TRUTH & BEAUTY
[...AND RUSSIAN FINANCE]

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STRATEGY

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The Fear Issue

To Live in "Interesting Times"

The history of mankind is one of long periods of continuity, punctuated by the occasional bout of sudden acceleration – fundamental discontinuities; while men living during said discontinuities suffer the inconveniences of war, riot, revolution and famine, they do have the compensation of living in "interesting times" – as the classical Chinese curse[1] would have it.

At present, the only absolute certainty is uncertainty. Those talking heads who thunder down each day about the "inevitable" collapse of Europe are smoking dope – there is nothing inevitable about it; it is one of several possible outcomes, a function of political choices which are by nature unpredictable. That said, a cataclysmic outcome (and a repeat of the Great Depression, at least in the West, would probably qualify as "cataclysmic") remains a distinct possibility; we are horrified by the incompetence, politicizing, self-interest, and outright denial rampant in the European political class. While Washington offers an equally unedifying spectacle of political paralysis, destructive partisanship, breathtaking hypocrisy and a tenacious refusal to accept reality, at least this involves only a single government (well, at worst, two mutually antagonistic moieties…) rather than 17 (or 27).

As we go to press, the odd thing is that markets have become becalmed – probably a case of meltdown fatigue. As traders, as investors, as entrepreneurs, as citizens, as mammals – we must be concerned. We are living with a particularly vicious bear sleeping fitfully at our feet. At some point in the not-too-distant future, he will presumably awaken and wreak serious havoc – not just upon our marks-to-market but upon the very fabrics of our societies. With time, we have become accustomed to his presence, and are reduced to nervously watching our trading screens, humming a lullaby and hoping for the best…

[1] *i.e.* "May you live in interesting times" – *the fact that no Chinese person has ever actually uttered said curse is no impediment…*

A Note from our "Sponsor": *in our last issue, T&B proudly announced our new sponsorship agreement with El Aleph Cruising Yacht - it was, in fact, meant as slightly tongue-in-cheek.*

El Aleph is an avatar for T&B – we are one and the same; the yacht is the fruit of the two years spent crawling around the bilges in the tropical heat and humidity, first in rural South Sulawesi, Indonesia, then in Bali. She is used primarily as an owner's yacht, but is available for charter by friends and readers of T&B. El Aleph stars in two new videos on YouTube:

http://www.youtube.com/watch?v=JwfPRn1DqzA http://www.youtube.com/watch?v=-qJ8quUv2kI

Myth Busters – A New Feature

In an ongoing attempt to wrestle this unwieldy beast of a publication down to reasonable size, T&B shall attempt to break out our favourite examples of cognitive dissonance, revealing them for what they are – mere phantoms, living in dread of the light of day…

Myth Busters – Part I: Russia

- **Russian Capital Flight**

This is the bugbear at the origin of the myth-busters section. If one repeats anything often enough, adducing some evidence which, at least at first glance appears superficially relevant, people will ultimately accept it as true, without bothering to consider the alternative explanations for the data.

While Russia's *"torrential capital outflows"* are cited *ad nauseum* in the media and mainstream analysis (from Alfa Bank research to opportunistic insertions into virtually every FT Russia story – from politics and budgetary policy to fashion and haute cuisine) it happens to be nonsense, at least as usually presented. Since some of our readers may be wary of our objectivity as we lead yet another sacred cow out to slaughter, we will cite several of the more prescient Russia strategists:

Our friend Liam Halligan of Prosperity Capital first brought this myth to our attention, arguing that the Central Bank of Russia was encouraging outflows in its struggle to keep the rouble down; absent capital outflows, the currency would soar towards the low 20s, causing a recurrence of the Dutch disease which struck Russia before the 2008 global crisis. Furthermore, Liam argued, capital outflows were not suitcases full of greenbacks heading for Switzerland, but rather, largely a product of Russian corporations and oligarchs investing abroad – in particular in the ex-Soviet space, as well as European retail banks desperately raising deposits in Russia to fund their cash-constrained European operations – something which the Central Bank has repeatedly flagged.

But there is another fundamental factor at work: **all major commodity producers are capital exporters**.

In a recent issue of his EM Advisors Group, John Anderson[2] notes that, as regards capital outflows, Russia falls smack in the middle of the field for EM hydrocarbons exporters (see graphs, below). As noted by Chris Weafer, the recent sharp reversal of capital outflows was not especially good news, just as the previously-high outflows were not particularly bad. Instead, they are the mechanical reflection of a factor which anyone with access to a Bloomberg screen (or a daily newspaper) can see: crude oil prices. When oil prices rise, the trade account surplus tends to be balanced by capital account outflows – when prices decline, so do capital outflows. "Capital Flight", on the other hand, is a totally different phenomenon, occurring when savers fear massive economic instability and or devaluation (Argentina, Greece, Italy, Ukraine), and seek a haven for their assets.

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[2] *Jonathan Anderson, Emerging Markets Advisors Group – a must-read for institutional asset managers trading in the emerging markets. jonathan@emadvisorsgroup.com*

Chart 1. Should you be watching this chart?

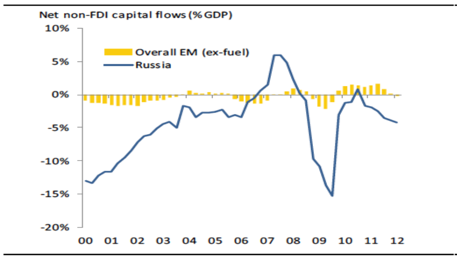
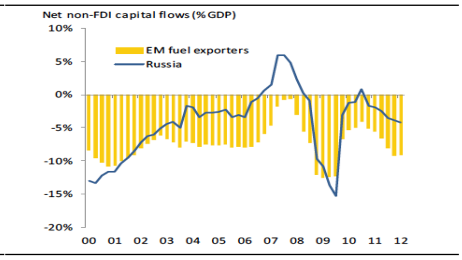


Chart 2. Or this one?



We would add that Anderson also demonstrates that domestic investment by Russian residents is smack in the middle of the range for emerging markets; there is no objective evidence for an inordinately high degree of capital flight.

- **Russian Economic Underperformance**

In discussions with our Russian friends, we hear the constant refrain that Russia is not "*living up to its potential*" – and, in absolute terms, they are of course right; as usual, the only thing missing is some sense of perspective. T&B is hard-pressed to find many countries that currently are living up to their potential: Southern Europe? The Visegrad Group? The Baltics? France? The US? Times are tough indeed.
The point is that, in relative terms, Russia is doing very well. Unemployment at 5.6% is less than half the levels of the US (U6), or Europe (and less than one-quarter Southern European levels). Debt-to-GDP is around 7% (as opposed to an average of 90%, away), disinflation is continuing with CPI dropping into the low single digits, industrial output has held up better than expected, with GDP expected in the 4%-5% range this year. The CBR is the only major Central Bank to have held rates steady this year; with everyone else racing towards zero, it is actually talking of rate hikes.

Impressive leaps forward have been made in agriculture and banking (albeit for a very low base), mobile phone and Internet coverage are better than in the US, while retail, energy and metals and mining are seeing at least a gradual modernization. On the other hand, overall efficiency is low, corruption remains a major problem (but see below), management skills are outmoded, public services remain dismal (though again, improving) and while nowhere near as dire as usually portrayed in the West, infrastructure investment has been inadequate, especially given the cashflows available: Russian Railways still offers a passenger experience similar to that enjoyed in Western Europe of the 1950s**;** the road network is shoddy, regional airports are mostly cattle-class (though with an increasing number of new, shiny counter-examples) and the of the housing stock is distinctly slower than China (although, after Ekaterinburg, Novosibirsk and Cheboksary, a recent trip to Kazan revealed yet another provincial city undergoing a total reconstruction – roads, housing and public infrastructure – though much of this new architecture is utterly ghastly…)

- **Corruption – *How Much did you get Paid to Write This?***

Corruption IS a problem – everyone from Putin on down agrees on that… but the point is that, having worked in or been involved with projects in Asia, Eastern Europe and Latin America, T&B can assert that Russia is certainly no outlier. While the (highly untransparent) "Transparency International" polls put Russia near the bottom of the list, these polls do not purport to measure "corruption" – they measure the perception of corruption – a vital distinction, since, while upper-class Brazilians and Mexicans love to tell foreigners how much their countries have evolved, Russians vie to outdo each other with lurid tales of outrage and evil-doing. Results of perception-of-corruption surveys are as much a reflection of the national character as of the situation on the ground.

As confirmation of this, when polls ask questions along the lines of "*have you or a member of your immediate family actually paid a bribe in the last 12 months*?", then plotting the results against GDP per capita Russia falls squarely in the middle of the pack for middle-income countries.

From our personal experience, it is getting slowly better. In the early 2000s, no foreigner would go out in Moscow without his passport – which would likely result in the demand for a $100 backhander to avoid spending a couple of hours at the local commissariat. Nowadays, no one we know carries his passport, while that scourge of Western life – the traffic citation – has made its appearance in Russia (replacing the rather more civilized clutch of RUB1000 bills).

- **Unfree and Oppressed in Moscow**

Many of T&B's Russian friends persist in believing that paradise starts immediately across the border. We would invite them to try living for six months in our native France (where the fiscal inquisition rages with medieval intensity), the UK (with its ubiquitous surveillance cameras, DNA data-bases, extra-judicial imprisonment orders, and rampant street crime) or the US (Big Brother is watching very closely, indeed) before complaining about how "unfree" Russia is. Given that the repressive mechanisms are still not as well organized as in the West, Moscow may well be the last European city where one can still feel free…

As regards economic opportunity, we usually enquire whether they would rather be a new graduate looking for work in Paris, Madrid, Rome, Los Angeles, or Moscow. Think hard before answering…

- **Russia's "High-Risk" Economy**

This one is a bit more subjective. In our view, the Russian economy is safer than any of the Southern European Eurozone countries, though perhaps marginally less stable than the likes of Germany, Finland or the Netherlands (we say "marginally less" given the overwhelming exposure of the Euro core countries to the ills afflicting the Eurozone as a whole, as well as serious continent liabilities and dangerously-exposed banking sectors).

Russia's risk factors are more global in nature – commodity prices (*vide infra*), Asian growth, and global financial instability – yet Russia still has her coping reflexes intact; those of us who witnessed the response to the 1998 financial crisis (people retreated to their dachas and grew a new potato crop) were left with an admiration for their survival skills; we very much doubt that any Western European country could come through a crisis of similar magnitude with its political system intact.

Unlike the situation in 2008 – where thanks to the "Kudrin negative-carry trade" Russian banks were dangerously dependent upon wholesale funding from abroad – the banks are currently net foreign **creditors**, Russia is substantially underleveraged, with the credit cycle still in its early days.

- **Russia in Trouble with Oil Prices Below X$ (the Reader can set X = to any Positive Integer < $80)**

Russian growth would indeed slow to a crawl if oil were to fall below X (our best guess for X is about $75) **and then stay there for 18 months** – which, given our constructive view on Asian growth, we think about as likely as Menatep offering to sponsor T&B. If we are wrong, and were oil to plunge to, say $60 for an 18-month period, the rouble exchange rate would take a large part of the strain, and while the government would probably run a moderate budget deficit, spending could be trimmed and reserve funds depleted during the interim.

- **Putin II – Brezhnev: Call Home**

Were someone to give T&B just one franc for each bit of culpable nonsense written about Vladimir Vladimirovich, we could open our own Swiss private bank!

Russia is neither stagnating nor is she rushing forward at a Chinese clip. There is a slow, steady improvement in governance and business practices – frustratingly slow for those of us used to the wildness of the 1990s. Russia is becoming an increasingly "normal" country.

When Vladimir Putin assumed the presidency in 2000 he was faced with a pressing problem – **there was no money**… the state was quite literally bankrupt. This problem was solved by compelling the oligarchs to pay their taxes, especially for mineral exports. As Putin resumes the Presidency in 2012, this problem recurs – it is no longer feasible to run a budget surplus based on the simple expedient of paying doctors and teachers $100 per month; for better or for worse, Russia is moving towards the

European social model. Since mineral exports are already taxed to somewhere near the Pareto threshold, the next obvious source of revenues is the state companies – which have frequently been run by and for the benefit of their stakeholders, rather than as for-profit entities.

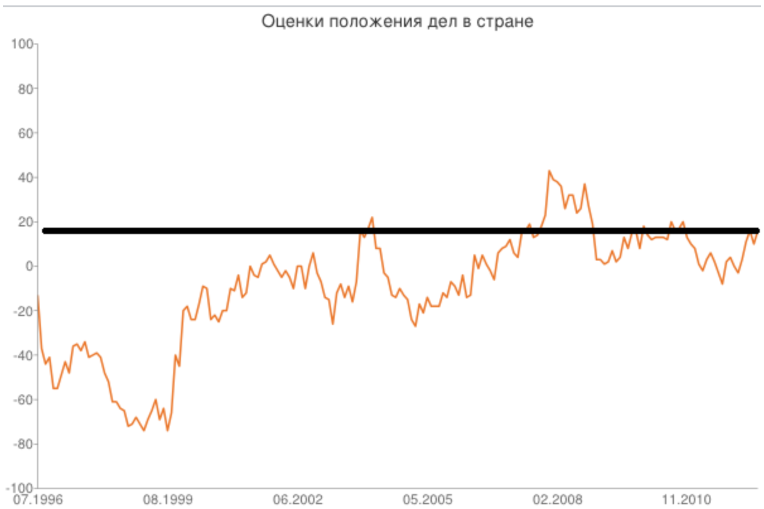
Igor Sechin – the head of the newly created Rosneftegaz holding, is tasked with compelling the state companies to properly account for their earnings and to pay proper dividends. Mr Sechin is generally perceived as being someone not to be toyed with, and is fully capable of standing down behemoths the likes of Gazprom and Transneft. We are already seeing the first fruits of this strategy as dividend payouts are improving quite sharply.

- **The "Putin Dictatorship" is about to collapse**

T&B is planning to apply for a reduction in our time in purgatory equivalent to that spent refuting mendacious idiocy during our stint as a strategist here on earth. Since you are tired of hearing us repeat it, we offer and extract from a recent Forbes article by Mark Adomanis, flaming The Guardian:

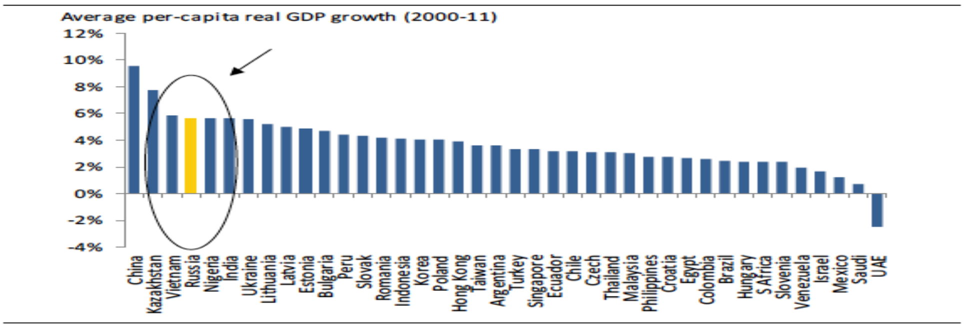
This sort of aggrieved "the sky is falling, Russians will soon be in the streets demanding blood! Putin is doomed!" editorial has been appearing after every terrorist attack and natural disaster since Putin first came to power. I remember reading similar, almost identical, editorials after the sinking of the Kursk, after the Nord-Ost theater siege, after Beslan, after a dam collapsed in Siberia, after the suicide bombings on the Moscow metro, and after the horrific forest fires of 2010. And yet, apparently against all odds, Putin is still here and Russians are still, generally, supportive of him.

A point T&B has been banging away on forever – not only do the Western media consistently get it wrong, but worse, they reliably fail to learn from their mistakes, repeated over and over again… Mark adduces some evidence:



The above image is Levada's graph of the overall index of Russians' opinions on the country's direction. A bit more precisely, the index is the difference between the positive and negative answers to the question "is the country going in the right direction or is it on the wrong path?" The line I've drawn into the graph shows where things are as of May 2012. As you can easily see, the current level of public satisfaction is significantly higher that it was for large stretches of Putin's first stretch as president (basically the entire period from late 2004 to mid 2007), let alone the mid and late 1990s. If, as the Guardian says, Russians are increasingly dissatisfied with where things are going, why are they not telling pollsters that?* Does that graph look to you like a story of collapsing public confidence?

We would add that the reason for Putin's popularity is self-evident – again, borrowing from the polymath John Anderson:



It's the economy, stupid!

- **Russian Spring**

Okay, we are whipping a dead horse here, but even T&B has the right to an occasional victory round.

As we have written since the beginning of the "Facebook Protests", these posed a threat to the Russian government commensurate with that posed to the Washington power elite by the "Occupy" movement. After a "million-man march" (which fell short by some 980,000 men…), and a final rally which proved a damp squib, the movement has folded up its tents and melted into the night, making fools of the legion of commentators who warned that Russia was about to spiral into unrest, uprisings and revolution… before ultimately choosing a "freely elected" government, totally beholden to Western interests. In fact, the protest movement faded into nothingness without having managed to formulate either a leadership or any coherent expression of its goals. Our conclusions:

-Russian society is coming of age, with the development of a fast-growing middle-class which increasingly believes that it can influence the course of the country; the political system is badly lagging; it is vital for Russia's development that these rising new classes find a voice.

-Like every other country, Russia desperately needs an opposition – preferably one that is constructive, sane and which agrees on certain basic principals.

-Alas, the current Russian opposition (or rather, the oppositions – there are literally dozens of 'em, from quasi-fascists to hardline communists, with only a smattering of liberals) is not it. The fact that the country which gave us Herzen, Tolstoy, Lenin, Gogol, Solovev and Florensky – indeed more great thinkers than one could shake a stick at – should come up with nothing better than Nemtsov (a fool), Kasyanov (a crook), Limonov (a fascist), Navalny (a smart, amoral opportunist, given to hard-right nationalism) or our personal favourite, Ksenia Sobchak (Russia's answer to Paris Hilton) is an enduring source of bewilderment; and do not blame it all on Putin – the opposition was no better during the Yeltsin years!

- **Tymoshenko, Khodorkovsky and Andrei Sakharov**

It is quite extraordinary that while, in the good old days, the Western press was rife with talk of "murderous oligarchs" shooting their way to riches (in a recent court action in the UK, reference was made to "a killing every three days" in the aluminium wars, while oil and banking were equally hazardous) history has been hastily re-written. While in the 1990s, Khodorkovsky's name was closely associated with tales of mayhem, the Western press suddenly forgot what they themselves had been writing when Khodorkovsky – a murderer and a gangster – was rapidly adopted by Washington following his abortive attempt to sell half of Russia's largest oil producer to Exxon.

As regards Tymoshenko, T&B was not in Ukraine at the relevant times, however she is widely believed to have been one of the toughest oligarchs in the even more vicious Ukrainian business wars, during the course of which she rapidly became a multibillionaire. A former Ukrainian Prime Minister is still in prison in the United States for recycling a bribe she paid him into the purchase of a home in California's Marin County (no, he was never the sharpest knife in the drawer…) – yet oddly enough, Mrs Tymoshenko was never prosecuted for paying the bribe. We see little reason to assume that her misdeeds stopped with mere bribery… which would have been an exception, rather than the rule.

The counter-argument – that others were equally corrupt and thuggish but were never called to book – is unarguably true. We would simply note that both Tymoshenko and Khodorkovsky knew the rules, played the game, were merciless with their adversaries (many of whom who suffered fates far worse than prison) and should not now act surprised when these same rules are employed against them.

Myth Busters II: Almost-Everywhere-Else

- **Lies, Damned Lies – and Chinese Statistics**

Everyone knows that Chinese statistics are gamed (but only when they are good; whenever bad news is announced, it is taken at face value). The Communist Party sets growth numbers wherever it likes – and thus, like Bernie Madoff, consistently hits performance targets and thus (and except for brief periods when they were fustigated for **understating** growth) have grossly exaggerated Chinese growth for decades (although oddly enough, in the interim, China somehow managed to become either the world's second largest economy – or its first).

Work by Andy Rothman of CLSA, which established CRR (China Reality Research) in 2006 clearly demonstrates that both the main official and the alternative statistical series are largely in keeping with reality, and are reliable indicators of commodity demand as registered by China's trading partners, as well as fitting with price series from other Asian countries. Again, if regional politicos were massaging their growth numbers up, it is hard to understand why they would not have massaged the politically very sensitive CPI numbers down during the inflationary burst which followed the post-2008 stimulus packages (as regards electricity production, it is an indicator for **heavy industry** – steel, aluminium and cement – rather than for overall economic activity).

- **The Coming Chinese Implosion**

While talking heads and short, nasty, brutish hedgies have been predicting a Chinese collapse since the middle of the last decade, China stubbornly refuses to comply. Recent data suggest that the slowdown in Chinese growth probably bottomed in early Q2 2012; 2nd quarter GDP growth declined to 7.6% – enviable by the standards of the so-called developed countries.

Ah, but the reader will reply – you are missing the fact that growth in electricity production was in the very low single digits. In fact, as noted above – electricity production is an indicator for heavy industry – not for overall economic activity, which is more dependent upon services and light manufacture. While consumption of steel, cement and aluminium are largely a function of construction activity, the official figures already demonstrate a slowdown in construction; the power numbers simply confirm what we already knew and taking them as "further evidence" for a slowdown is double-counting.

Indeed, it is probably in Chinese interests to create the perception of a rapidly slowing economy – scaring commodity vendors into lowering their prices, and forestalling calls by Western capitols for a revaluation of the Chinese Yuan.

- **Arab Springs toward the West**

The elections in Egypt have offered us the unaccustomed spectacle of Western liberals cheering the advance of Islamic parties favourable to female genital mutilation. More broadly, there is a fundamental misconception resident in the Western political DNA – the notion that, if only they were given the chance, everyone would vote for governments friendly to our own interests.

Nothing could be further from the truth – much of the Arab crescent is caught in the fatal embrace of population growth outstripping any capacity of the economy to provide adequate employment, with the resultant poverty, frustration and occasional hunger favouring the rise of extremist parties.

The cards are being reshuffled in the Middle East, and while T&B lacks the expertise to predict what the new deal will look like, we suspect that the next dominoes in the queue will be one or more of the major oil producers.

- **S&P was "Discredited" by the Rise in US T-Bonds Following the Ratings Cut**

A choice bit of lunacy, *inter alia* repeated three times weekly on Bloomberg. In fact, the agencies were discredited years ago: a) like the guy who shouts "*be careful!*" immediately after you miss your step and go sprawling face-first onto the carpet, they are lagging indicators, and b) they are corrupt, most recently having peddled AAA ratings (at prices of up to $1m a pop) for toxic structured securities, helping to bring the global financial system crashing down. The ratings are somewhat useful in a single domain – the initial area of expertise of the agencies, rating corporate bonds in developed markets where one finds a good correlation between ratings buckets and the likelihood of subsequent default. As regards sovereigns and EMD, the agency ratings are significantly worse than useless.

The downgrade of the US and selected European debt ratings was long overdue – and everyone knows it. The UST strengthened, neither because of the downgrade nor despite it – but rather, because there is little else left for the institutional investor to buy – no place else to put his money. Much like the strength of the dollar, it is simply a reflection of how dire every other asset class appears.

Japan is a case to point – with a debt/GDP of nearly 300%, no sane person could assert that it is a "good credit", yet that does not prevent its bonds from trading 50bp inside of UST… *caveat emptor*!

- **YPF – Argentina Unravels**

Argentine economic policy certainly gives a new sense to the term "unorthodox" but, oddly, despite the incessant predictions of doom and gloom (from reactionary Goldman's analysts to the broader financial press) over recent years Argentina has enjoyed by far the fastest economic growth of any country in the American continents.

This good luck may or may not last – inflation is again ingrained (and is running at more than twice the official measures), there are signs of overheating, and pressure on Forex reserves has forced the government to sharply restrict convertibility of the (overvalued) peso, creating a de facto two-tiered exchange rate. Of Argentina's two main export markets – Brazil and China – growth in the former is crunching below the 2% level, thus endangering Argentine auto sales; on the other hand, China will certainly not be cutting its food imports anytime soon. The fact that Argentina is locked out of borrowing in global capital markets – generally cited as a weakness – may in fact be a blessing in disguise, serving as a hard constraint for budgetary surpluses; indeed, Argentina is currently paying down its sovereign debt load at a rapid clip.

In any event, if the Fernandez government has done one thing right, it was the nationalization of YPF, Argentina's key oil producer, which had been used as a cash-cow (>90% dividend payout) by the Spanish Repsol, resulting in a precipitous decline in Argentine oil production. The Spanish may huff, puff and threaten, but their means of pressure on Buenos Aires are very limited – while for the Argentines, it is literally a matter of survival.

- **India – Democracy's Rainbow**

That India is often cited as a model of how poor countries can develop within a democratic context is a striking example of cognitive dissonance at work, ignoring the fact that perhaps a hundred million Indians still live in desperate, Sub-Saharan African poverty, with a substantial proportion of them "Untouchables" – born into a life of humiliation and destitution within the caste system.

Twenty-five years ago, China was far poorer than India – today, the difference is striking, but in the opposite direction. While China may imprison the odd democracy activist, anyone travelling first through rural India, then through rural China, can be forgiven for seeing the contrast as a clear confirmation of the benefits of one of the possible variants on "authoritarian" governance.

- **Adam Smith Governance shall Liberate Mankind**

What is odious about the Right is not their egotism (T&B is a charter member of the 1%, and aspires to nothing more than to remain there, indeed, to rise into the 0.01%), but, rather, their hypocritical and blatantly self-serving claim that a system which has proved hugely beneficial to a minority of us is, in fact, a boon for all of mankind – for truck drivers, cleaning ladies, and assembly-line workers; nonsense! At some point it becomes a zero-sum game – the more we take out, the less remains for the drones. The US middle-class is being crushed, as the super-rich thrive as never before. Might there be some relationship here?

The ideological problem is that simple minds thirst for simple rules – Ayn Rand and similar comic book theologies. In fact, total economic freedom and zero economic freedom are equally disastrous for the majority of men. Having just returned from Sweden, T&B is compelled to admit that Nordic Socialism – combining a high degree of free-markets orthodoxy and competition with substantial state involvement in all aspects of society with systematic redistribution of incomes, is clearly the economic system which provides the greatest benefit to the greatest number.

One does not become Sweden[3] – one needs be born that way, so for the rest of us, the difficulty lies in finding a reasonable middle-ground between the rapine of pure capitalism, and the stagnation and deadweight of the Southern European social model.

- **The Death of the Emerging Markets/BRICs**

T&B has repeatedly remarked that the only problem with the Emerging markets is that there really is no such thing – like the BRICs, from the purely economic standpoint it is a useless category (although, from a political standpoint, the BRIC group may well be meaningful); indeed, any category lumping together Uganda, Israel and China is nearly as useful as the teats on a bull!

There are the Asian markets of greater China; there is the set of Asian countries dependent upon greater China; there is Russia-CIS; there is the set of the oil exporters – the performance of which is not obviously correlated with that of the energy importers; there is Mercosur in South America…
If there is an investable index which looks like "Emerging Markets" that is simply because the same rag-tag band of investors play the non-G7 markets; in the short term, the perception creates the financial reality – in the medium/long term, it is irrelevant.

- **Latin America can be Usefully Divided between the "Democratic" (Mexico, Brazil) and the "Authoritarian" (Cuba, Venezuela)**

Mexico may or may not be Democratic, but it is close to hell on earth for many of its inhabitants. T&B spent our childhood there, at a time when driving through the countryside, one encountered swarms of children with the swollen bellies and wasted limbs characteristic of late-stage chronic malnutrition.

Returning some decades later, one still sees them. Despite moderate economic growth, the fate of the common man has grown worse, not better. Mexico boasts the world's richest man – Carlos Slim – and literally millions of starving children – hardly a recipe for social peace and harmonious development. Perhaps that is one reason it has sunk into a state of open warfare with the drug gangs. As regards Brazil, despite economic growth far superior to that of Mexico, the favellas of Rio are a veritable no-man's land, while isolated rural areas in the north suffer an almost-African degree of poverty.

Turning to Cuba, in terms of GDP, it is far poorer than Mexico, suffering from the fundamental economic dysfunctionality of Marxist economies. That said, distribution of wealth is a great deal more egalitarian than in its Caribbean peer group. Driving around Cuba, including the most rural and mountainous regions, one encounters no hungry children nor abandoned pensioners, and while

[3] *Though we can only admire the success of their socio-economic model, personally, we would rather slash both wrists than live there – while unarguably beautiful (in a rather ponderous, Hanseatic way), with a healthy, prosperous population, Stockholm manages to combine a Russian climate with a Western, comically exaggerated degree of political correctness – i.e. T&B's idea of hell!*

transport is dire, housing substandard, and food starchy and protein-short, rural health and education services are at a developed-country level, infinitely better than in their more "democratic" neighbours (confirmed by WHO infant mortality, human development, and literacy figures).

In short, nowhere did we find paradise – but what we are sick of is the craven hypocrisy of those who would fustigate Castro or Chavez for attacking the Empire and suppressing economic freedoms, without mentioning the domestic social consequences of the right-wing economic policies of some of their more orthodox neighbours.

- **"The Sole Superpower"**

Superpowers are going the way of the dinosaur. First of all, a stable arrangement requires two superpowers – each creating a justification for the other; in the absence of real competition, there is a tendency towards imperial overreach and the failure to hold together alliances. The world is moving towards the emergence of a gaggle of major regional powers – Brazil, Russia, Turkey, South Africa, Germany etc. as well as two with more global aspirations – the US and China. The former is still the unrivalled leader in military force, while the latter has all the economic growth. The reader is invited to lay his bets on the outcome.

- **"Markets hate Uncertainty"**

We close with a personal favourite – a mantra for generations of brain-dead financial journalists, it is obvious nonsense. Uncertainty is an integral part of markets – indeed, were there to be no uncertainty there would be no markets, and indeed, the markets are wont to eliminate from the gene pool anyone inclined to think himself in possession of absolute certainties of any description.

What is true, on the other hand, is that the market could happily dispense with that whiff of raw fear which has become so prevalent… as, indeed, could your correspondent.

Readers are invited to submit myths to be busted in our next issue…

Part II - The Decline of the West – A Rant

The good news is that we have a ringside seat for the end of the world…
(the bad news is that we are inside of the ring!)

T&B – like at least our Western readers – chose to be born during a blessed era. War was something occurring in far-off places, experienced only on television or in the newspapers; hunger was a state to be actively desired in an era of plethora; poverty was nothing more devastating than the ownership of an old car or having to take the Tube to work – whilst for most of us, after breakfast in Paris, we might take lunch in Marrakesh or in Moscow – or dinner in Beijing.

In our dissipate youth T&B formed part of an empowered and confident rising bourgeoisie – the great Western middle-class. While the periodic financial crises struck us as quite fearsome, in fact they proved to be mere bear markets – momentary disruptions of the steady progression of mankind to a shining and secure future. Like citizens of Imperial Rome (or Soviet Moscow), we could not imagine a collapse of what seemed so solid, so stable – disregarding the fragility of a complex system subtended by a vital web of trading relationships, military force, financial flows, divisions of labour, and a socio-political organization combining compulsion with rewards, transforming economic wealth into political power. We can be forgiven for having missed the fragility of the system into which we were born – which thus seemed to us nothing more than the natural order of things.

By definition, the decline of any empire begins the morning after its apogee – the West almost certainly crested on the evening in 1989 when the Berlin Wall came down. We can still hear History laughing at the prognostications of her demise; the sole great power came to imagine that its supremacy would fall outside the march of time – 20 years later, "History" is in ruddy good health!

1989 can also serve as a marker for the beginning of the Great Credit Bubble – or rather, of the rolling bubbles with the illusion of economic growth and prosperity maintained by artificial means: massive credit creation, with a series of asset bubbles, the last of which was the US mortgage bond pyramid.[4]

A Handful of Dust – A Trader's Lament

It is hard for those of us living in market-land to remember that there was a time when each morning one could turn on one's Bloomberg without a sense of dread. A time when we feared, at worst, a trade going against us, or a market sell-off, a rate hike… not the collapse of the entire socioeconomic system that feeds and protects us; such fears were once the appanage of cranks, survivalists, and Austrians. No longer – catastrophism has gone distinctly mainstream!

Speaking with our friends in finance, everyone suddenly seems to hate his job – even those who are still making money find it deeply dissatisfying. Fundamental research (never T&B's stock-in-trade) has become almost comically irrelevant; markets have no discernible pattern other than nervous oscillation, while one gets a sore neck following the steady stream of contradictory headlines, brainless policy declarations, broken promises, failed summits and political incompetence elevated to the level of fine art. The volatility is fierce but cyclical, with a general sense that we are living on borrowed time – no one has much idea of what lies on the other side of the approaching discontinuity.

*Even in September 2008 – as we watched in terror the US financial system accelerate into a death spiral, dragging the world in its wake – along with some gallows humour, there was an excitement – almost a sense of elation; at least it was happening **fast**.*

No longer – now we are living a slow-motion train wreck, a gradual drift into madness as European "policy-makers" are reminiscent of the last, panicked months of the pre-crisis Yeltsin government – when each day brought its crop of wildly contradictory statements, absent any coordination or concern with market impact – Schäuble contradicts Merkel; Van Rompuy announces solutions when none are at hand; Merkel cuts deals – then freely reinterprets them to suit her domestic audience; German councils of the Good and the Great demand that mere anarchy be unleashed upon the world, oblivious to the fact that a Euro collapse would crush an export-dependent German economy which still sends 40% of its exports to Europe; France blithely calls for growth, then opts for those same methods which have so effectively stifled it; whole countries go into denial; the Finns and the Dutch appear intent upon torpedoing any rescue package whatsoever, avoiding the need to pay other folk's debt, while blithely indifferent to the infinitely greater cost of a European meltdown; the Greeks are being Greek, while the Spanish – having latterly gotten religion – struggle valiantly to avoid a collapse that only a joint European approach can avoid.

It is like watching laughing children happily tossing about a live hand-grenade. This is no way to run a continent!

History Accelerates

Long-time readers will know that T&B is not inclined towards predictions of imminent apocalypse; the end of the world is, almost by definition, an outlier; our general bias is towards gradual rise and decline; tacit Karl Rove, great empires do not in fact "create their own reality" – what they do is to create the illusion of a reality, and this illusion is tenacious, and under ordinary circumstances fades only very slowly.

There are, of course, exceptions – catastrophic events which accelerate the natural processes of rise and decay: the declines of the Austrian, Turkish and Tsarist empires were catalysed – but certainly not caused – by the Sarajevo assassination of an otherwise-superfluous Austrian Archduke. The 1931 failure of

[4] *Across the Atlantic, debt-fueled property speculation occurred in only a couple of "peripheral" countries, but a massive bubble was instead blown by bank financing of government deficit spending – in the wake of the Lehman's collapse, the European situation suddenly went toxic.*

Austria's Creditanstalt was only the culmination of a slow collapse in Austrian finance (itself largely a function of the settlement at Versailles), yet it triggered a catastrophic chain reaction culminating in a wave of bank failures, economic depression, and ultimately war. Twenty years ago, the slow rot within the Soviet Empire suddenly accelerated into a catastrophic implosion no one had seriously envisioned a few years previously.

For the second time in the past five years, we are credibly threatened with the risk of a true discontinuity. **There is no certainty here** – any attempt to calculate the odds of a catastrophe is an exercise in futility. What is clear however is that, given the depletion of G7 Central Bank and governmental resources, the situation is infinitely more dangerous than in 2008, while the irresponsibility and incompetence of European governments seems quite breathtaking.

Again, the outcome is not pre-ordained – the newly-minted Cassandras jostling for a media slot to intone about the "inevitable" catastrophe in the Eurozone are fools – neither they, nor your correspondent, nor you, dear reader, has any certainty as to what the outcome will be. They could conceivably be proved right, but that would constitute a failure of the political process – not the obligate outcome of some law of nature. What we can say with a high degree of conviction is that, broadly speaking, there are two possible outcomes: a rapid acceleration of European integration with a "lost-decade" – i.e. a prolonged gradual deflationary unwind or, yes, an economic catastrophe causing irreparable damage to the West – but not, quite fortunately, to the "World".

The East is Red...

If T&B has had a single major theme over the past 15 years, it has been the secular decline of the West (and of its première power – the United States[5]) as the Asian century gets underway in earnest. While much has been made of the relative ascendency of the emergings vis-à-vis the G7 powers, we think that this is largely a function of the phenomenal growth of Greater China and its Asian appendages; we are somewhat sceptical of the concept of the BRICs as a major economic bloc – the top commodities suppliers, Russia[6] and Brazil (as well as Argentina, Indonesia, etc.) should do well from the rise of China; India and South Africa are outliers.

Whilst the United States is busily seeking to recast itself as a Pacific power, given the overwhelming economic weight of China along the Pacific Rim, they are grasping at straws. *Inter alia*, Chinese tourism is joining Chinese mineral imports as a major plank of the Australian economy, the Philippines is totally dependent upon Chinese agricultural markets, while Taiwan is increasingly integrated with the mainland; the entire economic elites of Thailand and Indonesia are Chinese, and remain deeply loyal to the motherland – for now, only Vietnam, Singapore and Japan are in play. A US carrier group could conceivably defend Taiwan against a Chinese amphibious assault, but certainly not from sudden exclusion from all Chinese markets; reunification is thus only a matter of time. Similarly, China is now the predominant economic power for most of South America – Brazil, Argentina, Venezuela, Ecuador, etc. This leaves only Chile, Colombia and perhaps Peru for the putative Trans-Pacific Pact.

[5] *For the one-hundredth time, we are not, and never have been predicted the disappearance of the US as a unitary state, nor even as a great power; we are speaking solely in terms of relative decline.*
In the past decade, the US has lost two major wars, suffered stagnating incomes, shed a fraction of its middle class, run up an unsustainable deficit, while its political system has become largely dysfunctional due to extreme partisanship. Its soft-power has been substantially eroded; its financial model is under challenge following the carnage of 2008, while the primacy of the US dollar has been artificially prolonged only by the havoc in Europe.
According to that notoriously anti-American institution Goldman Sachs, China will be the world's largest economy early next decade – T&B suspects that, at least in PPP terms, it already may be (certainly, if one accepts the claim that the RMB is massively undervalued, then China is already number one). Neither French nor British global primacy survived long into the 20th Century – yet both countries are still very much with us – indeed, arguably better off devoid of their imperial aspirations.

[6] *As a Russocentric publication T&B can only hope that Russia will avail herself of the opportunity to turn East, catching a ride on the rising powers rather than remaining transfixed by her "European past and cultural identity", a wasting asset in a fast-changing world. While we have been frustrated by their apparent failure to "get it", we are finally seeing signs of a rapid acceleration in Russia's Eastward march. May it continue!*

The Atlantic Alliance – A Great Future (Behind it)

A nasty schadenfreude is manifest in the Anglo-Saxon press, with some American commentators apparently happy to see the Euro crisis distract attention from their equally dire straights. This, of course, misses the point: The West Inc. – at least as we have known it since 1945 – is very much a unitary phenomenon; were any part to crumble, the whole would be severely affected.

While the US was and remains *primus inter pares,* its post-war power base was built upon an Atlantic military alliance held together by the perceived Soviet threat, a set of global financial institutions specifically designed to further US economic interests, the primacy of the dollar in global trade, a unitary political philosophy (the "Washington Consensus") and the complete absence of any credible competitor of adequate size and global reach. All of these factors are now reaching an end:

- Dilution effect: at its peak, the US accounted for ~37% of global GDP; that fraction has now dropped below 25%, and can be expected to further contract as the US sees relative GDP stagnation, while at least some subset of the emergings continues to enjoy rapid growth.
- The fiscal time bomb: The panic about Europe (with a blended debt level of ~4% GDP) has conveniently distracted attention from the US fiscal deficit (>8%). Even ex- unfunded liabilities, the US now has a government debt/GDP nearing 100%, with no credible plan to reduce it. While thus far this has proved remarkably painless, there is legitimate doubt as to how long this can last – Italy had no difficulty borrowing just 12 months ago, France still can…
- Europe: The US is joined at the hip with an old-world in deep crisis. There are several possible outcomes, ranging from the merely depressing to the frankly catastrophic. US commentators will probably become somewhat less smug the day a collapsing European financial system sends Wall Street banking into a death spiral.
  Our one source deep within in the US administration inform us that the Obama team is desperately pushing Europe to do something – anything – to stave off a meltdown until the day after the US November election; typically bereft of any long-term thinking, they the apparently don't consider it their problem after that.
- Alternative Models: The secular rise of China has provided an alternative model – increasingly attractive to other developing countries. At the very least, China's success demonstrates that a mixed state-private economy can work, and that free-markets can be successfully dissociated from Western-style representative political systems.
- Rebalancing the IFIs: A situation in which Belgium has a greater weight in the IMF than does China is simply not sustainable – either the IFIs reform and diversify, or they become an irrelevance.
- The rise of the Yuan: While T&B somewhat overestimated the future role of the Euro, we underestimated the speed with which the RMB would gain global market share as China makes the internationalisation of its currency a major priority. While some commentators have expressed scepticism regarding the feasibility of this shift, these tend to be the same people who, a decade ago (when the Chinese economy was one-third its current size), were equally sceptical about the potential economic growth of the Dragon. For a good review of the currency issue by the WTO, see http://www.wto.org/english/res_e/reser_e/ersd201210_e.pdf
- Imperial overreach: Having failed to attain its stated objectives in both Iraq and Afghanistan, and with neither the appetite nor the financial means for further adventures, the US is obliged to seek alliances in pursuit of "regime change" where it is increasingly being

blocked by the incipient China-Russia axis. With the defeat of Sarkozy, and the weakening of the political right in Southern Europe, as well as a probable shift leftwards in the next German elections, European governance will be decreasingly Atlanticist in outlook.

How to Trade It :

-*Happiness is a warm carry-trade*

Please see our last issue (Notes from China), available on *www.truthandbeauty.ru*, for trading axes.

This month, we have little to add (other than the fact that we would take a punt on the Provincia de Buenos Aires 2015s – a very high-risk trade, but with a 25% YTM, one is well paid to take the risk; this extends to all manner of Argentine assets).

We would still not touch global equities with a barge poll (although Russia is set for a major bounce if Europe does not melt down – that is a largish "*if*"), and we continue to enjoy the generous carry on offer in the Emerging debt markets.

Otherwise, we remain flat/short the Euro, and are hedging against the unsustainable US fiscal montage by swapping the bulk of our exposure into Singapore Dollars and RMB. We are long Rouble-Euro and SGD-Euro. We remain constructive on oil prices. All men live in hope…

T&B

Readers are warmly encouraged to forward T&B to any party who might be interested. Comments should be directed to Eric Kraus, on eric@nikitskycapital.com

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For a taste of Paradise, after the London/Moscow weather…

(In these markets, you never know when you'll need an Ark!)

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It should be assumed that the author and/or the funds he advises will from time to time have long or short positions in any of the assets discussed, or derivatives thereof. These positions may at times be contrary to the views expressed.

Like cats and horses, markets – whether emerging or emerged, are apt to do as they damned well choose, and a considerable measure of luck is required to come out in one piece. Exercise caution in all things. Good Luck!

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