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STRATEGY

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Death Wish II

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T&B – Death Wish II

So much to say, so little time

T&B has been fairly quiet of late, markets having again brought home to us the sheer unknowability of the world – an unfathomability previously commented upon by W. Heisenberg, Joseph Conrad, or the great Buddhist teachers (George Soros had a few things to say about it as well…).

Recently returned to Moscow after an interlude sailing the lush seas of SE Asia aboard El Aleph *www.elaleph.ru* (though alas, without ever quite managing to break loose from virtual reality, as our Bloomberg Anywhere screen continued to glow blood-red via satellite link) we are constantly being asked whether this is 2008 all over again… or, indeed, is it something even more sinister? We must admit that we have limited certainty, indeed it could be argued that we are **still** in 2008; perhaps, as in the movie *Groundhog Day*, we always shall be.

What has goaded us to write today has been the steady stream of doom and gloom from many of our peers. Even the bulge bracket has now gotten in on the game (Goldman's continues to seek to quantify the unknowable by assigning precise mathematical probabilities to a range of outcomes, including our going back to living in caves) – perhaps due at least in part to their own sharply reduced circumstances in a rapidly deleveraging world. Meanwhile, the cottage industry of independent strategists to which we are still loosely joined is engaged in a contest of who can engender the most hair-raising scenario, generally presented as an absolute certainty.

It is hard to maintain any sense of balance amid the steady stream of depressing headlines; a recent Bloomberg poll showed global investors to be deeply pessimistic, with a substantial proportion expecting not just lousy markets but major social disruption, revolution and war. Of course, most of them probably picked up their ideas, at least in part, from their screens, so it becomes somewhat self-sustaining: despondent investors speak to naïve financial journalists, then become increasingly pessimistic since the media are full of bad news! We have some doubts as to whether most of those who are currently prognosticating have any more of a handle on the problem than do we.

None of this means that T&B should be classed amidst the thinning rank of the optimists; instead, we are raising uncertainty to a fine art. The fundamental problem is that the outcome is no longer within the realm of economics *per se*; it is almost entirely a matter of politics, with the imperatives of the "democratic" electoral systems and a wilful decision to ignore the constraints of financial markets leading to a series of deadly dangerous policy missteps; these missteps have driven markets to now price risk at unsustainable levels, causing further damage to the underlying fiscal situation of the crisis-hit peripheral Eurozone countries.

Although we are gravely concerned by signs of paralysis among European policy makers in response to the impending economic crisis, as well as by a certain unwillingness of the G7 political class to acknowledge the dictates of reality "*Le pire n'est jamais certain"* – the worst is never quite certain. All men live in hope, and the various possible outcomes include scenarios in which intelligent life finally evolves on Planet Earth, the financial crisis does not spiral out of control, and at the cost of a prolonged growth-recession scenario, deleveraging can be accomplished without catastrophic disruption, i.e. a bumpy but ultimately soft landing.

As we go to press, our sole Russian political prediction (a best-guess, really) has been verified: Vladimir Putin shall return to lead his people through the desert, and presumably, into the Promised Land. (The second half of our bet – that Alexei Kudrin would be handed the keys to St. Peters – has proved rather less insightful, at least for now.)

Overall, we are relieved – Russia is known for her ability to surprise, and of late we have had just about all the excitement we needed. Our view is controversial. Not just the usual clique of corrupt ideologues disgracing the pages of the *FT* and *The Economist*, but also some honest and well-intentioned independent commentators have taken issue with our view, criticising the failure of the Russian political system to evolve from the personal to the institutional. In response, we will argue that the only alternative proved to be highly unsatisfactory – especially from the foreign policy standpoint – and that further stability in Russia will allow the continued evolution of Russian society towards the boring, predictable, middle-class European-style Social Democratic model.

Finally, we shall also have the pleasure of discussing our singularly infelicitous bullish call on Greek bonds (you can always spot the pioneers – they're the ones with the arrows in their backs…) and why we are not yet quite ready to capitulate.

Poisoned Fruit – The Roots of the Crisis

The previous regime brought us to the very edge of the precipice… but with the new government, we have taken a great step forward!

Anon

The good news is that there is no danger of a "double-dip" recession; the bad – that this is attributable solely to the fact that the world never actually exited the 2008 crisis, itself the ineluctable culmination of 20-odd years of debt-fuelled growth in the developed markets.

As T&B never ceases to intone, the West (or, more properly, the G7, making Japan an honorary member of "the West") has been in relative decline vis-à-vis the rising powers of Asia for two decades at least. Both Europe and the United States have continued to live well beyond their means, making enthusiastic use of their credit cards rather than accepting a politically unpalatable contraction in living standards. Whether these imbalances finally took the form of unbearable pressure on the European Common Currency, or a recessionary implosion of the American real-estate/credit bubble (subprime, *CDOs,* et al*), the fundamental problem is essentially the same. The expectation that one could grow one's way out of an unsustainable debt burden – when most of the recorded economic growth in the G7 countries was already being sustained almost solely by accelerating credit expansion – was always a forlorn hope.*

As we write, the European Union has taken a step back from the cliff edge, and financial markets have regained some stability, with the risk of an immediate implosion receding, at least temporarily. Even the most felicitous conceivable outcome for the developed markets would involve a painfully restrictive fiscal policy – years of running 4%-5% primary surpluses, given the accumulated debt.

The most egregious offender in the fiscal sweepstakes was, predictably, the United States; with a budget deficit approximately twice that of the EU (blended), and with an extremely stimulatory monetary policy maintained during times both of feast and of famine, it has predictably reported a higher rate of "growth" over the past decade than has Europe; said growth is now proving to be something of a mirage. Where we have seen steady growth has been instead in terms of income inequality, with a small fraction of the population grabbing an ever-rising slice of the total pie; the median per-capita income (i.e. 50th percentile) has actually declined over the 14 years between 1997 and today. Of course, the illusion of increasing well-being for all was preserved by encouraging the middle-classes to borrow against ever-rising asset values – primarily real-estate. This has obviously now ended, and one searches in vain for a new motor to drive growth.

The EU has, in the most part, been somewhat more virtuous, however suffering from the fatal flaw of premature monetary union in the absence of proper mechanisms to assure fiscal (and political) integration. The aggressive fiscal response to the financial havoc which blew across the Atlantic in 2008 dangerously destabilized an unsustainable debt montage – always something of an accident waiting to happen. Whether popular or not, painful economic reform and further European integration are now ineluctable.

It is not a matter of where one's personal preferences tend as regards the political model for Europe – T&B far preferred the very diverse Europe of the 1980s – Holland and Portugal might as well have been on different continents (even in the 1990s, one could still see Portuguese farmers ploughing with oxen). The point, however, is that the Euro experiment has locked the European Union into a glide path for fiscal/political integration – with the only conceivable alternative a global meltdown with unpredictable socio-political consequences.

Following on the American subprime crisis of 2008, the Great Recession has now moved into the European phase, with the threat of sovereign default and extreme pressure on the Common Currency. The general perception of the situation is somewhat distorted by American influence over large swaths of the global media, in particular the financial press and networks, finding it convenient to focus attention on the sins of others so as to distract attention from their own failings. In fact, blended European fiscal sustainability is substantially better than that of the US; however, the fragmentation of European governance has meant that the underlying economic imbalances have rapidly degenerated into a crisis, with the response hampered by desperately slow and dysfunctional politics.

What is unfortunate is that much of the commentary about Europe is now focused upon what should have been done a decade ago, as well as upon the moral rights and wrongs of fiscal transfers and burden-sharing – fit subjects for theologians and future historians, but totally irrelevant when faced with a clear and present danger of financial Armageddon. The interesting question is not "*what should have been done"* but rather, "*what now needs to be done"*!"

A Step Back from the Cliff-edge – Merkel gets Religion

A week ago, T&B wrote: "We are watching with horror the apparent contest between the American and European political establishments to see who can be most appallingly incompetent, irresponsible, wrong-headed, ideological misguided, and profoundly obtuse. Alas, there is no clear winner – each time one or the other side appears to have established a commanding lead, the other comes galloping up out of the backfield. Of course, the Americans have one advantage here – they have only one horse in this race, as opposed to 27 European entries. Watching the European political elite, one gets *a dreadful feeling of watching a group of happy children playing delightedly with a live hand-grenade…"*

A week later, and the best we can say is that the grenade is still unexploded, and the tots are now starting to eye it with what appear to be some very serious misgivings.

The cacophony on the European political scene had recently become reminiscent of Russia during the Yeltsin years, but on a continental scale. Every single European country somehow felt obliged to get its two bits in, while within individual countries, assorted twilight political parties imagined that they had been afforded an unexpected shot at redemption via shrill campaigns in defence of the "inalienable rights" of their long-suffering electorates. The arrest and ritual lynching of IMF head Dominique Strauss-Kahn in New York deprived Europe of the one truly authoritative figure in the effort to craft a unified response to a fast-deteriorating situation, while his successor, long accustomed to a role as nothing more than a mouthpiece for Sarkozy, availed herself of the unaccustomed opportunity to speak her mind quite freely – without quite realizing that, like Central Bankers, IMF directors are first and foremost under an obligation to not frighten the 'orses.

Predictably, this pandemonium resulted in blind panic in financial markets, as hopes for a concerted response were raised – then dashed again – with each successive declaration. Among the worst offenders were those closest to the levers of power – Merkel and Schäuble – who vied in perfecting the art of saying two perfectly contradictory things at the same time (i.e. that the Euro must and would be saved, while no new support measures would or could or should be adopted). Their moralising about Greece, wondering aloud whether or not it could be salvaged – may well have put much-needed pressure on Papandreou, but also cost hundreds of billions of Euros by driving debt spreads for the peripheral countries to unprecedented levels, forcing the ECB to become the sole source of funding for the beleaguered PIIGS and driving the overly exposed commercial banks to the wall.

Whether or not one agrees with Mr Geithner's handling of the American economy, it is entirely possible that he was the key figure responsible for what appears to have been a sea-change in the European approach to crisis management. The Obama administration was clearly terrified at the likely consequences of a Greek default,[1] and Geithner was dispatched to read the Riot Act to the European Union. His advice was that rather than try to increase the gross size of the EFSF, the ECB be used to backstop the new Facility, allowing it to leverage up its portfolio to the multi-trillion range if necessary.

Initial signs were not encouraging (Geithner was snarled at, first by Schäuble *et al* who – somewhat irrelevantly – complained that they did not need to listen to lessons from the representative of a country running deficits twice the European levels, then by Van Rompey who petulantly refused to discuss fiscal matters with an American in the room). Geithner nevertheless appeared remarkably self-assured upon his return to Washington, claiming to be quite certain that the Europeans would soon come around and do whatever necessary to defuse the crisis. Perhaps the scoldings were solely for public consumption, as the European political class did not wish to be seen to be acting under American tutelage. In any event, a few days later the tone of discussions had changed quite radically – the constant drumbeat of alarming statements died down, allowing markets to at least draw breath; discussions broadened out to include various possible means for increasing the size of the anti-crisis package, while the overwhelming ratification of the EFSF by the German Bundestag gave reason to hope that the crisis could finally be contained.

This, of course, does not remove the near certainty of, at best, a growth recession within the G7 countries. As we have noted before, as regards the US, there are only two possible outcomes – either the sovereign debt will be inflated away, or the necessary fiscal restraint will lead to a prolonged period of deeply subpar growth. Given the weakness of the political system, our expectation is for the former.

[1] *The relevant – if desperately overworked – simile is that it would make the Lehman's default look like a church picnic… T&B has little use either for churches or for picnics, and would rather give this one a miss!*

Death Wish!

Our sincere apologies for the stream of consciousness – it is the world gone mad, not us!

It is becoming physically impossible to issue a comprehensive review of the European debt crisis before being overtaken by the headlines. Just as global markets were beginning to contemplate the possibility of civilization as we know it spared from collapse, and oft European policymakers acquiring at least some vague notion of reality, the insanity resumed: our screens flashed the news that that the Europeans were "considering" a "reopening" of the Greek debt swap. With the European banking sector teetering on the brink of default, and Morgan Stanley being dragged down with it, this was precisely what the market did <u>not</u> need to hear! Global equities went into free-fall, the dollar and Treasuries soared, commodities were crushed, sovereign CDS hit historical highs while bank CDS soared back to the immediate post-Lehman's levels. Emerging debt and equity markets became totally illiquid, with traders presumably stocking up on canned food, emergency power supplies and bottled water. Was this quite necessary?

The Greek debt swap was a bad idea; tinkering with it an even worse one – but creating additional levels of uncertainty by going public with vague, half-baked reflections on the possibility is totally insane!

What is wrong with these people? Are they truly seeking to replicate the experience at Chernobyl (or, at best, Lehman Bros.)? Is there are a desire to start over again from zero? Or are they so totally wrapped up in their pathetic ideological/bureaucratic mindset that they are literally divorced from reality and cannot foresee the effect of their musings on nervous financial markets in the age of instant communications?

T&B shall offer no further predictions – we are descriptive, not prescriptive – but would warn anyone believing that a sovereign default or two would constitute a healthy clearing of the system that they would do well to watch a couple of the Mad Max movies. The events of 1929 blighted the lives of a generation, bringing the Western world to the brink of destruction a decade later. We are not convinced that the experiment need be repeated.

Dans le Meilleur des Mondes possibles

In recent weeks, the reader will have encountered a slew of prophecies of global economic of doom and destruction – what they have in common is that the outcome is presented as being God-ordained and utterly inevitable – analogous to the constant predictions of imminent collapse of Russia which have discredited the pages of the FT and The Economist over the past decade. Happily we can state outright that the doom and gloom crowd is simply wrong – not because a cataclysm is impossible, or will necessarily be avoided, but in their assumption that said cataclysm it is ***inevitable****. It is not. It is a function of specific policy choices – a generalized crisis is only one possible outcome among several.*

What is quite extraordinary is the manful certainty with which the great majority of commentators reiterate their contention that Greece <u>shall</u> default (as opposed to the less contentious statement that Greece <u>may</u> default). Absolute certainty is a rare commodity in this world… and its possession never protected anyone from making a fool of himself[2]. There is an element of dishonesty here in that most commentators conveniently omit a number of the inconvenient facts, e.g. were Merkel's government to fall, the replacement – the SDP and the Greens – would be parties far more pro-European than the current government, while the almost-certain eclipse of the FDP party will ultimately remove the most anti-European elements of the current Bundestag.

For Greece, there is an alternative outcome: that the errors of the past be accepted for what they are – errors. Greece availed itself of its accession to the Eurozone to run up a credit card bill that it cannot conceivably service <u>at current market rates</u>. An outright default would lead to an uncontrolled loss of confidence in the other peripheral countries, not just Ireland and Portugal but especially Italy and Spain, thus savaging the banking sector; all of this would cost a large multiple of the amounts necessary to salvage Greece. Therefore, a two part solution needs to be envisioned:

Greece's problem is not its debt-load *per se*, but rather the cost of servicing that debt load at market rates; in debt/GDP terms, Japan has managed a debt load substantially higher than that of Greece to date with little difficulty. The reason, of course, is that Japan can service its debt at near-zero interest

[2] *An opportunity of which T&B may well avail ourselves, this without the benefit of certainty, absolute or otherwise – our bullish call on Greek bonds was based upon a probabilistic analysis, perhaps misguided… time will tell!*

rates. Russia, on the other hand, defaulted in 1998 with a debt/GDP level equivalent to only about 70% of GDP. Of course, at the time, Russia was obliged to roll over its debt at rates peaking well above 100% per annum – clearly an impossibility. The question is not whether Greece can run a budget surplus (a mathematical impossibility with the current montage), but rather, run a primary surplus, i.e. a surplus before debt service – the 2012 budget calls for a 1.3% primary surplus.

To avoid default, Greece's existing debt load needs to be guaranteed by the EU, allowing it to be serviced essentially at Euribor (a bit over 1.5% p.a., soon to drop to 1%). Management of this debt should probably be handed over to a European debt agency. Freed of the need to refinance the old debt at market rates, Greece would be compelled to live within its means by the simple expedient of no further lending – i.e. if the Greek governments wished to borrow further, this would take the form of "red bonds" – bonds specifically not guaranteed by the EU, not cross-defaulting with old debt, and bought at the buyer's sole risk. Obviously, the cost of such issuance would render this option impractical, leaving Greece with the imperative of either running a balanced budget (hopefully, with a small primary surplus, so as to service the old debt) or of defaulting on internal payments (i.e. to suppliers, civil servants, or pensioners – much like Russia circa 1997). This latter outcome would be a purely internal matter, with very limited impact upon the remainder of the EU.

The "voluntary" restructuring of current bonded Greek debt – essentially a political fig-leaf which amounts to the shifting the burden around between the ECB and the more exposed banks (which will doubtlessly receive discrete compensation for their write-downs) – may be the necessary political price; in our view, it simply renders the entire exercise more expensive given the knock-on effect on Spanish and Italian bond spreads. Private investors will almost certainly decline to participate in the exchange.

The Eternal Russia – The Eternal Return

The major story is, of course, the return of Vladimir Putin to the Russian presidency – an outcome which we always thought likely given that Medvedev seemed a deeply counterintuitive choice for the Russian presidency. Totally lacking in charisma and with no experience of politics, he was singularly unsuited to lead a country like Russia – with its long history of personalization of power.

The announcement itself was handled with typical Russian coordination and deft spin management. It appears that FM Alexei Kudrin, who clearly coveted the PM position for himself, may actually have learned of Putin's choice via the press. In any event, his dismissive statements about refusing to serve under Medvedev were quite uncharacteristic of this normally cool and unemotive functionary. Medvedev took up the gauntlet and promptly dismissed Kudrin on national television; seeking to project an image of tough decisiveness, he instead came across as both petulant and nasty.

The *FT* was delighted; with its habitual mendacious dishonesty as regards all matters Russian, they headlined some nonsense about a "*Rebellion in the Kremlin*". This was, of course, intentional and culpable disinformation; there was no "rebellion" – rather, a single key minister who had lost out in his bid for the Premiership bailed, while a couple of advisors to the losing camp expressed their disappointment in terms fairly moderate by Russian standards. On the other side, the local conspiracy theorists are largely convinced that the whole thing was a set-up to allow Medvedev to appear tough and decisive – a very optimistic read, we don't believe a word of it; as a general rule, we prefer not to attribute to conspiracy what simple incompetence can explain.

- **Med-who?**

Like many intellectuals of his generation who grew up at a time when there seemed to be only the stark, black-and-white choice between Washington and the Soviet Kremlin, Medvedev appears to be naively obsessed with the West, and with the US in particular. He may have overdosed on Deep Purple[3] records in his St. Petersburg dorm room, and in this is out of step with a large majority of his countrymen who (outside of the 3% of the population which is young, multi-lingual, middle-class, and

3 *A rather pedestrian choice – if one is to be imbued with the rich and vibrant American counter-culture of that period, a good dose of early Dylan, and perhaps some Velvet Underground, and Jim Morrison would have been more fruitful.*

lives in Moscow/St. Petersburg) are far more ambivalent. His reform initiatives appeared to be pulled at random from a playbook – then quickly forgotten, or buried in some obscure committee. While a few have created some positive media buzz, drawing attention to Russia as an investment destination, concrete results have been few and far between (*the fact that the great majority of European companies operating in Russia are highly profitable has been largely blacked out by the tame, manipulative Western press.)*

The running joke in Moscow was that there were clearly two factions: a Putin faction and a Medvedev faction… but no one was sure to which one Medvedev himself belonged! He has always been something of a cipher, and beyond a Westernizing gloss, there was little indication of what he truly stood for. Was he simply an emanation of Putin? Did he bring his own ideas? It is unlikely we will ever know.

The love for Medvedev expressed by members of the Western political elite appeared to be based more upon a forlorn desire to deal with ABP (Anyone but Putin) than on any specific virtues of Medvedev; this love should perhaps be tempered by the fact that the public reason for the split between Kudrin and Medvedev was the latter's demand that 3% of GDP be employed for a build-up of the Russian military; if there was one true Westernizer, it was clearly Mr Kudrin – T&B is running several bets that Kudrin will be back in a position of power within the next 24 months.

Indeed, we suspect that there is more than a little relief in Western capitals as Putin, a known quantity, reassumes formal power in Moscow. Although the swap was presented as having been long planned, T&B always believed that VVP had chosen Medvedev as an experiment, keeping his future plans open for as long as possible; as events revealed his choice of successor to be non-viable, he chose to reassume the Presidency himself. It would appear that Medvedev initially attempted to resist, before giving way before Putin's far greater popularity and the political apparatus; it is possible that the swap was offered to Medvedev as part of a deal for him to go quietly – if so, then we would very much doubt he will still be PM two years into President Putin's next mandate.

In any event, Medvedev's fate was sealed by his catastrophic mishandling of the Libyan situation at the United Nations (regardless of the morality of Western countries taking sides in a civil war in order to preserve their access to oil fields, Russia should have either vetoed the resolution outright, or instead, joined in with the crusaders; by abstaining, followed by angry criticism from the sidelines, the Kremlin sat down squarely between two stools – antagonizing both parties equally and dealing Russia out of any final settlement).

While the British press ran the usual hysterical rants (Cameron was clearly <u>not</u> favoured with advance notice), what was most striking was the very mild reaction of the American media; indeed, usually well-informed sources have claimed to us that the Kremlin had given Washington advance notice of the swap, with the Obama administration voicing no objections. Certainly, the very balanced coverage in the American press gives some credence to this view; "guidance" apparently came down from on high to downplay this story.

- **The Pragmatic Sanction**

While some commentators have considered the swap to represent a setback in the maturation of Russia's political system, we disagree. From a pragmatic standpoint, there was no other obvious candidate, and we did not savour the prospect of seeing a second mandate for a very uninspiring president, simply to make a (somewhat abstract) point. Furthermore, there is something inherently contradictory in having asserted that Medvedev was nothing more than Putin's creature, not a "democratically" chosen president – but that now, were a (far more popular) Putin to stand down for his creature, this would suddenly render Medvedev democratic. Without Putin's support, Medvedev would never have reached the national scene, nor would he now have any meaningful electoral prospects. Once again, we would offer a second interpretation: that the working definition of "democratic" for many in the West is *"that which advances the geopolitical interests of Brussels/Washington/London."* The dogs bark – the caravan passes.

Fundamentally, we believe that the return of Vladimir Putin will buy time – time during which Russia will continue its ongoing, organic evolution towards the European norm. An old generation dies off – a new one assumes its place; arising from the same soil, it too will be shaped by the long and singular

Russian culture and historical heritage (as fundamentally different from that of Western Europe as it is from Japan or China). This generation will not be "Western" but will bring with it a profoundly different personal history and experience, as well as a totally different set of incentives. This steady evolution is occurring as we speak; no one spending any time in Moscow, Ekaterinburg or any of the other major cities can fail to notice the steady evolution of Russian society. The middle-class continues to grow, businesses are formed, people become increasingly cognizant of other cultures and foreign countries, a professional class has been created and we see a gradual "normalization" of Russian sociology. The new Russian elites are increasingly foreign-educated; their sons educated, at least in part, abroad spend a few years working for Bain or Merrill's, before returning to apply their experience in the one place that they have a real competitive advantage. The likelihood of Russia returning to some variant on the Soviet model is precisely the same as of it resurrecting Tsarism, or falling again under the Tartar yoke.

Moscow "feels" far more like Europe than it did a decade ago. As in other developing countries, this process shall ultimately lead to the creation of a political system more responsive to the demands of the rising middle classes. Indeed, perhaps the greatest challenge for Russia in this decade is that the system is becoming more democratic – in the sense that the government has become exquisitely sensitive to the desire and needs of the populace; Russia is moving towards the European Social-Democratic model, decreasing the "efficiency" of the Russian budget, though of course, enhancing the well-being of the populace. Long gone are the days when bureaucrats or police could be paid $100/month while pensioners lived on $6 – having attained decent living standards, the middle-classes expect continuity.

Looking forward, we do not know when Putin will leave, nor under what circumstances – what we do know is that he will leave a country totally transformed by comparison with the circus we knew in the 1990s. For this, we are deeply grateful to Vladimir Vladimirovich.

Greece – No-one ever went bankrupt (by underestimating Politicians…)

T&B's recent bullish recommendation on Greek bonds has recently proved singularly, almost comically misguided… Mea Culpa!

That said, it ain't over until the fat lady sings! *Bloodied but unbowed (albeit, somewhat less self-assuredly than last June) we are not yet quite ready to capitulate. If the Greek bond swap goes ahead as planned, then a substantial gain by comparison with current market levels can be expected; even if not, prices do not suggest much downside under mainstream scenarios.*

Four months ago, amidst the rapidly growing concern about Greek fiscal sustainability, we noted that the cost of bailing out Greece – while very substantial – would be only a small fraction of what the failure to do so would cost. Further noting that "s*taring down the barrel of a gun clears European minds most wondrously*", T&B made two keys assumptions: first, that European policy makers could see the danger of the situation as clearly as we did, and second (mistakenly) that they would muster up a forceful response before it grew truly dire.

In fact, the Europeans – the Germans in particular – got thoroughly tripped up on their own politics, stumbling through a series of contradictory, misleading and discordant declarations, first agreeing to a bailout package, then almost immediately beginning to back-track, with a cacophony reminiscent of the later work of Alban Berg (or Boris Yeltsin). The consequences were very much what we had warned of – the market took serious fright, dumping not just the sovereign assets of Greece, but those of any country south of the Rhine; this drove up the borrowing costs of the remaining PIIGS, tanking risk assets of whatever nature and bringing Europe to the brink of a renewed banking crisis. Our best guess is that this fumble will increase the cost of the ultimate package by a half-trillion Euros or so.

This is of course reminiscent of the run-up to the Lehman's debacle – when a political decision was made not to spend the $16 billion or so necessary to backstop Barclays' offer to keep Lehman's in one piece, instead letting the chips fall where they may. The eminently predictable consequence was the paralysis of the global financial system – the US administration took serious fright, jettisoned their irrelevant "free-market" ideology – and spent hundreds of billions of dollars to build an improvised firewall. We can only hope that Europe can learn from their example, putting out the fire before it spreads.

- **Greek Expansionism**

While we clearly erred by excessive optimism as regards the ability of the European governments to react rapidly and forcefully, we have been (alas!) proved right in our assertion that *if Greece went down, it would be the least of one's worries* – the damage to other financial assets hugely outweighing anything the Balkans could throw at markets. At one point last week, we were a couple of headlines away from a global meltdown – we may still be so now.

Our baseline assumption remains that Greece continues to receive support from the Troika, and that a default can be avoided. This will be a long, protracted process which essentially involves periodically holding the Greek Premier out over the abyss for a good look down into hell, extracting some formerly inconceivable concessions in return for another thin tranche of funds, and then, three months later, beginning the process anew. Obviously, this game poses a serious danger of accidental miscalculation.

There has been much dismissive commentary about the Greeks' unwillingness to take pain, generally by people who have never been to Athens. Civil servants are being laid off (something utterly inconceivable – and illegal – in most European countries), nominal wages are being slashed, services cut back, and large swaths of Athens are scarred by shuttered shops and failed businesses. Greece is a developing country which was briefly leveraged into an "advanced economy" and which is now sliding back into its former status. This is painful, disruptive, and traumatic for any country – any temptation for Schadenfreude should be tempered by consideration of the potential global consequences; once again (as in 1914) "*the Balkans produce more history than can be consumed locally!"*

While it has been suggested that the Europeans are simply trying to push the "inevitable" default back until their banking systems are capable of handling it, the most likely date for that would be "never"; thus, albeit with a limited degree of conviction, we assume no default in the foreseeable future. There remain real dangers: the Greek political system could fail as pressure from the street became acute, rendering the country ungovernable – equally the European political system could seize up; like in August 1914, despite the spectre of imminent catastrophe, nationalist/populist political forces could push the world over the brink. These are all within the realm of the possible, but none are certainties – human life is ultimately unsustainable… yet all men live in hope!

The Twilight of the West

The good news is that we have a ringside seat for the decline of the West… the bad news – we are inside the ring!

Anon

The miserable thing about being a seer is that when you get it right – no one remembers – when wrong, not one forgets!

Actually, it may be worse to get it right since what seemed bold and provocative predictions a decade ago – the secular rise of China, the birth of a multi-polar world, the Malthusian struggle for resources – become banalities so widely held that one no longer dares reiterate them for fear of ridicule.

*When not totally distracted by the flashing of electronic digits on an LCD screen, T&B has been known to muse on some of the Great Questions – inter alia: "*Why here?"; "Why now" (i.e. at this particular time in a 14 billion-year history); "are we approaching a discontinuum...?" *If, very unexpectedly, we find any definitive answers tonight, we shall include them in an appendix. For now, suffice it to say that what best characterizes the "now" in which we live is a frightening acceleration; processes which once took centuries to play out now blaze to the fore in a matter of years. The world is obviously rushing towards an asymptote – a fundamental discontinuity; since the ultimate outcome is something best not* *discussed in a family-oriented publication, we shall confine ourselves to commenting upon some of the intermediate stages.*

When, two years ago, in a vehement and slightly tipsy argument with a French diplomat parroting the typical Western line as regards Vladimir Putin, T&B snarled that "*pretty soon, you people will be crawling hat in-hand to the Chinese, begging for a handout*" we were, of course, being gratuitously provocative…or so we thought. Little did we imagine that "someday" was about to become "today".

How wrong we were! Calls for Chinese financial assistance by various European leaders were recently slapped down very publicly by Beijing – which suggested that support might ultimately be forthcoming, but only in return for clear marks of obeisance from those uppity white folk, in particular immediate free-market status within the WTO, as well as undisclosed political concessions. Interestingly, it was not Brussels but rather the Republic of Belarus which last week received some substantial Chinese financial support – $1bn in unsecured loans and major investment agreements. Perhaps not coincidentally, Lukashenko has never been heard to utter a critical word as regards Chinese policy.

Almost daily for the past 20 years we have been served up yet another series of reheated warnings of the imminent end to the "China story", presumably fed by short (as well as nasty and brutish) hedgies. China is certainly not impervious to the economic cycle, and the risk of yet another Chinese banking crisis and/or a real-estate collapse cannot be excluded. There has been misallocation of capital, as well as serious social inequities and dislocation. The absence of a proper asset management industry has created a series of minor bubbles ("minor" since they are fuelled with cash rather than with credit). Competition between the regions, and for power within regions, has led to an increase in bad loans and questionable investments. Central planning has led to inefficiencies, but whatever its theoretical limitations, in practice, China's success is in no small part attributable to its singularly purposeful, competent and well-coordinated governance.

Over the past decade, tacit any warnings of impending collapse, the Chinese economy has tripled in size, while the Chinese populace has enjoyed the greatest increase in wealth in recorded human history; we would note that low-wage industries are beginning to delocalize from China to Vietnam and Indonesia as the Dragon hikes wages, moving up the value chain into capital goods, transportation, and technology. China has become the key factor in the majority of global commodity markets. The future is now.

We are not predicting imminent regime-change, but rather a continued shift to a multi-polar world, one in which Beijing shall have a disproportionate weight. The consequences are already felt in the developing countries of Asia, Africa and increasingly Latin America, where China is assuming the erstwhile place of Washington – preoccupied with its serial misadventures in the Middle East. The real challenge will be to accommodate this fundamental geopolitical shift in a peaceful fashion.

While we always assumed that China's "harmonious development" policy was a temporary imperative to avoid prematurely alarming the West as regards its meteoric rise, we have been surprised by the alacrity with which China has moved towards a more expansionist and forceful foreign policy, expressing something akin to the Monroe Doctrine as regards its own neighbourhood, in particular the South China Sea which Beijing apparently views as a Chinese lake. While it could be argued that this is primarily defensive, given China's resource dependency and susceptibility to naval blockade (analogous to the situation of Japan which led to the attack at Pearl Harbour), the great danger in the coming decades will be a collision between the rising new hegemon and its rapidly waning Western counterpart, still armed to the teeth and disinclined to abandon its habitual prerogatives.

How to trade It: Like Porcupines make Love[4]

To speak of "trading" this market is something of a misnomer. Markets have gone from a diverse casino offering numerous different games of some mix of chance and skill to a single roulette wheel with no numbers: only black and red, i.e. risk on/risk off. Or perhaps not – there is one set of numbers one must still bet on – 2008 or 1929, i.e. either the market is going to become seriously oversold, followed by a bounce of at least 50% as happened three years ago, or it is going to be found lying dead on the pavement in a global depression. Our best guess is that this is a 2008 scenario, but at present we would be very hesitant about catching falling knives… There will be a time – probably soon – so try to keep all of your fingers and toes! We are currently a bit short on inspiration (but are inspired to remain cautiously short, yet cutting back our position sizes).

- **Currencies – Flight to (bad) Quality**

Markets are creatures of habit, and when panicked, revert to a simple internal logic. Flight from risks = buy dollars; whatever the fundamental logic or illogic, buck this trend and you will be crushed! Therefore, the USD was clearly the place to hide until either the crisis abated, or went go back to living in caves. While we continue to believe that the dollar is in long-term decline, there is currently surprisingly little concern with the "long-term".

The crosses are, if anything, even more irrational. Last time we looked, neither Sweden nor Norway (much less Singapore) was a member of the Eurozone. This has not prevented their currencies from getting hammered whenever the market sells Euros. The emerging currencies are submerging fast, the AUD/NZD are down under, and only our favourite punt – the Chinese Renminbi – is holding up against the rampaging dollar. The Rouble is entirely in the maw of the European debt crisis, and its level is almost entirely a function of events in Athens/Paris/Berlin, not in Moscow. Predictions on the Rouble rate are necessarily contingent upon the global risk-on/risk-off appetite, itself driven by developments in the European periphery. Attempts to predict Rouble performance based upon Russian internals are an exercise in futility!

- **Commodities – Buying Beta**

Despite a great deal of nonsense in the financial press about the reasons for the sell-off in various commodities, the fact that almost all are moving in lockstep suggests that the primary driver is risk-aversion/market hypercorrelation. The oil market has thus far held up far better than in 2008, however, the night is still young…

Ultimately, of course, the Chinese Dragon has legs – many legs – and commodity demand will be driven by Asian growth to levels well beyond anything sustainable by our increasingly hard-pressed planet; for now, the medium-term outlook for commodities of all stripes is excellent – but we have the short term to get through first, so do please mind the volatility!

Once the current volatility subsides, we would be long the agriculturals and energy; we remain approximately neutral precious metals at current levels.

- **Emerging Fixed Income – Last to go**

One of the surprises of this summer was how well the emerging bond market held out against the spreading havoc in financial markets. No longer! Risk is now being aggressively sold, with the market particularly illiquid for Belarus, Ukraine, Kazakhstan as well as the high-beta Latins – Argentina and Venezuela (though the latter has been bouncing on Chavez health rumours). Selling is – as usual – highly unselective as margin calls are going out, and dealers refuse to make markets.

The emerging corporate bond space has gone totally illiquid with dealing spreads widening out to absurd levels – Russian Standard Bank was recently shown at 76.25 – 89, i.e. a 13-point spread, as the dealing desks refuse to take on any risk at any price; this occurred in the absence of any news whatsoever affecting the underlying credit, which remains unchanged. Once again, as we argued in 2008, Russian corporate debt, especially the banks, will offer a compelling buying opportunity and an

[4] *Very carefully…*

exceptionally good risk-reward ratio; that said, the ambient insanity in the markets could still grow worse before getting better. Caveat emptor!

As regards the underlying credits, we cannot stress enough how different the situation is from the previous crisis. The Russian banks are all profitable, there is far less leverage in the system, and, vitally, unlike in 2008 where thanks to Kudrin's "sovereign negative carry trade" Russian banks and corporates were heavily dependent upon foreign credit lines, today the banks are net creditors in international markets. Most vitally, however, the Central Bank of Russia has again made it abundantly clear that there will be no banking crisis, and like in 2008, Russian reserves will be employed as necessary. The Rouble is being allowed to find its own level with limited intervention by the CBR, and we doubt that very much support will be necessary for the banking sector (other than via provision of cheap, unlimited CBR liquidity). We currently feel more comfortable with Russian bank risk than with their European or American counterparts.

Once some bottom is found, we would be looking to buy the worst-hit credits – inter alia Promsvyaz, RUSB, Nomos, HCFB, etc. The risk-averse will find much joy with Alfa Bank, or even Sberbank. Of course, the likes of Vimpelcom, TNK-BP, and the metals will also be quite compelling. Once again, we suspect that late this year we will encounter some extraordinary buying opportunities, both in debt and in equities – we will again favour the bond market, given the fundamentally lower risk of Russian corporate debt assets.

- **Russian Equities – Globalization and its Discontents**

What has been largely unremarked upon in the financial press is the fact that, while in 2008 Russia severely underperformed global markets, plunging by as much as 75% due to the unwind of massive leverage, it is now performing very much on a par with its global peers: down 23% YTD, the RTS is doing neither better nor worse than Germany, France or Hong Kong. The Russian market is, of course, absurdly cheap given very limited Russian macroeconomic risks, and a rebound will ultimately occur – at present, however, valuations take up about as much space in traders' minds as do the rings of Jupiter; it is all about market dynamics and beta. It is illustrative that the announcement of Mr. Putin's return to the presidency had precisely zero effect on equity prices – the market rallied 2% on the Monday following the announcement, due solely to the slightly better tone in European markets (*note the usual narrative had been that "uncertainty" as to the Medvedev succession had been holding back the markets, and that a decision for Medvedev to run again would have led to a 10% rally – nonsense on both counts, we think).*

The only Russian equity exposure we have been recommending are the high-dividend preferred shares – TNK-BP and BANEP, to which we might add SNGSP and even TATNP. With yields on the first two in the 20% range, we would increase exposure without excessive worry about price action. Of course, with the Russian market trading at a P/E of 4.9 (and probably around 6.5, ex Gazprom), whenever there is some relaxation on the global front, money is going to be made by buying the worst-hit assets, in particular the metals – but again, we shan't be first to get back in.

The Future of Finance (buy a Farm!)

In the 1960s, financial services accounted for about 4% of American GDP with a somewhat smaller share in Western Europe. This was a happy period, characterized by steady, sustainable economic growth, low debt loads, and the gradual rise of a self-confident middle-class, secure in the knowledge that their children would live better than themselves. The financial sector essentially fulfilled its theoretical role of allocating capital to the areas of highest marginal returns, with a substantial but acceptable friction cost.

A half-century later and this share had increased to 13% of GDP, without any clearly measurable improvement in general well-being. Indeed, financial services provide no useful goods or services to consumers – the entire industry is a tax, and this banking "tax-burden" has become crushing. It is ironic that right-wing commentators constantly decry the cost of governmental inefficiency; while they have a point, compared with the financial industry, governments provide truly extraordinary value-for-money!

Recent market turbulence shows that the system has become almost entirely self-referential – with an increasingly tenuous linkage to the underlying reality (d.b.a. the "real economy"). Those doubting this assertion must ask themselves why the prices of wheat, oil, currencies, pork-belies, Russian equities and Argentine debt all move in lock-step, with the grotesque volatility rendering reasonable economic forecasting all-but-impossible for the beleaguered productive sector. Cyclicality is enhanced by the self-sustaining nature of market behaviour: first, everyone is in denial, markets hold up strongly as if walking on air, and bears are a lonely species; then, as the needle moves from elation to justified worry, suddenly everyone moves – as one man – to the opposite side of the ship, tipping it further, and quickly sending any holdouts sprawling into the bear camp – the needle hits panic levels. Hopefully, at some point a new contrarian vision emerges, as investors realize that the end of the world has been predicted more frequently than it has been attained – and a relief rally develops.

The "good news" is that economic systems are to some degree self-righting. The drying up of credit will strangle many of the financial innovations of recent years. The banking model is largely bankrupt – American banks grew to grotesque size by risking customer deposits via increasingly complex and deadly dangerous financial instruments; their European counterparts grew by leveraging up their balance sheets 50-fold, buying "safe" government debt and living off the carry. Both models are as dead as the Brontosaurus. Disintermediation is squeezing brokerage, while asset management fees are being compressed. Whilst a major increase in regulation is coming and should be welcomed (even if some of it will be misguided – the Americans will certainly find a way to punish S&P for daring to state what everyone knew – that the Emperor had no clothes while the Europeans continue to fantasize about an absurd and unworkable Tobin Tax, apparently just to punish those nasty markets), regulation is something of a side-show; market forces themselves shall gradually squeeze the financial industry back into its erstwhile size. For now, it is possible that some of the ambient macroeconomic pessimism is attributable to the major banks feeling justifiably depressed about their own prospects.

A Word from our Sponsor (Ourselves!)

Besides our habitual bear-case buy list – *canned food, fire-arms, and land in New Zealand* (which, given the downgrade and sliding currency, has just gotten a fair bit cheaper) – those concerned with the risk of fiscal confiscation or rapid inflation may choose to adopt another, definitive and more immediately gratifying strategy: **Spend it!**

We would be delighted to assist – several heroes of the local finance markets have recently chartered El Aleph for family cruises – a wonderful time was had by all, especially the wives and kiddies who finally got some quality time (in one case, requesting that we shut down the broadband satellite link!). It is not exactly cheap (though certainly more affordable than the equivalent in the Med), but – if you went into the current markets short – you can almost certainly afford it. Do drop us a line…

T&B

Appendix: Democracy – the final Synthesis?

One of the most terrifying features of the current crisis has to be Mrs. Merkel blithering about her steadfast refusal to "bow to the diktats of financial markets" – analogous to a farmer refusing to bow to the imperatives of the weather. It is perhaps brave, even noble, but equally, it is totally insane… the hurricane cares not who bows before it, who stands fast – it uproots trees and swamps buildings, it will not be denied.

- **Theory**

Man's mental processes are shaped by the words we choose to express ourselves, and since we cannot conceive of thought without language, it is vitally important that careful attention be paid to the values attached to certain key words. Even a journalist as lucid as W. Münchau falls into the trap of unquestioningly employing the term "democratic" as synonymous with virtuous – as if the electorate were infallible.

When a word becomes a universal – and, in particular, a universal good (or evil) – then it is very likely to become perverted, and, ultimately, to serve as an impediment to clarity of thought. Obvious examples include "nation", "God", "race", "freedom", "human rights", etc.[5] Given our experience of 15 years in Russia, to this rogues gallery we would be tempted to add "Democracy", at least as an absolute value (i.e. the notion that a political regime should be judged solely upon the basis of how "democratic" it is, rather than on how functional, effective, or beneficial to the populace).

The fundamental problems of democracy are self-evident:

- Democracy is a concept, not a system, the implementation of which is dependent upon a political process; if this process is defective, then it can swing towards the worst excesses of populism, manipulation, capture by special interests, or simple dysfunctionality.
- Like other dominant ideologies (Pax Britannia, *la mission civilisatrice*, etc. in the European colonies), there is a strong temptation for its main practitioners to employ it as means to forward their own parochial interests, hidden by a fig leaf of universality. It has certainly been employed by Washington as a cynical geo-political weapon in the CIS, rather delegitimizing the concept in Russia.
- For it to function requires a well-educated populace; if this populace is manipulated or simply ignorant of the implications of its choices, then the theoretical benefits are lost. Complex problems are susceptible to simplistic presentations; what our concierge thinks of the macroeconomic implications of restrictive monetary policy strikes us as irrelevant to the policy debate. The "dumbing down" of American media goes a long way towards explaining the increasingly primitive political discourse in Washington.
- It is readily susceptible to manipulation of public opinion – the ownership of vast swaths of the press by financial interests almost guarantees the corruption of public policy. Murdoch is reputedly proud of his role in starting the disastrous Iraq war, second only to that of Tony Blair.
- It strongly tends towards short-termism, given the rapid electoral cycles, and the temptation of a government to enjoy the good times, leaving the consequences to their successors.
- It tends to sacrifice the rights of minorities in favour of those of the majorities, easily falls into the grip of politically-influential groups, while favouring business interests (America), the lower-middle classes/civil servants (Europe), and the old over the young (everywhere).

The obvious counter-argument – and it is a good one – is that modern European democracy has proved superior to all previous political systems, and one cannot readily point to a system that works

[5] *Perhaps flags constitute a physical example of symbols which take on their own perverse reality in the minds of the masses.*

better. In our view, this repeats the mistakes of Hegel, Marx, and more latterly Francis Fukuyama. Democracy has proved generally superior to previous systems, just as constitutionally-limited monarchy proved superior to absolute monarchy, itself an improvement over tribalism. It does not necessarily follow that the current system is the final synthesis – rather than simply a new thesis which itself will ultimately be superseded. We are neither convinced that the world has reached the End of History, nor that other forms of governance will not ultimately evolve – certainly, the example of China suggests that the world is entering an era of competing models and the one-size-fits-all ideology is doomed.

- **Praxis**

T&B is not much concerned with abstract questions of political science, and are currently more exercised by the threat of impending doom and default in the G7 – we suggest that "democracy" may be a chief culprit, and that any exit from crisis will involve at least a temporary fudge.

While the current problems in Europe have been widely attributed to a "Democratic Deficit", we would argue that instead, it is a democratic surfeit which is currently making much mischief[6]. Europe is caught between two choices – one bad, the other catastrophic: *to bail or not to bail.* The German tabloid press has excelled at whipping up public indignation as regards bailouts for the feckless Greeks (or the sleepy Portuguese, the drunken Irish, or the lazy Italians) all of whom, out of some deep-seated perversity, simply refuse to be Germans. It is somewhat more difficult and less fun to explore the historical, cultural and social roots of these differences, seeking not retribution but realistic solutions; the tabloid reader's eyelids would grow heavy by the third paragraph.

As a result, several European politicians wishing to save their societies from the horrors of a new Depression shall be obliged to fall upon their swords. Zapatero has done so already, Merkel may soon have to; Berlusconi and the FDP have clearly chosen not to. Numerous small countries (Finland, etc.) are being whipped into place after briefly bursting into the limelight, but, theoretically, still have the capacity to disrupt the entire process. The outcome remains very uncertain.

Meanwhile, across the pond, the rise of the Tea Party is not without parallel to the Germany of the 1930s; the anger of an increasingly impoverished and threatened middle-class has been channelled away from the natural leftward path by a hard-right, populist group of ideologues. Fortunately, there is no natural leader among them (the foremost was recently outed as a coke-sniffing sex fiend – *http://www.guardian.co.uk/world/2011/sep/15/sarah-palin-alleged-cocaine-marijuana-book*) and to the limited extent that American politics is predictable, we continue to expect the US to swing towards more centrist-leftist politics in coming years. In any event, the success of the far right in demonizing such radical concepts as universal medical care in the minds of its likely beneficiaries says much about the power of the media and the dangers of populism.

*Readers are **invited to forward T&B** to any party who might be interested. We write to be read! Comments should be directed to Eric Kraus, on krausmoscow@yahoo.com*

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[6] *Even were a 51% majority of the citizens of a given country to opt for policies endangering a new Great Depression, would justice be served by compelling the remaining 49% to pay the price?*