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TRUTH & BEAUTY
[...AND RUSSIAN FINANCE]

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STRATEGY

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The Full Monti

(Readers primarily interested in our views as regards trading financial markets may skip to page 10)

The Full Monti

To my beloved Anna, who sincerely believes T&B to rank among the world's great literary achievements – perhaps, someday, she will actually read one!

T&B has been roused from a vernal torpor by the unaccustomed good news from the European financial markets, now ricocheting across trading screens the world over. Beginning on page 10, we discuss the news from the ECB, and, especially, the implications for our preferred financial assets. This is a trader's issue, though, of course, we begin with a discussion of the increasingly insane Western views on Russia – as personified by the "Feline Civic Disorder" which has so exercised Western hacks.

For first-time readers, we will reassert our fundamental views – at least as regards Russia, the Western press is broadly corrupt, the governments hypocritical, populist, self-interested and frankly obtuse, the Kommentariat ideologically blinkered and obliged to sing for its supper. Unlike in the USSR, the few voices of reason (e.g. Professor Stephen Cohen) do not receive visits from the KGB in the middle of the night – that, at least, provides some motivation; instead, they are simply ignored by the media, while cheap presstitutes such as Albans, Lippman, Gessen and the truly loathsome

Applebaum are given unlimited airtime. It is hardly surprising that the public is systematically misinformed.

The irony of course is that the ultimate result of this gross manipulation has been a truly spectacular own-goal for the West. As T&B has warned for the past decade at least, the rift between Russia and the Atlantic Alliance is widening, leaving Russia faced with a choice between isolation or strategic alliance with China; President Putin has clearly opted for the latter.

China, of course, happens to be the sole global power currently in a position to imperil the fundamental strategic interests of the West. Russia's historic mistrust of the Yellow Peril, as well as her reticence to see China as an equal and an ally, has been gradually eroded by a decade of gratuitous provocation by Washington, London and Brussels, leaving Russia to find allies where she can. From the Chinese standpoint, this is a gift from heaven, helping to shield their one potential Achilles heal – dependency upon imports for a range of resources: energy, grain, ores, and even fresh water. Political alignments ultimately follow from economic interests; how anyone could have thought that this eminently foreseeable outcome would advance the strategic interests of Europe or the US we must leave to the reader's imagination – the logic behind a decade of bear-bating totally escapes us.

The irony, of course, is that Russia has been a fundamentally conservative (at times, outright reactionary) power since the early 19th Century. Although T&B tends to shy away from geographical determinism, we recognize that, devoid of natural boundaries or durable allies, invaded and totally devastated by European armies three times in little more than a century, first Tsarist Russia, then the Soviet Union sought to maintain strategic buffers against the perceived threat of aggression from the West. Indeed, Post-Soviet Russia is the ultimate status-quo state – seeking not to overthrow the existing order, but, rather, to enhance her own stake in it. China, on the other hand – clearly intent upon reassuming her erstwhile central position in a Sinocentric world – is a very different story...

Whether or not Russia's political system pleases the West is irrelevant – she is neither part of the European Union, nor does she aspire to become the 51st American state. Like every other country, Russia has her strategic interests and goals, and will act to further them as best she can; she is neither a defeated nor a penitent power.

Future historians will long ponder the spectacular own-goal scored by Washington-London-Brussels, and the appalling failure of strategic thinking as regards Moscow. Let it displease some of our readers, but the end of the USSR is the story of repeated betrayals of Russia by the West. As pointed out by Professor Stephen Cohen in his seminal Soviet Fates and Lost Alternatives[1] *Gorbachev missed one of the fundamentals of diplomacy –* get it in writing*!*

There was nothing inevitable about the collapse of the USSR – which was neither defeated in war, nor overthrown by internal uprising; it presents the unique case of an empire voting itself out of existence. Russia expected to be rewarded by her erstwhile adversaries for abandoning the Soviet empire and rejoining the West of her own free will; she was, instead, treated like a defeated and penitent power.

With the collapse of the apologetic, compliant Yeltsin government, the West was confronted with a more nationalistic and purposeful regime – while Vladimir Putin was fundamentally neither pro- nor anti-Atlantic, he was naturally wary of the Western powers, and devoted to the furtherance of what he sees as basic Russian interests; while this may prove inconvenient for the West, it was to be expected, and at least some attempt at understanding Russian interests and motives would have led to far better mutual outcomes.

Instead, what we have witnessed, in particular from the Anglo-Americans, has been little more than an expression of national antipathy along with a stubborn, clumsy desire to dominate. The West has no moral high-ground left to occupy – but much more to the point, precious little leverage to use against Russia. Having snatched defeat from the jaws of victory, they should not be surprised to see Russia blocking their foreign policy initiatives, in close collaboration with the new and disruptive rising emerging powers. All in all, an extraordinary failure of Western diplomacy.

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1 *An absolute must-read for anyone interested in the genesis of modern Russia: of how and why of the Soviet collapsed – not due to some historical inevitability, but rather as a result of individual acts and personal interests, of calculations and miscalculations.* http://www.amazon.com/Soviet-Fates-Lost-Alternatives-Stalinism/dp/0231148968

Through Western Eyes – Russia in the Media

Cat on a Hot Tin Roof

Nothing better illustrates the craven hypocrisy of Western coverage than the recent Pμssy Riot[2] (PR) story; while it has received many hundreds of times the coverage it deserved, we cannot quite ignore it, given the indignant yelping of the tame Western media, as well as the truly extraordinary volume of political spin generated.

As an aside (and our personal feelings are here quite irrelevant) T&B feels sorry for them, as we feel sorry for almost anyone confined to a prison – from Bernie Madoff (with his medieval 150-year sentence for simple fraud) to the incarcerated PR provocateurs – but we feel sorry precisely as we would for someone who went looking for a gas-leak with a lighted match… it was not going to end at all well.

As is so often the case, what is interesting is not what it tells us about Russia (it is hardly a revelation that Russia remains a deeply conservative society, where the Church plays a role far greater than in secular Western Europe) but what it tells us about the West.

Whether or not it may please the Western media, there are things one simply does not do in Russia[3]. There are acts that one could probably get away with in Stockholm or Amsterdam, but which would have the direst consequences if performed in Moscow, Beijing, Riyadh or Bogota. The post-modern society of modern-day Scandinavia does not represent a "universal human aspiration" – it is a particular cultural variant, perhaps entirely appropriate to those societies that have adopted it, but it certainly is not viewed as a necessary or even a desirable social evolution by the citizens of numerous other countries. Indeed, Anglo-Saxon Political correctness has become a frankly totalitarian philosophy, arrogating the right to condemn any society that sees the world through a more traditional lens.

In any event, this is a strictly Russian problem – we would strongly suspect that the man in the street in New York or Stockholm would give nary a tinker's damn for what Russians think of his particular social model… if only they could understand that the reciprocal also applies.

Blunder in the Cathedral

To review what actually occurred, five members of *Pμssy* Riot (PR), an offshoot of the anarchist, (pseudo)-punk political collective Voina (headed by Pyotr Verzilov, husband of PR's NedezhdaTolokonnikova) invaded Moscow's Cathedral – Christ the Saviour – wearing baklavas and brightly coloured provocative dresses, rushing to the front of the Cathedral, where they performed an obscene pantomime, kicking up their legs and shouting obscenities while several cameras rolled. No actual song was sung – the "music" was added post-production, with offensive scatological lyrics.

The performers were quickly removed from the cathedral by security, and three identified members were arrested over the following weeks, held in preventative detention for five months, tried for "acts of hooliganism motivated by religious hatred", and while apparently cleared of the "religious hatred" charge, sentenced to two years in a penal colony (a softer version of imprisonment, with the possibility of outside employment and home-leave at weekends) for "hooliganism" as defined in the Russian penal code.

While the Western press has been careful to try to create a "nice, spunky girl-next-door" image for the *Pμssies*, they have carefully avoided reporting upon their previous public acts – which would clearly nauseate the great majority of Western readers: these included filming a group sex with full penetration in a public museum (with one of the participants nine months pregnant) apparently to protest

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2 *(Apologies for the ellipse, but most of the investment banks have intrusive obscenity filters – so far has politically-correct idiocy progressed that when one writes to Bloomberg citing their own coverage of P*ssy Riot, one gets back a "compliance warning" for the use of the p-word… meow!)*

3 *Those of our readers who have followed our twisted path will probably remember that T&B provoked a bit of a* scandale *some years ago by referring to one wayward oligarchic group as a pack of "bandits" – briefly rendering our lives in Moscow far more interesting than is usual for financial strategists. That said, it would never have crossed our minds to publically insult Russian Orthodoxy, much less to stage a provocation in Moscow's cathedral – our taste for provocation stops well short of a death wish.*

the selection of Dmitry Medvedev for President. Subsequently, a member of the group was videoed inserting an entire stolen chicken into that orifice which subsequently gave the "Punk Band" its name, again purportedly as an act of "political protest" (sic); the videos of these performances were proudly posted on the Internet by Voina[4].

What possible relevance any of these pornographic stunts had to the political issues they wished to protest is not self-evident; what they do demonstrate is the total alienation of the authors from the mainstream of Russian society – as well as a degree of cultural/political tone-deafness surpassing anything that we have witness by an already desperately-clumsy Russian opposition.

Neither of the previous stunts received any criminal sanction (despite both being clearly illegal under Russian obscenity statutes) and one comes away with the impression that Voina was left just enough rope to hang themselves – indeed, if prior to the Cathedral stunt the hypothetical question had been posed as to where they could create the greatest possible outrage, along with maximal media coverage, one might have guessed the Christ the Saviour Cathedral[5]. If this was indeed their intention, then they succeeded – apparently beyond their wildest expectations.

Reporters Storm the Cathedral

Anyone not in a coma or immured in a cave will be aware of the media frenzy surrounding Pµssy Riot – ironically, on the same day that they were sentenced to two years in a penal colony, 42 striking miners were shot down in South Africa, while a Texas school teacher – the mother of three young children – was condemned to five years in prison for having had sex with several of her pupils, none of whom were minors at the time. Needless to say, neither of these stories received one-hundredth the media coverage of PR.

The PR story had all the elements necessary for a media circus – three sexually-attractive young females, anti-Putin protests, a post-modern subtext, human interest (two of them were mothers of young children) – all in all, it seemed a wonderful stick with which to bait Putin. Coverage was by necessity highly selective – to have openly discussed their previous antics (see footnotes) would have quickly converted sympathy to disgust, so these were glossed over.

Along with their ugly history, PR was neither a band (they have neither recorded a song nor done a tour; official criteria for membership involve the ability to scream, certainly not to sing), nor punks (punks are quintessentially apolitical). The press was equally parsimonious with other inconvenient truths – Vladimir Putin almost certainly had nothing to do with their prosecution, having learned of it in the press, and that, while initially the Russian populace was fairly indifferent, as public awareness of the details of the case increased, the opinion polls showed an overwhelming majority in favour of truly draconian punishment.

At the climax of the circus, an ex-Beatle and a superannuated rock-star generated some free publicity by calling for the immediate release of PR, while the editorialists apparently launched a competition for the most ludicrously inaccurate portrayal of the whole affaire.

While personally, T&B hoped that the Pµssies would get off with a reprimand and time spent in pre-trial detention, our view was clearly in the minority – opinion polls showed that Russians were overwhelmingly in favour of a tougher sentence, with only a very small minority wishing to see them freed outright. While issues of criminal justice are not decided by opinion polls, neither are they to be influenced by foreign rock-stars and bent journalists.

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[4] *We do NOT recommend opening the enclosed links - certainly not on a full stomach. Nevertheless, for those readers who might doubt our version or who wish to learn more about these (deeply diseased) individuals – Voina has kindly posted links to their previous "artistic-political endeavours" – which we provide for your delectation.*
http://plucer.livejournal.com/281211.html
Video:
http://www.livevideo.com/video/D15EC9A58D104244B16C4135B9010B47/how-to-snatch-a-chicken.aspx
http://blip.tv/file/4649224
http://www.zoopy.com/video/5p9q/how-to-snatch-a-chicken

[5] *The Kremlin itself is far too well protected, as well as representing temporal rather than spiritual power.*

Political Implications: Vladimir Vladimirovich – say "*Thank You, Pμssies!*"

Had the Russian administration deliberately sought for a means to trip up and discredit the political opposition, we very much doubt whether they could have dreamt up anything as devastatingly effective as the PR Cathedral stunt. In fact, the means to discredit the opposition was handed them on a platter…

The collapse of the USSR and the havoc and misery of the 1990s left Russians with precious little confidence in their institutions – to put it mildly, neither the press, the presidency, the courts, the legislative branch, the army nor the police force are universally admired – certainly none of them can compare with the widespread veneration of the Orthodox Church. Whether the reader believes that the modern Russian Church deserves such respect is neither here nor there – Russia has no history of separation of secular and temporal power – no Guelphs versus Ghibellines, certainly no Canosa. Whatever the Yeltsin-era constitution may say, an alignment of Church and State are taken more or less for granted. Russia remains a deeply conservative society, and with the Marxist ideology discredited with the collapse of Soviet Communism, from the 1990s the Church has personified the return to deeply-held Russian values and traditions, as well as a turning away from the internationalist rhetoric of the Soviets towards a more nationalistic, Slavic tradition.

Our old friend Peter Lavelle, RTTV, writes:

Pμssy Riot and Russia's corrupt creative intelligentsia

The Pμssy Riot trial, conviction and sentence has captured the world's attention, though the vast majority of Russians have little or any sympathy for what this so-called punk band did in one of Russia's most revered places of worship. But what Russians think or feel has never been part of Pμssy Riot's (Voina) agenda. Pμssy Riot, their handlers, and a growing number of what is called Russia's "creative intelligentsia" have a very different program – and it has been attempted and failed before in Russian history.

When it comes to politics, the creative intelligentsia has a sad history of failure, arrogance, and irresponsibility. When it comes to winning power, these same people say they are interested in democracy, but they know they cannot win elections – their priorities do not match the interests of the majority of voters. This is where Pμssy Riot comes in.

Because the creative intelligentsia is essentially lazy and basically in contempt of the average Russian, this small minority turns to short cuts, shock and awe, and eventually to the West begging it to "save Russians from themselves" – let's call them "Bolshevik Punks."

This is a program that attempts to negate the current political establishment and convince the world that today's Russia is somehow morally illegitimate. All the while, one poll after another in Russia demonstrates that the creative intelligentsia is out of step with what Russians claim to be their self-identity and the kind of country they wish to live in. Insults and vulgarity can hardly create a better society - appealing to the better parts of our nature and winning hearts and minds can.

Whilst T&B fully agrees with Peter on this, it cannot be a good thing for the Russian urban avant-garde to become as totally alienated from the rest of society as were its 19th century predecessors – a similar rift formed in the US in the 1970s, leading to a long period of reactionary governance and social regression. T&B has repeatedly expressed a hope for further Russian reform, but unlike most self-serving Western commentators, we do not interpret "reform" as the slavish emulation of the West; Russia must reform within her own beliefs and traditions. The self-appointed intellectual elites of Moscow and St. Petersburg will be doing themselves and their country a grave disservice if they forget the traditions and beliefs of the soil in which they were born.

Therefore, from a purely political standpoint, for a renegade pack of Muscovite "alternatives" to attack the Church was an act of political idiocy rarely if ever matched in recent history. PR assured itself the support of that tiny fraction of post-modern Russian society that already hated the Putin administration, while earning the contempt of a substantial majority of the population[6]. To gratuitously antagonise the populace you hope to liberate is insane, and can only suggest that they were so totally cut off from the mainstream of Russian society as to somehow imagine that their performance would discredit the Church, not themselves.

Much more significantly, PR/Voina left the already weak and fragmented opposition in a truly parlous position: having to chose between condemning the Cathedral invasion along with the variously obscene Voina stunts – which would simply antagonize their own desperately narrow electorates – or failing to condemn them, and thus being tarred with the same brush. Mostly they stumbled, issuing weak and contradictory statements, attempting to simultaneously distance themselves from the provocations and from the prosecution. To the Russian everyman, this "wet" response made them look like supporters of sacrilege and sexual depravity – never a good base for the construction of political parties.

PR has succeeded in unifying Russia as no one since Ivan III. Communist Party Chief Gennady Zyuganov has come out with a statement strongly supporting the Orthodox Church. The Russian Jewish Federation supported the government, saying that it would have worked out far worse for them had they tried their stunt in a synagogue[7]. Creating unity in Russia has always been a huge challenge, and they came as close as anyone else, though perhaps not in the direction they had hoped for.

Not surprisingly, a number of our liberal Russian friends and correspondents – many of whom have been highly critical of the Putin government – have recently sent us messages of support or even contrition. For the second time (the first being Russia's repulse of the Georgian attack on South Ossetia) they are confronted with an unambiguous illustration of the dishonesty, hypocrisy and Russophobia of the Western press, the handmaidens of their governments engaged in an age-old geopolitical competition. It is hardly surprising that most Russians ultimately choose to side with the interests of their own country – not with those of its rivals. Welcome home!

Presstitutes of the World Unite – You have Nothing to Lose but your Strings

T&B has repeatedly accused the Western press corps of "corruption" – not in the sense of accepting well-stuffed envelopes (that is simply Russian-style "honest corruption") but rather, for their infinitely more pernicious campaigns to further the financial and political interests of their owners. In a recent e-mail exchange with one journalist, we were admonished that "For the record, we call 'em as we see 'em and sometimes others agree with us and sometimes they don't and we don't care either way. Anyone who can't see that either isn't paying attention or is just focused on the one issue, and a little too smitten with Putin to see beyond it." *- manly, devil-may-care, stuff, but it begs a series of questions, which we posed to him:*

1. In public discussions among intelligent and informed observers, in academic circles, in the blogosphere, or on Eric Kraus' personal Facebook page – one encounters a very wide variety of opinions – ranging from the bitterly critical of Putin and his administration, to the strongly supportive. Why is it then that, with the Western press so free and pluralistic, one encounters such a total homogeneity of views? We would challenge you to cite a single mainstream Western medium that could be characterised as globally favourable to the current Russian administration.

2. During the 1990s, when the Yeltsin administration was clearly beholden to Washington/London/Brussels, and for historical reasons, was compliant and seeking to curry favour with the West, we can both agree that press coverage of Russia – though somewhat diverse and often mildly critical – had an almost systematically-positive slant. As mayors of oil provinces were being gunned down and a generation of pensioners starved, these inconveniences were glossed over as "growing pains". Do you seriously ask us to believe that

[6] *T&B was shocked by the venom this story elicited in the most unlikely quarters; we were slammed by some of our otherwise liberal Russian friends for having expressing the hope that PR would be set free with a fine and a warning. Several urban Muscovites, working in managerial positions in Western firms (and by no means supporters of Vladimir Putin) were outraged by the relatively light sentences, insisting that PR deserved ten years in Siberia – and to Hell with Western opinion.*

[7] *Oddly, one Mufti came out with a somewhat disjointed statement in support of PR, but he is known for his antipathy to the Church.*

now, with Russia governed by a President somewhat less friendly to the West, the shift in press coverage to the almost systematically negative was purely coincidental? Are you trying to sell me a bridge?

3. We both know a wide variety of Russia-watchers, both in Moscow and abroad. Why is it that in your recent papers one finds the likes of professional critics of the Putin administration – Masha Lipmann, Gessen, Nemtsova – but not a single supporter? Are you unable to find any? I think that we both know at least a dozen in common.

4. Finally (and I certainly do not mean for this to become personal, but it is germane to the discussion) do you honestly believe that you are free to express (and especially, to change) your overall opinion and interpretation of the complex Russian reality, and that you could do so without jeopardizing your career? What would happen to a journalist who decided that, whatever his weaknesses, Vladimir Putin had his people out of the desert, and that Russia had improved beyond recognition under his rule? It is one possible viewpoint – even if you don't happen to agree; would he keep his job? For how long?

T&B is still awaiting his answers…

The Eternal Russia

Having attained that Holy Grail of financial market jockeys everywhere – to become an independent fund manager – T&B is no longer compelled to write detailed and quantitative macroeconomic commentary, never our strong suit anyway. The economic releases are far better analysed by others, inter alia VTB's Alexei Zabotkin, a "strategist's strategist" – we have little new to add and thus confine our comments to an overview.

That said, what is striking is that, for a country about which we have been warned of doom, destruction and despair for the past 15 years, Russia is doing really quite well, thank you; seen from 37,000 feet, the Russian economy is a lone spot of dull green amidst the blood-red and dark gray of Western Europe, coming within spitting distance of the "three fives" – 5% unemployment, 5% inflation and 5% growth, to which we would add, almost zero net debt (in fairness, the GDP projections have recently been downgraded to 4%... alas, we are a bit too close to Europe, where import demand is not exactly booming). Social welfare has improving steadily, birth rates are up dramatically, mortality is on a declining path as social stability improves, and the society is clearly undergoing a process of normalisation.

The financial press has been carrying on a campaign of disparagement for the past decade, and the reader will note that most articles purporting to show the parlous state of the Russian economy will cite the weakness of the RTS index – true, but irrelevant. T&B has not been particularly bullish on the RTS since before the 2008 crisis – nor, for that matter on global equities in general. Jon Anderson has demonstrated that, while EM GDP continues to grow far faster than the DM GDP, their margins and ROE have converged almost entirely. There has thus been no fundamental reason for EM equities to outperform.

In fact, we continue to believe that equity index performance tells one a great deal about the dynamics of… the equity market – but precious little about anything else! Readers doubting this somewhat provocative assertion need only look at the Chinese indices; for most of the beginning of the last decade, while Chinese growth was a multiple of the growth anywhere else, its equity index was flat as a pancake – so much so that T&B used to tell clients that the best way to leverage up on Chinese growth was to buy the RTS. That all changed in the second half of the decade, when the index went ballistic, topped out, and then crashed back to almost where it had started. In the meantime, China became either the world's second largest, or its largest economy. Too bad it was so difficult for financial investors to catch a ride.

Russia is no longer either the best or the worst of its class. It has become a middle-growth, middle-European, middle-income economy, primarily driven by domestic consumer growth, and with an early-stage credit cycle and much unsatisfied consumer demand; it has overtaken Portugal. That said, the Russian economy is relatively open, and growth prospects are limited by the recessionary global outlook – Russia will likely outperform her peer group, but is very unlikely to soar alone.

And so, what is there not to like? The Good/Bad/Ugly

T&B is seen as a vehement supporter of Putin and a perennial Russian bull, perhaps blind to the failings of our adopted land. This is a half-truth at best – yes, we firmly believe that the rise of Vladimir Putin was the best thing to have happened to Russia for the past millennium (not, overall a particularly good one – happily, the millennium now just getting underway appears far more promising…), however we are blind neither to his failings, nor to the weaknesses of the system which he has put into place.

-POLITICS

T&B has never subscribed to democratic fundamentalism. Indeed, some of the main weaknesses of the current system may be due to an obsession with at least the outer trappings of Democracy, and thus, the failure to at least pass through a Chinese-style system with continuity provided by a reformed Party, with individuals replaced as necessary, without affecting the continuity of overall policy.

-Our, first, and most obvious, worry is that – despite all appearances to the contrary – Vladimir Putin is mortal; we have no way of knowing who would follow him were he no longer able to govern. There may be a well-thought out plan – or there may not be; it would be interesting to know. We believe that the appointment of Dmitry Medvedev was intended as an experiment to see whether he would make an adequate successor. If so, it was a poor choice – Medvedev had none of the characteristics needed to successfully govern Russia. Perhaps Mr Putin's greatest weakness is his systematic loyalty to a small circle of men he has known for a long time, and who may or may not deserve that trust.

Fortunately, as Russia grows richer and more conservative, with entrenched economic interests for whom continuity is vital, one would assume that a transition of power would be far less traumatic than those of the previous decades, however some well-articulate succession plan would be reassuring.

-With the exception of the Communists (whom are no longer in the competition for the leading role) Russia has no real political parties. While the Chinese Party has substantial internal democracy channelling local and regional input up to the national level, the system in Russia appears obscure and somewhat dysfunctional. Again, Putin has done an extraordinary job of maintaining stability while the economy self-organises, but the weakness of the administration and legislative bodies has resulted in very sub-optimal economic development.

-The reintroduction of regional gubernatorial elections gives some hope for the development of a constructive opposition, with some actual experience in governance; this will be, at best, be a long, slow process.

-Whereas in his first term Vladimir Putin managed to be very much all things to all men, as Russian society develops and diverges, this is no longer possible. Instead, as his popularity increases in the heartland where he has made inroads into the Communist and nationalist electorates, he has lost the cities – in particular, the young, urban elites. Like Western politicians, Putin clearly caters to his own electorate – perhaps reminiscent of Richard Nixon's play for the "Silent Majority" during the long period of the American reaction against the relative liberalism of the 1960s.

While the realignment probably represents a net gain in terms of votes, it does not advance our hoped-for evolution and transformation of Russian society – <u>not</u> in the direction of some imposed Western model, but rather, towards a reformed, specifically Russian variant.

-ECONOMICS

As regards the macroeconomics, we are very sanguine. Macroeconomic management has been excellent. Russia has extremely low debt, declining inflation, and improving social welfare; the politics are quiet, the banking system a net foreign creditor, with confidence in the banks supported by their performance during the Global Crisis. Both the Central Bank and Finance Ministry proved highly competent during periods of financial stress.

-We think the fashionable obsession with "diversification" and high-tech totally misguided – a waste of both time and money. Russia will not become a major producer of mobile phones or fast-moving consumer goods in our lifetimes – it is simply not in the business culture. While there are several poles of technological excellence ripe of development – software, aeronautics, weaponry, etc. the obvious areas for economic growth are agriculture, services, domestic infrastructure and transformation of natural resources. Agriculture should someday outweigh oil.

-The impact of corruption is real but grossly overstated. The corruption surveys measure not corruption but the perception of corruption, and Russians compete to tell wild tales of official misdeeds. If the surveys were remotely credible, then Russia would simply not have the foreign reserves it does. That said, not just administrative corruption but especially, inefficiency and old-fashioned pig-headedness are a major impediment to the development of the sort of network of small and medium enterprises that have been so important in Northern Italy and Germany.

-Russia, the top agricultural importer for most of the 20th century, is now a world-class grain exporter, and, more impressive still, is set to become a net exporter of poultry; a huge animal husbandry project is now underway aimed at reaching self-sufficiency in beef. Given the deep Chinese market at Russia's doorstep, this is an obvious pole for development.

-Turning to the financial markets, while we have seen vast improvements in the management of the banking system, of public and private debt, and of the currency, we remain deeply frustrated by the equity market. There are virtually no truly public companies; most firms are controlled by a majority shareholder or group of shareholders, whose interests are frequently not aligned with those of the minorities, about whom they care very little.

-The main weakness of the banking system is the lack of both domestic liquidity and of capital for further growth – regulatory capital requirements are fairly draconian and we see no risk of a banking crisis, however the sector is almost totally dependent upon the Central Bank for the provision of liquidity.

-Any number of recent stories in the oil, mining, banking and telecommunications sectors have left equity investors feeling randomly exposed to machinations by majority owners about which they are generally the last to know. Furthermore, until recently, dividend flows have been niggardly and share buybacks almost unheard of – that, at least, is now changing, as more companies begin to announce transparent dividend policies and to increase their pay-outs.

-As we have been repeating for the past 15 years, the fundamental weakness of Russian financial markets is the absence of deep pools of long-term domestic liquidity. The pensions reforms have been botched, repeatedly, and we see little or no effort at creation of the sort of domestic, long-term investment capital that could begin to render the Russian market independent of global risk-capital flows. Yes, the fusion of the Micex and the RTS, along with the establishment of a single depository are important and long-overdue steps, but without domestic financial institutions, the market will remain something of a casino.

-As a destination for direct foreign investment, Russia is unmatched. The great majority of foreign companies doing business in Russia are performing extremely well, and most are increasing their investments as Russia continues to outperform its neighbourhood. A new automobile plant is being opened each year in Russia, as they close down elsewhere in Europe. The generally happy outcome of foreign investment in Russia forms a sharp contrast with the very unfortunate experiences of numerous foreign investors in China…

-We remain somewhat sceptical about the benefits of WTO membership – most of the expected benefits are intangibles… we far prefer the tangible kind!

Global Finance – Apocalypse postponed…

In our last issue, T&B remarked upon the sheer unpredictability of the European macroeconomic situation, while expressing the gnawing fear that the European political class had totally failed to comprehend the severity of the brewing debacle, and/or would remain engaged in a game of chicken ending up just past the cliff edge.

Hope dies last, and a series of (for once, well-coordinated) statements by the likes of Merkel, Draghi and Monti over the last few weeks give some reasonable hope that the apocalypse may yet be averted. While the German popular press has embarked upon a shrilly-misguided campaign to discredit the rescue effort, risking a Euro-crisis with disastrous implications for numerous countries – but first of all Germany – the governing coalition has, for once, displayed considerable political courage with both Merkel and Schäuble refusing to give way to the populist hysteria. While we will claim no deep understanding of German politics, we take some comfort in the fact that, were the Merkel Government to fall, it would be replaced by still more pro-European political parties – the Social Democrats and Greens.

A caveat is called for – a number of our peers remain unconvinced and still pessimistic, whilst the Blogosphere is replete with predictions of imminent doom and destruction. **Again, anyone who claims to be able to predict the final outcome with any degree of certainty is either visionary or stoned** – we suspect the latter. The G7 debt crisis is still in its early days, and given recent experience, the European politicians are perfectly capable of screwing it up yet again. Furthermore, even the most deft and risk-tolerant crisis management does nothing to solve the underlying problem – what it does is to allow desperately needed time for a prolonged and painful workout. Under the circumstances, this is the best one could hope for, and we are guardedly optimistic about the medium-term outlook.

Coda – the New Abnormal: The Lord Shall Not be Mocked!

T&B has repeatedly been awed by the ability of the financial/analytical community to collectively ignore what should by now be obvious to every sentient being on the planet: that we are, at best, only half-way through a long period of deleveraging, a consequence of the "rolling bubbles" of the past 25 years.

Perhaps it is due to the majority of commentators having only the long period of steady growth beginning in the 1980s to look back upon, with every sell-off simply an opportunity to buy the dip; or, perhaps it is more a function of the financial interests of their employers, but each week our Bloomberg screens are replete with the lamentations of financial journalists and bank analysts endowed with the attention spans of June-bugs, dismayed that the most recent PMI or GDP numbers from one or other G7 country shows – shock-horror – signs of a slowdown.

For the avoidance of doubt, the developed world is currently in a **deeply recessionary period** – whether or not the technical definition of a "recession" is met is quite irrelevant. While Europe is already crunching, the US remains above water solely by the expedient of running an ~8.5% budget deficit; the day they finally balance the budget, GDP will go negative. *Sorry for proclaiming the obvious but it apparently requires restatement. None of this is rocket science.*

The only real question is whether the emergings can provide enough growth to prevent a global crash. Our relatively bullish stance on China has thus far <u>not</u> been falsified – despite daily scare stories in the press, Chinese industrial output as just been announced at +8.9%, fixed asset investment is up 20.2%, retail sales are up 13.2%, property prices have stabilized, while 2012 GDP is estimated at about 7.5%. Given the absence of any net growth in export orders as the rest of the world contracts, these numbers are quite extraordinary, and **were they to be reported by any other country, commentators would be speaking not of "*hard-vs.-soft landing scenarios*," but rather, of a "*spectacular and totally unprecedented blast-off*".**

That said, given the importance of their export sectors, neither China nor Russia is immune to the global downturn; at best, with deep and liquid domestic consumer markets and room to leverage, they are the sole remaining hope for global growth. Ex-Chinese growth, in 2009 the global economy would have doubtless swung into a catastrophic depression.

It is perhaps a thin reed – of the remaining BRICs, India's problems are now becoming painfully apparent (we have long considered Indian democracy to be a distinctly mixed blessing); Brazil is bouncing off zero growth; as regards South Africa, we never thought it belonged to the group, so its gradual decline is neither a surprise nor of any profound significance – Turkey and Indonesia strike us as far more credible baby-BRICs.

We continue to believe that the coverage of China in the financial press is almost as clueless as its coverage of Russia, again due to gross prejudice. Investors will continue to believe what they read in the FT/The Economist at their own expense – we are delighted for them to do so, as this provides us with an easy target to trade against.

In short, investors would be well advised to discard any illusions; if the 30 years preceding the 2008 crunch taught them to expect V-shaped recoveries, other letters are now more likely – a long line of Ws for instance. Under these circumstances, we would tend to favour value, and, especially, the generation of cash flows to the investor – i.e. high dividends. Our own preferred asset class, emerging fixed income, is likely to continue to outperform quite substantially for as long as base rates remain capped, but economies do not collapse altogether.

It remains our working assumption that markets will enjoy a few more years of ultra-low interest rates, low (if no longer declining) inflation, and very weak growth – an ideal scenario for our leveraged debt plays. On the other hand, we consider that, at some point an inflationary breakout becomes inevitable – and trading strategies must be ready for rapid shifts. We continue to keep our durations short and our currency allocation flexible. Beware! The standard hedging strategy – shorting long duration benchmarks, could be savaged by outright monetary funding of government deficits via bond purchases in the secondary market.

Where could we be wrong? We think the likelihood of global growth surprising to the upside is similar to that of T&B being awarded the Khodorkovsky prize… discard it out of hand. The danger, of course, is of a resurgence in inflation. While our working assumption is that, in the near-term, slow growth and unused capacity will cap price pressures, if we are wrong, the massive monetary creation of recent years will provide more than ample tinder for the conflagration. Furthermore, we cannot exclude the risk of governments consciously opting to inflate away their huge debt loads, which simply cannot be repaid without unacceptable social consequences. Ultimately Japan and the US are most exposed to this risk, with neither one having yet even begun to address their fiscal problems.

How to Trade It –

Lever me up, Scotty!

Whether you are trading pork bellies or Venezuelan bonds, prices across all financial markets have recently been driven primarily by global risk-on/risk-off. The havoc in Europe had scared investors onto the sidelines – with huge piles of undeployed cash awaiting a chance to get itself into trouble. Thus, with any sequential improvement in expectations for the European Debt crisis – from, say: "Imminent Catastrophe of Galactic Proportions" *to merely* "Worried" *leads to a veritable lunge for risk. T&B is fully in the fray.*

The statement by Monti that the EU would do "everything necessary" to save the Euro – subsequently confirmed by Hollande and Merkel – appears to mark something of a turning point. Not that the crisis has been miraculously solved – far from it – but the EU leadership is finally showing at least some signs of a determined, coordinated, and coherent approach. This is greatly to be welcomed.

The key to this shift appears to have been the belated realisation by the German government that the worst damage from a break-up of the Euro would be felt not by Spain or Italy, but by Germany itself. The new Deutsche Mark would revalue by as much as 40%, while demand from their main European export markets would collapse totally, hurling the export-led German economy into a deep depression.

The announcement of unlimited bond purchases by the ECB with the proviso that countries requiring Central Bank support accept a binding austerity programme is the best news that could have been realistically hoped for. Numerous hurdles remain – political, legal, legislative and especially, public opinion in the creditor countries, which has ranged between the merely ignorant, the pompously obtuse, and the partisan-to-the-point-of-jingoism; as per usual, it has been badly misled by the media. Fortunately, in a rare display of political courage, the European leadership has shown some willingness to ignore the noise from the street.

There is still ample scope for negative surprises – from the German constitutional Court, to the Finnish or Dutch electorates, not to mention the brinksmanship of a singularly incompetent Spanish government attempting to delay its inevitable request for a European bailout for as long as possible, in the hope that *something – though they know not what* – obviates the need to submit to a humiliating austerity program. That said, from a markets standpoint, the risk-reward ratio now appears fairly compelling; if one awaits a final resolution of all outstanding issues, he will also have also missed the entire bounce. At worst, markets should enjoy a tradable recovery lasting into the autumn.

Implementation, Dammit! – Trading Strategies

Currencies

We are back to shorting the US dollar against a broad range of currencies and hard assets. Given that the next fiscal crisis is likely to take place in Washington (though timing is a matter of conjecture – the "Fiscal Cliff" could potentially trigger a panic), we are looking to lay off the dollar exposure in the portfolios we manage.

Our primary hedges remain long the Singapore Dollar and the Chinese Yuan, with perhaps a side-bet on the Korean Won; the SGD has strengthened sharply this year against both USD and especially, the Euro; following Monti's announcement, we closed out long SGD/short Euro positions, but remain long the SGD vs. the USD. Meanwhile, after several years of slow, steady appreciation the RMB had come off by about 1% YTD, and is now off about 0.5% - a very modest price to pay for the insurance; we would watch the NDF markets increasing our Chinese exposure whenever the RMB trades at a forward discount. The payoff is likely to be unspectacular and slow in coming, but a long-term strengthening of the currency of the world's strongest economy has an aura of inevitability.

We are deeply distrustful of the fundamental value of the USD, the JPY, and the Euro, in approximately that order. This does not mean that one cannot capture short-term trading profits by being long any of the above, but ultimately we see a continued shift in the global centre of financial gravity benefitting the Asian currency block. For the shorter time-horizon (the only one which anyone really cares about) we would be ready to buy dollars if for any reason the market moves back from greed to fear, while further shorting the USD with any further improvement in the mood.

We are broadly neutral the Rouble, but with a bullish short-term bias. If the global rally in risk assets continues and oil prices hold their current levels, it is likely to move towards the 30 level against the USD, at which point we take profits and go flat. Of course, the RUB remains very high-beta and constitutes an excellent short during periods of risk aversion.

Gold – by no means our favourite metal – has performed very nicely given further US monetization of debt. We would see it more as one component of a hedging strategy for dollar-based portfolios. On the other hand, the gold-mania displayed by some subset of the human race strikes us as wildly irrational; the US Republican Party recently pushed back the frontiers of idiocy by claiming to be seriously considering the reintroduction of the Gold Standard.

The Gold Standard served the world well enough for several hundred years; not that it was absolute proof against inflation – the devastating Great Spanish Inflation followed upon a massive inflow of gold and silver from the New World, but the Gold Standard worked well enough during many centuries of slow and gradual economic growth. Of course, since the Second World War global GDP has gone parabolic, hugely outstripping the supply of physical gold. The main purpose of a currency is transactional, and there may not be enough gold in the galaxy to meet the needs of a modern, globalised economy on this one planet. Furthermore, if physical gold holdings were necessary to back all circulating currencies, it would cost something between $5,000 and $10,000 an ounce, leading to a misallocation of economic resources of truly cosmic proportions as everyman and his dog dug feverishly for what is an ultimately useless (if sometimes lucrative) metal[8].

Fixed Income

Emerging corporate fixed income markets have been glorious of late. Unlike in 2008, during the worst of the most recent risk-off period they held up remarkably well, with money flowing out of equities, seeking yields above the negative real rates of benchmark assets. Much of the selling by prop desks and hedge funds being squeeze by respectively regulators and redemptions was absorbed into private banking, where emerging market debt has suddenly become quite fashionable. Traditionally conservative institutions are now happy to provide leverage against this once slightly disreputable asset class.

The main problem has been a lack of liquidity as some bank proprietary desks have been wound down, with risk limits slashed at the others. The street banks are now behaving like brokers – with no inventory, and no desire to be caught short; their screen bids and offers are often as not totally fictitious, rendering price discovery exceedingly difficult with dealing spreads at occasionally grotesque levels. As a counter-example, we should cite our friends at VTB, who have been showing tight markets in good sizes across the range of second-tier Russian debt assets, while refraining from playing the silly games indulged in by some of their local competitors.

-Provincia de Buenos Aires – Don't Laugh at me, Argentina…

In our last issue, after watching the market get the Argentina story comically wrong, T&B finally bit the bullet, putting out a buy recommendation on Provincia de Buenos Aires 2015, then yielding an absurdly generous 25% YTM – totally unjustified by the actual default risk. In the event, the bonds are up a good 15-20 points in the past two months (we finally issued on 17 July, at which time Provincia BA 2015 traded @ 72, up from 66; as we go to press, it is trading @ 88).The Provincia BA 2018s and 21s have moved somewhat less and are likely to close the gap, with a good ten points of upside still in them.

This trade was instructive. Perhaps the simplest and most successful trading strategy has been to carefully monitor the financial press – Bloomberg and the FT – then, when they become particularly shrill about any given country, especially when that country is accused of deviating from the liberal orthodoxy, seriously consider the purchase of its debt assets. For the past 10 years at least, this strategy has worked remarkably well.

Of course, Argentina does have a series of serious economic problems – with a very heterodox approach to their management. It is an open secret that the government understates inflation by about 60% (9.9% vs. an estimated real 25%), the currency is badly overvalued (though the Peso is now being allowed to slip in line with real inflation), the official exchange rate is a fiction, feeding a busy black market, and a long list of restrictive measures have been instituted to try to stop capital flight (to date, with considerable success.) Since the 2002 default, the government has been excluded from international capital markets, and has been obliged to pay down maturing debt with CB reserves.

That said, since the default Argentina has enjoyed spectacular (if very uneven) GDP growth – by far the highest in Latin America. Agricultural production is world-class, well managed, and yields a substantial current account surplus. The all-important relationship with China is developing in the background, as the Dragon scours the planet for food supplies. Debt is being steadily paid down, and there is little doubt regarding the willingness to pay. Given Argentina's history, the inability to borrow abroad may be counted a blessing in disguise.

As discussed in our previous issue, the real catalyst for the sell off in the bonds was the nationalisation of Argentina's largest oil

[8] *An alternative explanation is that gold bugs imagine that they shall be able to draw upon their stash of the yellow metal in the afterlife – T&B sees no evidence that they are correct.*

company YPF, which was taken from Spain's Repsol. The Spanish oil major had been running YPF as a cash cow, failing to reinvest its bounteous profits except to service debt on a very suspicious vendor-financed holding structure. Scarce capex led to a precipitous decline in output, turning Argentina into a net energy importer. Under new management, a series of international deals have been signed, and there has been a rapid increase in planned investment.

Whether or not one happens to agree with Kirchner's way of doing business, from the bondholders' standpoint, selling down Argentina exposure due to a redirection of the bounteous YPF cashflows to the sovereign was insane. Argentina's medium-term credit outlook was clearly enhanced by the takeover; threats to sue in international courts will have their usual outcomes, and several international oil majors, not least the American Conoco, are now elbowing their way in to drill YPF's Vaca Muerta field. Accessible oil-provinces are currently few and far between…

Finally, Provincia de Buenos Aires is trading at a substantial discount to the sovereign. Again we think this discount unjustified. While there is clearly bad blood between Macris, the governor of BA and the Kirchner administration, which has attempted to tighten the strings on the province for political gain, we simply do not believe that the federal government could allow Argentina's capital province to go bankrupt without totally disrupting the national economy; the only scenario in which we see BA going to the wall would be in the event of a renewed sovereign default – not likely for the foreseeable future, three to four years at the least.

In short, there are no bad assets – only bad prices, and while the Buenos Aires province is obviously a risk-trade, we think that the bond pricing greatly exaggerates the likelihood of default. While the 2015s have tightened dramatically (YTM now ~13%), the 2018s are still paying almost 19%.

Meanwhile, back at the Ranch…

*More broadly, the BA trade provides an excellent illustration of the logic behind our "Axis of Evil" trading strategy. As one of our readers recently pointed out to us, "*the participants in financial markets make lemmings look like rugged individualists"*; we would add that they (traders, not lemmings) have a systematic right-wing bias.*

Therefore, countries which align themselves with the interests and policies of Washington/London tend to be rewarded with far tighter spreads for a given degree of underlying risk than those less friendly to the Atlantic Alliance; the latter frequently offer substantially higher yields for the actual default risk. The agencies are also not neutral – whether this is just another example of the egregious corruption displayed during the CDO bubble, or much more likely, simply a function of ideological bias, countries espousing policies unfriendly to the West are likely to be lower rated than their pro-Western peers.

***We are only in it for the money** – Regardless of any personal politics, we would tend to sell assets of those countries trading rich to their fundamentals, while buying those trading cheap absent fundamental justification – in general, the Axis of Evil. Over the past year, we have enjoyed fairly spectacular returns on Venezuela, Belarus, Argentina and serviced Cuba (alas, there are no traded instruments in Iran). On the other hand, investors buying similar duration Mexican or Colombian instruments have missed the party; those investing in Iraqi bonds are still underwater.*

-PdVSA – St. Hugo, Ora per Noi

T&B has been very bullish on PdVSA since 2009. While the company is badly run, it also happens to be sitting atop the largest hydrocarbon reserves on the planet; whilst relations with Washington are execrable, China has become Venezuela's top trading partner and financier, and is providing huge credit lines to fund both the development of hydrocarbon reserves, as well as social projects benefiting the local population. Since 2009, bond prices have more than doubled.

Politics have been a key driver, although not as generally reported. A few months ago, Bloomberg was attributing the strength in PdVSA bonds to the expectation that Chavez' illness would prevented him from returning to the presidency. Several months later, he is apparently quite fit, and enjoys an unassailable lead in the polls yet the bonds are trading at their highest level of the past five years. In fact, a return of Chavez to the presidency would signal continuity and stability – exactly what bond investors need.

We continue to like PdVSA, however as they tighten towards the 10% YTM level we would be taking some profits; at >18% YTM they were a no-brainer; at 10% they are fairly priced; in the middle-high single digits (8%) we would be out, awaiting the next go-round.

-Better Weather for Wind

WindIM has finally begun to surge. A complex asset, it is the very high-yielding holding structure for Wind, the third-ranked Italian mobile phone carrier, itself controlled by Alfa Group/Vimpelcom. While the structure of these instruments is too intricate to be fully analysed here, despite very high levels of leverage and the lack of any guarantee from VIP, there is a substantial likelihood that they will be called and Wind debt refinanced far cheaper by the Russian parent, contingent upon some sort of peace deal between Alfa and Telenor (given Mr Fridman's track record with his foreign Russia, we would bet on the oligarch taking this round).

To some extent they are orphaned assets (the emerging market debt funds don't own it because it is situated in Italy – the European high-yield funds think it's Russian…) and were pricing more as derivatives of European default and equity risk than for their own fundamentals. While they have strengthened substantially in recent weeks, we think them still cheap to the real default risk.

*We would here insert a health warning – Wind bears substantial risk, especially the PIK notes, and could ultimately be worth a great deal more than current prices – **or nothing at all**. Readers should study the available research and form their own conclusions.*

-Kazakh Banks – and let the Fundamentals be Damned…

T&B will be travelling to Kazakhstan later this month as guests of Almaty's première broker – Visor Capital, in order to meet with the local banks. We have been recommending Kazakh bank exposure (KKB, ATF and BCCRD) since 2009, thus far with very gratifying results. A note of caution is called for – bank accountancy is a dark art, and Kazakh accounts tend to cover up the fact that, taking into account not just reported NPLs, but also accrued, unpaid interest, all of the major banks are essentially bankrupt [9]. Counter-intuitively, this is not necessarily a reason not to buy – much depends upon considerations of sovereign policy and political stability.

Our working assumption has been that the Kazakh government chose to let three banks go to the wall during the recent crisis, while intending to support the others, in particular KKB, which has enjoyed repeated rounds of support via subsidized government lending programs.

As regards the matter of the accrued interest item, we are informed that there is no date by which these real losses must be recognized – our suspicion is that the banks shall remain zombies, wandering across the steppes for many years to come. While we would not touch the equity with a barge pole, the debt seems interesting, in particular the perpetual subs – callable with a coupon reset in 2015 or 2016, combining high cash flows with very limited duration risk (the new coupon will be reset with a large premium to 3/6-month UST rates, three or four years down the road). *Once again, caveat emptor.*

-Ukraine – Better than Expected

In fairness to our friend Konstantin Kucherenko of Dragon Capital, Ukraine's top local brokerage (and our main Ukrainian counterparty) we may have been a trifle too pessimistic about Ukraine.

Readers may remember our assumptions: 1. Ukraine is clearly on an unsustainable fiscal path, 2. Therefore, some form of external support is vital, and 3. The only options are: a) Russia – but that would require signing up for the Eurasian Union (our preferred option); b) Europe – which would require submitting to the political mandates of Brussels, in particular as regards Mrs Tymoshenko; or c) the IMF – requiring a six-fold increase in gas prices to households, not exactly a vote-winner for Yanukovich. Instead, Ukraine appeared to be playing for time – despite the fact that time was clearly working against them;our discussions with the Central Bank and the FinMin were not at all reassuring.

In fact, there was one option which we had missed (in fairness, it did not appear to be on the table even six months ago) – China. The

[9] *Halyk bank excepted – and perhaps ATF given the credit guarantees provided by its parent, Unicredito.*

Chinese are hungry for agricultural resources and happy to build relationships with countries richly endowed in export capacity, especially those out of favour with the West – most of Africa, Belarus, Venezuela… and now, Ukraine.

China has opened some largish lines of credit, in particular for development of favoured industries such as energy and agriculture. Given that China Inc. has more dollars than it know what to do with, they are happy to pay up front, and it would appear that Ukrainian Forex reserves are being replenished – holding stable at around $30bn, despite the need for continued CB support of the currency.

With yields tipping below 8%, we would give the sovereigns a wide berth. Our favourite trades would be subsovereigns or selected corporates (if one is going to take the macro risk, one might as well enjoy the yield pick up.) Now that our old favourite, Alfa Ukraine has redeemed at par (immediately after which Alfa wound down its Ukrainian banking business), we are left with City of Kiev, badly mismanaged but the capital city nonetheless, Metinvest (which as a stand-alone would be rated triple-B, ex-sovereign default risk), DTEK, and the banks. As regards the latter, we would be cautious – there is still a serious risk of Hyvrina devaluation following the elections, in which call all of the banks would all take a hit. Risk-tolerant investors may wish to look at Privatbank, still yielding in the low double-digits – a somewhat dodgy institution, it is Ukraine's largest bank and thus clearly TBTF[10]; but. As regards the state-controlled Ukreximbank and FUIB, they provide a modest yield pickup; *some of our UK friends have done very well indeed on the agricultural bonds – MHP and Avangard; alas, T&B struggles to buy assets secured with chickens…*

-Russian Banks – Safe and boring

Finally, this would not be T&B talking bonds were we not to mention our favourite "free-money" carry trades – the second-tier Russian bank bonds, both senior and especially, subordinated.

The list of eligible assets has been somewhat widened with the new issuance – notably RUSB 2017 and Promsvyaz 2017, considerably more liquid than our old favourites - PROMBK and RUSB 15s/16s; we continue to like the Nomos 2019, despite the somewhat murky buyout of Nomos now being engineered by Otkritie, apparently with blessings from on high (*very high*…). This takeover is obscure even by Russian standards – no one we speak with even claims to fully understand the true story; both VTB and the Deposit Insurance Agency have been looking to sell their stake in Otkritie, thus far without any success – yet Otkritie is now planning to buy an institution far larger than itself, with a huge line of credit from VTB itself. Our working assumption is that someone with very deep pockets is looking to own what will become Russia's second largest non-state bank (after Alfa).

Russian bank supervision is becoming increasingly rigorous, with the banks far less complex and exposed to G7 debt problems than are their European/American counterparts; as it stands, Nomos is an excellent credit – the fact that the combined entity will be systematically (very) important may mean that the deal will ultimately be seen as a credit-enhancement, rendering the 10% coupon quite compelling. The bond market appears to agree, with Nomos 19s trading up towards 101 this morning.

Note that we do not expect to see any spectacular spread compression in second-tier bank bonds – prices of which remained remarkably stable during the summer market weakness and have thus moved little during the recent risk-on rally; they are the ideal carry trade – leverage, if available, can be applied quite liberally given their low volatility.

-Duration – Keeping it Short (if not always Sweet…)

T&B has been cautioning about keeping portfolio durations short for the past six months – we were perhaps "right too early" (just another way of saying "*wrong*"). As Treasury spreads hit their tightest levels of the past 250 years (yes, for the UK numbers go back that far) all economic rationality was thrown to the wind, and we missed the last round of tightening as sovereign rates plunged literally through the zero bound.

[10] *We have been confidentially informed that its loan book is reminiscent of Night of the Living Dead – but who worries? Just another example of the moral hazard trade in action!*

The underlying rationality will ultimately make itself felt. No sentient being lends money to the US Treasury for 30 years for 2.8%...this applies doubly to Colombia or Mexico. At some point – we do not know precisely when – despite successive rounds of monetization the long-dated assets will give back at least some of their recent gains, possibly in a spectacular fashion: we are licking our bearish claws in anticipation. With long-duration Colombia trading very close to UST, we can think of a couple of good shorts…

-Commodities

T&B can claim little expertise in commodities, however we have been successfully arguing against the bearish consensus on oil since 1998, and are beginning to acquire some confidence in our own abilities to at least recognize the obvious (apparently, not a widely shared gift) Asian growth is slowing, but it is slowing off of higher absolute levels, and the actual call on physical commodities is continuing to grow.

Although the Peak Oil theory is currently out of fashion, the new reserves being found are increasingly expensive to exploit, with lifting costs for the newest projects running to $50-$80 per barrel, not counting the huge Capex. Furthermore, the bearish consensus by oil company analysts has actually been a major factor driving the rise in oil prices; low predicted forward prices have meant that numerous projects were mothballed as being uneconomic given the high hurdle rate.

In view of the parlous global economic situation, we would rejoin the consensus in avoiding industrial metals (we did not say "go short' – just be cautious), would buy gold/silver, and especially, would remain long oil – if only via an "oily" portfolio, i.e. companies and countries heavily leveraged to the oil price.

As regards the commodity complex in general, our level of confidence is here somewhat limited – while it is currently quite fashionable to be a commodities bear, much of this is based upon comically misguided views on China, and as noted by our friend Jon Anderson in Beijing, the bearish commodities trade may already have its best days behind it.

In our own view, the "super-cycle" is still very much alive.

-Equities

While in the current global context we remain more partial to fixed income than to equities in view of the continued deleveraging and the resultant deceleration in economic activity and margins, there will be the occasional tradable countertrend rallies – one of which we are currently enjoying.

We would put a premium on liquidity, and would trade with a short time exposure, positioning via indices/ETFs, *inter alia* in Chinese A shares, HK H shares, but also, selected Russian equities. On our home market, we reiterate our preference for the oil Prefs: Tatneft, Banep, TNBPP and Surgut – in approximately that order. Going forward, we expect a fundamental shift in the way equities are valued, i.e. not for cash flows to the company, but rather, cash flows to the investor. With some of the Prefs expected to pay upwards 15%, one can hold them for yield, simply ignoring the price action.

Our old friend Marc Faber announced to us two months ago that he was buying a range of beaten-down European blue chip equities; while, at the time, the words "suicide note" came to mind, as usual, he was proved right, and must be up about 25% on his portfolio. Alas, we think it a little late to rush in on this trade, though some further upside can be expected. On the other hand, we will stay clear of positioning in the US market, given the fiscal havoc to come.

In summary, T&B sees a tradable countertrend rally, and intends to participate, while keeping a wary eye on the door. The crisis that began in 2008 is – at best – only half done, and it should be a priority to survive the remainder of the bad years, so as to be able to enjoy the next bull-phase – surely to occur sometime during the coming century or two. Patience is a great virtue, we are told. We hope to attain it – preferably RIGHT NOW!

Happy dodging the slings and arrows…

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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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!