanageable. Despite some European political leaders being either terminally obtuse or in deep denial, the operational management at the ECB is no less cognizant of the problem than is T&B. In a crunch, we would expect virtually unlimited support from Washington and Tokyo (and even Beijing and Delhi) – we all occupy one, small planet…

If we are correct about the likely outcome of the European crisis, then the current turbulence constitutes a buying opportunity. While disinclined to catch falling knives, we are awaiting the moment to buy the peripherals – in particular Greek 3-4 year risk, which is clearly mispriced to the curve. While at a yield of nearly 14% it is already quite compelling, an outbreak of market turbulence might deliver better levels.

- **Rates - Lower for Longer at the Short End - Beware the Long End**

We have repeatedly warned that 10-year rates at 2.5% were nothing more than the personification of the "greater-fool theory", i.e. that NO ONE owned 10-year US government debt for a 2.5% YTM. Everyone thought themselves smarter than everyone else, and thus, able to get out in time…

Although nominal US growth will remain positive for as long as massive fiscal and monetary stimulus can be provided, there is no evidence of this becoming either inflationary (yet) or self-sustaining; Fed hikes are not to be expected. The carry trades have an excellent season ahead, but we would avoid getting lured into buying the long end.

- **Equities – Of Rising Tides and Russian Ships**

T&B is not an equity-specific publication, and we tend to recommend portfolio strategy rather than individual equities; investors will either do their own research, or trust in luck!

[8] *Of course, we don't have an index, but if we did, uranium would clearly be outside of it!*

Our general overweight of the Russian equity market proved surprisingly defensive during the recent sell-off, and given the increasing interest we are seeing from Western investors, we would stay long into the New Year. With a gradual improvement in the underlying economy, and continued strength in commodities prices, provided that the European debt crisis does not suddenly accelerate, Russian equities should continue to rerate.

Our general market strategy involves a strong China-centric bias, i.e. we would **buy whatever China needs, selling whatever China produces**. This supports our commodities call – in particular anything exposed to the oil price. Besides providing very compelling dividend flows (which were expected), our two favourite oil equities –TNK-BP and Bashneft Prefs – have seen the best price action amongst the oils this year (which we did not expect). Amongst our other top picks, Novatek and Sberbank have done well (Novatek rather more so). Smart is good – lucky is better!

We are taking some profits in Indonesia and India, and increasing Thailand (via ETFs) as well as China (via funds – the VP Funds being a particularly good option for taking long-term exposure).

From a risk/reward standpoint, the major problem is the risk that a European crisis could cause a panicked move out of EMEA equities with some knock-on effects in Asia. Perhaps some protection needs to be bought.

Last month we recommended **long Nikkei calls** given the expectation of further yen weakness, as well as Japanese market technicals. These have performed well over recent weeks. Note that going long Nikkei also constitutes an excellent hedge for US dollar strength – toxic for most equity markets, but not for Japan, where yen weakness is the single greatest bullish factor.

- **Fixed Income – Buy the Familiar Assets - Spreads still compelling**

There is a current tendency amongst investors to venture out into the frontier markets of Africa, Asia, etc. This occurs late in every bull market and, in our view, is to be avoided.

It has been a weak month for the EMBI, which now offers slightly better entry levels. Given our preference for the higher-yielding, less liquid issues such as the Russian bank subs, for those not having natural flows we see little upside in attempting to trade the volatility. There have been no recent credit events[9] and, unlike the situation in autumn of 2008, the Russian financial system is no longer heavily exposed to US risk.

In Russia, we continue to like the subordinated bank debt. As noted previously, there is no reason to expect most of the subordinated bank bonds to be called, so yield should be calculated in terms of yield-to-final-maturity (yield-to-worst, on Bloomberg). The credit risk of the real banks (i.e. excluding pocket banks such as IIB) appears close to negligible.

Selected Kazakh and Ukrainian assets offer a good risk-reward. Previous calls are reiterated – we continue to like Privatbank, City of Kiev, AlfaUkraine and Metinvest in the Ukraine, with ATF and BCCRD subs our preferred assets in Kazakhstan. For the risk-tolerant, KKB offers some yield pickup over the others.

Credit fundamentals in Argentina continue to improve (the current burst of growth will most likely end in another bubble and crisis, but that is probably 3-4 years down the road…) and in our view, PDVSA remains an obvious mispricing – with a number of the global brokers (Barclays et al) belatedly coming round to our view.

Our recommended Argentina GDP warrants have performed quite spectacularly; there is likely a further 50% upside to them on a one-year perspective.

Fixed-income portfolio construction should involve a bar-bell strategy: a mixture of short-dated assets for which high lending values (LTVs) can be obtained, and longer dated assets with very wide spreads insulating them from a sell-off in Treasuries. The worst bond trades at present would be long-dated investment-grade, where the principal risk is not credit risk, but rather Treasury risk.

[9] *Other than the default of Mehzprombank (IIB) – but as flagged repeatedly, IIB was a "bank" only in the sense that the FIG bank-like institutions of 1997 were banks. It took no significant deposits, thus vitally not benefiting from the deposit-insurance scheme; it had no significant unrelated-party lending business to the real economy, serving simply as the pocket bank for a highly controversial political figure whose period of influence apparently crested in the beginning of the last decade (and to whose mistress T&B gave her first – and no doubt only – job in finance…).*

- **Commodities – Super-Cycle still Unbroken**

While it would be foolish to simply disregard warnings of bubbles forming in commodities markets, not all instances of explosive price action constitute a "bubble". Given our continued bullishness on China (if we are wrong about China, we are likely wrong about the rest…), we would expect continued pressure of commodity prices, in particular foodstuffs and energy.

All portfolios should have considerable oil and industrial metals exposure. We are on the record predicting that oil breaks the $100 level in the near-term – and most likely its historic peak of $147, at least briefly, sometime in the next 36 months (we have 30 months left on that punt!).

For those inclined to use precious metals for hedging purposes, having recommended silver, where price appreciation has been more than twice that of gold, we would now switch to PGMs.

- **Currencies – Bloodied but Unbowed**

Our currency calls have proved somewhat less felicitous, given the absurdly high level of non-selective "risk-off." The global wave of risk-aversion on the back of fears of a European debt crisis (theoretically constituting the second phase of the global crisis which began with the 2008 implosion of the US financial sector) has negatively impacted all dollar shorts, not just against the Euro (where we recommended taking profits) but also currencies partially- (CHF, SEK, NOK) or totally unrelated to Euro risk (SGD, AUD, NZD). Damage to the latter has been relatively modest – the Singapore dollar has strengthened against the Euro while weakening against the dollar by about 3%.

Contraintuitively, the "risk-off trade" provoked by justifiable fears regarding Euro viability caused a similar degree of weakening of currencies totally unexposed to Greek default risk, *inter alia* AUD, SGD and IDR. This market irrationality represents a compelling buying opportunity – our preferences still tend towards Asia, although we would also take some exposure to CHF, NOK and SEK.

A Personal Note

T&B was deeply moved by the many expressions of support and the several offers of sponsorship following our last publication.

We are in discussions with potential sponsors and thank all those who replied.

A number of our readers kindly offered to take out paid subscriptions. Alas, we have no way of managing the logistics, would be loath to cut off non-paying readers, and, frankly, cannot be bothered to do two letters – one for the haves, one for the have-nots!

Instead, readers wishing to support the overall quest for Truth (if not always for Beauty) may make a contribution to Wikileaks – which has provided a unique mix of enlightenment and entertainment, not witnessed since the Donation of Constantine was debunked…

Here is their donations page – *http://213.251.145.96/Support.html* – do please give generously… For large contributions, Hillary Clinton will thank you personally!