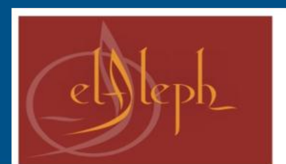
www.elalephcruising.com

TRUTH & BEAUTY
[...AND RUSSIAN FINANCE]



ERIC KRAUS & ALEXANDER TEDDY
eric@nikitskycapital.com

STRATEGY

5 APRIL 2013

A Hard Rain ('s a-Gonna Fall)

T&B – Hypothetical Prophets… 1
Global Markets and Mayhem 3
Another Day in the Death of the Euro 3
Enter the Politicians 5
Le Plat du Jour 6
Then Don't Start from Here! 6
Life after Debt? 7
Another Day in the Death of Cyprus 8
The Eternal Russia 11
Can She Dance – Part II 11
The Great Russia Discount 12
Is Russia Investible? 13
TNK-BP 14
How to Trade It 15

T&B – Hypothetical Prophets…

For Joanna, Hans-Joerg, and Marc – without whose constant nagging T&B would still be procrastinating and this note would still be hypothetical…

Regular readers will note that it has been a long time since T&B put fingers to the keyboard.

Being a prophet is a thankless task – get it wrong (e.g. the Greek default) and no one ever forgets; get it right (the outperformance of Russian fixed income, the secular rise of China, Russia's sovereign creditworthiness, the Moscow-Beijing Axis) and pretty soon you are spouting utter banalities (which, oddly enough, seemed wildly controversial just a few years previously).

Indeed, some of our themes had grown a bit stale. Anyone still trusting what they read on Russia in the deeply corrupt Western press is so totally immune to the lessons of experience that we cannot possibly hope to help – after 15 years of getting it spectacularly wrong, the papers still regularly predict an imminent Russian meltdown/political crisis. Anyone investing on the basis of what they read in the Financial Times/Economist/WSJ has only himself to blame. When you pick up your morning paper, try to remind yourself that what you are getting is largely manipulation/PR spin, and try to ask yourself not "is what they are telling me true?" but rather "Why are they telling me this? – where is the spin coming from, and how can I use this insight?"

More generally, the Russian state – rightfully – no longer gives much of a damn what London, Berlin or Washington thinks – the latter have been bluntly invited to mind their own business, and their ability to influence the Russian political process via their tame NGOs and think tanks is being sharply curtailed. While Russia's increasingly unreserved alignment with China – predicted here for a decade at least, has not yet acquired the status of a banality, it is quickly getting there.

Yet, there have been some major shifts in our views – we have gone Eurosceptic in the wake of the appallingly mismanaged Cyprus bail-in, as well as having become increasingly wary of the Russian equity market in view of the most recent corporate abuse. We remain long-term bullish on Russia, but are increasingly cognizant of the need for Russia to move to a new model – the low-hanging fruit has been picked. A substantial and sustained rise in investment is required to maintain growth – and that requires further reform.

Finally, we now expect the ultimate break-up of the Euro (absent a substantial change in the European political model). Note the world "ultimate" – i.e. this is NOT a trading call, and we are certainly not dumping risk assets in the expectation of a near-term Euroquake – such an event is by its very nature unpredictable – neither we nor anyone else we know had expected Cyprus to have the impact it did… but portfolio structures must take into account the event risk, and we would shy away from Euro assets.

Weather Report – Stormy

T&B can only reiterate our deep pessimism as regards the growth prospects for the G7 economies, including the United States – while, as per usual, the financial media are little more than a cheering section for equity brokers looking to entrap the small-fry, we have never believed in the Great Rotation, and see no reason to change our views now. Yes, we missed the recent 10% YTD move in the S&P, but taken in context, we would note that it has just regained its 2008 peak in nominal terms, i.e. by owning it, assuming a real inflation rate of 5%, an investor has lost – conservatively – 15% in purchasing power after dividends (or, priced in gold, as our friend Marc Faber would suggest, he has lost about 50%...). Yes, the continual wave of money printed must go somewhere, but global equities are not our preferred locus for the next bubble; fiscal drag is increasing, while employment and industrial production continue to disappoint – we would watch instead for incipient bubbles in real assets.

Our trading calls have been mostly felicitous – we remain massively overweight selected Emerging Markets corporate bonds – with no equities except for a sizable long on the Nikkei index. We gave up on the Russian equity markets some time back – for reasons of corporate governance (or the absence thereof) as discussed below in the context of TNK-BP. In currencies, we remain uber-long Chinese RMB and (*faute de mieux*) the USD, short GBP, short Yen (perhaps getting a bit long in the tooth?), and flat/short the Euro. We are possibly the only global strategist with no view on gold. We remain reasonably bullish on global risk-on/risk-off, but would invite readers to hedge or to trim leverage given the number of black swans circling overhead.

Global Markets and Mayhem

Another Day in the Death of the Euro

"When my information changes, I alter my conclusions... what do you do, sir?"

John Maynard Keynes

T&B was an early believer in the Euro, accepting the consensus view that it would allow a unification of Europe, as well as restricting the "outrageous privilege" of American money printing and the attendant economic instability arising from their (totally understandable) tendency to set monetary policy solely as a function of their domestic priorities. It is probable that the fathers of the Euro assumed that currency union would lead to an inexorable integration of Europe, rending impossible the internecine wars which have harrowed the continent since the decline of Rome. Unfortunately, what we missed is that, as in the case of "global culture" – which has largely meant an Americanisation and homogenisation of media, with the gradual strangulation of regional specificities – "European integration" has come to mean forced Germanification, with increasingly dire consequences for the Southern countries. **We are now abandoning our previously reiterated belief in the sustainability of the Euro and shifting to a bearish positioning on the Eurozone – not because of any fundamental economic imperatives, but due to the politics.**

T&B has long argued against the Eurosceptics' claim that the common currency somehow contradicts the fundamental laws of nature and is thus unsustainable – we continue to reject this view. Karl Popper did a creditable job of demolishing historicism (the notion that history has some teleological purpose in mind, and that it is merely the unfolding of a preordained template) and, in economic thought as elsewhere, uncertainty now reigns supreme. Unfortunately, during the decade following the introduction of the single currency nothing substantial was done to force meaningful fiscal/economic integration, leading to growing imbalances, along with debt-loads which have indeed become totally unsustainable within the existing political framework.

What the Greek default and its aftershock, the rape of Cyprus, brought home to us was that the Euro-crisis cannot be resolved within the framework of representative democracy in nation states (a political dogma in which T&B has precious little faith – but that is beside the point). Given the fact that the EU is not likely to transfer popular sovereignty to a council of Wise Men, nor even the German press to accept the complex reality that Germany has been the major beneficiary of the Euro, and should thus expect to write a very substantial cheque as the bill comes due, the common currency is effectively doomed. Timing is very much a matter of conjecture, and we expect the powers-that-be to do everything possible (except for what is actually required) to forestall a disorderly collapse.

Toward Sarajevo

One of the many ironies of the Euro crisis is that a monetary system intended to unify Europe, freeing it at last from the daemons of the past, is instead engendering a profound hostility between North and South. The increasingly nationalistic and jingoistic German popular press (calling it "gutter press" is being unfair to public amenities) inveighs against the lazy, feckless Spaniards and Italians lying about in the sun living off the hard earned savings of Protestant burghers, while in Italy or Spain it is no longer considered bad form to refer to Merkel and Schäuble as "Nazis" (somewhat stronger language is heard in Greece and Cyprus, where a couple of well-chosen adjectives are frequently added). Were two world wars not sufficient?

Needless to say, no one is without fault – which is essentially to say that there is no one to blame. The German press conveniently ignores the fact that Germany was the greatest single beneficiary of the Euro – which allowed it to further perfect its export machine, selling huge quantities of goods into its Southern neighbours, whom for their part benefitted from an oversupply of excellent German automobiles – on credit.

Southern Europe, finding itself magically freed from several centuries of poverty (and of that lingering sense of inferiority vis-à-vis the North),

responded to the sudden availability of credit at German rates in the same fashion as would any rational man – going on a massive shopping/construction spree, while spreading the "wealth" to the lower classes by a generous incomes policy. With the wisdom of hindsight we can affirm that the process of integration was implemented backwards – it would have first been necessary to implement fiscal and banking union, only then to implement monetary union. Next time they'll know better…

Down and Out – In Madrid and Lombardia

T&B has been on the road in Southern Europe. We find nothing remotely encouraging to say – this year, not even the weather was significantly better than Moscow – and the employment situation far, far worse. If the situation were not so grim, there would be something funny about the governments of a continent in deep recession (or depression, in its South/Western corner) lecturing Russia – with its slow-but-positive growth and 5% unemployment – about the virtues of a liberal economic policy.

Perhaps surprisingly, nowhere in Europe is the popular mood one of rebellion or of any longing for a violent overthrow of the existing order – there is no Marxist revolution anywhere on the horizon[1]; rather, one senses a quiet despair, escapism and cynical pessimism. Unemployment is endemic and systematic, in Spain and Portugal the unemployed do not even hope to find a job. People find ways to cope – the welfare state, the informal economy and family structures provide some support – but in terms of building a career, family and future, the prospects are grim.

One is seeing a situation of "internal default" which would be eerily familiar to long-time Russia jockeys. In Italy, the State is in arrears to enterprises to the tune of some 80bn Euros; with everyone starved of credit, some 1000 small companies go out of business each day, while a substantial proportion of the remainder are zombified, living from day to day, while wage arrears of three months or more have been reported. This month, the company running the Roman peripheral bus system has paid its workers only a small fraction of their salaries – after the municipality omitted to pay them. Companies in the North are reportedly resorting to barter. The situation is familiar to anyone who lived through the 1997 run-up to the Russian default. Spanish accounts payable are an amazing 5% of GDP – Italy is close. The system is starved of liquidity, what money there is does not circulate; companies are run for cash, investment stops, the State becomes insolvent, and non-cash equivalents are increasingly employed.

Of course, unlike Russia of the time, Italy still has a functional social safety net and tax system, while the degree of social misery, although serious, is in no way comparable with that of Yeltsin-era Russia. An entire generation is being sacrificed – the most energetic will emigrate, the remainder will sink into an embittered and impoverished middle age. Were such sacrifices to be compensated for by some reciprocal gain for the countries in question, it could be argued that they were painful but inevitable. Alas, we see no signs of improvement – only further decay and ever-increasing debt loads. It seems obvious that at some point something else must be tried.

Given the imperatives of monetary union and the North-South political divide, *in extremis* that "something else" can only be one of two things – either rapid inflation to reduce the debt load, or an exit from the Euro followed by some sort of sovereign debt restructuring, as well as a major hit to the banks. We note in passing that Italy, with a small primary budget surplus, but 2trn Euros in sovereign debt, is far better able to exit than would be the primary-deficit countries – Greece and Spain, which are dependent upon financial inflows to maintain a functioning state. We have no predictions as regards the timing – and expect a series of minor crises before something finally gives way, but we see no reason to be particularly optimistic on the ultimate outcome.

The Decline of the West – Hedonistic Adjustments

The problems of the Euro cannot be viewed in isolation, and should instead be seen within the wider context of the crisis of the West. While classical economics teaches us win-win equilibria in which all parties benefit from economic development in the poorer regions, common sense teaches us to distrust such

[1] *Perhaps the exception would be Greece – where we have not recently been. For historical reasons, in Greece orthodox Marxism has not been discredited as elsewhere on the continent.*

Panglossian story-telling, especially when the conclusions are particularly comfortable for the powers-that-be. While economic development is indeed not a zero-sum game, there is a strong element of competition for resources and markets.

The secular rise of China has constituted a distinctly mixed blessing for the West. At the onset, the spectacular development of the world's largest country was highly disinflationary, flooding the West with cheap manufactured goods and encouraging popular consumption. On the other hand, it spelled the gradual demise of the industrial middle-classes – unionized, skilled workers enjoying a secure and comfortable standard of living. Furthermore, as China became not just a source of cheap exports but also a major consumer itself (the reader will note that Chinese industrial wages have increased as much as ten-fold over the past two decades) there has been increasing competition for commodities[2]. Meanwhile, offshoring of services and computerisation resulted in a further widening of the income gap, with serious damage to the social fabric.

Enter the Politicians –

Of course we know what needs to be done to save the Euro… what we do not know is how to do it and then get re-elected!

Herman Van Rompuy

Dysfunctional political systems adapt to new sources of stress in a maladaptive fashion – thus, the West, Inc. largely failed to take measures to accommodate the rise of Asia. Rather than redistributing the damage as equitably as possible, everywhere consumption and lifestyles were supported by a build-up of debt – the famed "rolling bubbles" of the two decades terminating in 2008.

One of the extraordinary things about US society is the ability to believe in a commonly shared mythology. While most Europeans are aware of the gradual decline in the wealth of their countries, many Americans we encounter remain convinced that the U.S. remains an upper-middle class society of increasing affluence. This is of course not supported by the data – official US statistics (US Census Bureau) show median income (in real terms) to have **declined** by approximately 10% since 1999. In fact, the real situation is substantially worse, given that no one takes the official inflation numbers at face value. With a conservative but realistic inflation number – say an average 5% per annum (i.e. discounting the convenient but fraudulent chaining and hedonic adjustments) average incomes have declined by about one-third. One would assume a similar phenomenon was operant in Europe, although distribution has been more egalitarian.

With a few noteworthy exceptions, the general rule in democratic systems is that those whose profession involves getting re-elected on a regular basis will prefer to choose short-term solutions minimising any immediate pain. Schematically, both the US and the EU embarked on a two-decade debt binge – in the US, the loss of income was masked by a real-estate credit bubble, which allowed consumption to far exceed production, while in Europe, a more redistributive system involved bank finance of social spending to preserve and enhance popular consumption. The music, of course, stopped in 2008 when the collapse of the US real-estate finance bubble triggered a general unwind of global leverage.

A Short History of Time

Much of what has been written about the Euro (and well-nigh everything to be found in the popular press) tends towards a vapidly moralistic view on what are, in fact, essentially mechanistic phenomena. The problem is neither with the "domineering, scheming Germans", nor with the "feckless, lazy Southern Europeans" as portrayed in Bild and similar furuncles on the face of journalism. The German leadership doubtlessly believed that European integration would mark a decisive break with Germany's tragic history, while there was a real desire to modernize in the PIIGS, at least as regards Ireland, Italy and in Spain. Of course, from the Germany standpoint it was also convenient that the Euro eliminated a recurrent problem which had plagued it for decades – Germany would tighten its belt and become increasingly efficient, ultimately attaining a sizeable commercial surplus with Southern Europe, only to have the latter devalue every five years or so, resetting the clock and forcing the Germans to embark upon yet another round of

[2] *We have long argued that the role of the oil price spike to $153 in triggering the 2008 US financial crisis has been greatly underestimated.*

© Eric Kraus
eric@nikitskycapital.com

belt-tightening. Of course, from the standpoint of the Southern European countries, there was a compensatory advantage to a strong currency – the experience of repeated devaluations and higher rates of inflation had meant that investors would lend only at rates compensating for the erosion in the value of the currency plus a risk premium; both consumption and economic activity were thus seriously constrained by the high cost of capital.

The problem became one of perverse incentives and the failure of the political systems. The previously capital-constrained Southern European countries discovered the wonders of cheap credit, leading to housing bubbles of colossal scale in Ireland and Spain, while painful and unpopular reforms were eschewed everywhere, further reinforcing the welfare state and clientelist political system favouring entrenched interests – labour unions, closed professions, civil servants, the top banks, etc. When the European states found themselves obliged to provide massive liquidity to support their economies and banking systems in the wake of the subprime crisis, debt loads soared well beyond the sustainable.

Le Plat du Jour - A Menu of Bad Options

Travelling in Southern Europe, T&B is appalled by what we encounter. Much of the continent is moving from recession to depression. In Spain and Italy an entire generation is being sacrificed – young people who will never get a job, at least at home. Some – the most entrepreneurial and dynamic – will emigrate, the remainder drifting into an embittered and impoverished middle-age. The danger of a social explosion has been vastly exaggerated – what we find, instead, is quiet despair. The danger is not that the European population rebels against austerity, but that it fails to do so and instead accepts terminal decline.

As has been amply discussed in the specialist press, the situation of several Eurozone countries is quite simply insoluble within the current politico-economic context. Continued austerity will simply lead to a further shrinkage in economic activity, worsening the debt/GDP ratio – a reversal of austerity (besides begging the obvious question: *who ever is going to lend them the money?*) will arrest the decline in GDP, but at the cost of the debt load ballooning out of control. While for the United States we have long argued that by far the most likely outcome is for debt to be inflated away, in Europe there is another possible solution – default. Since the southern Eurozone states cannot simply monetize their debts, absent a willingness of the Northern countries to either reflate or to agree a massive one-time transfer of resources to the South (reminiscent of the effort made by Germany to integrate the East after the fall of the Wall) at some point increasing economic misery will drive them to exit the Euro.

Then Don't Start from Here!

The interminable debates regarding the damage done by austerity (at least, as regards the Eurozone) vs. the supposed sins of the central banks in pumping in liquidity strike us as misguided. As regards the first, those decrying the self-defeating nature of austerity within the current European context (i.e. absent default/devaluation) miss one simple but troublesome question: *who the hell is going to lend countries the money if they decide to reflate?* Or, as the Irish might put it - *if you are trying to get to a stable fiscal position, it is best not to start from here*; the best solutions are those that were not adopted ten years ago.

As regards the supposed sins against monetary orthodoxy committed throughout the West, the problem was not the desperate survival measures adopted by governments and monetary authorities in 2008; had the Fed not reacted as it did in 2008, we would probably now be trading for sea-shells and living in caves. The problem, instead, was the ultra-hedonistic fiscal/monetary policies of the preceding two decades. Rather than face the painful implications of the Eastward shift in the global economic centre of gravity and the headwinds from our neo-Malthusian stance on commodities (super-cycle not dead!) a decision was made to party till the cops arrived. They are here… coming up the stairs now.

Once again – and it is simply amazing how many of our peers miss this one – JM Keynes' prescriptions were not, repeat **not**, continuous fiscal/monetary stimulus *ad vitum æternam.* Keynes called for a countercyclical policy whereby fiscal surpluses and tight money were to be applied during times of rapid growth, allowing stimulatory policies to then be implemented to counter the slumps.

Alas, it seems too much to ask of elected politicians that they decrease the feel-good

factor at critical points in the electoral cycle (i.e. at any time whatsoever) – there is hardly any problem so pressing that it cannot be put off until after the next election[3]. Perhaps at least some of the political establishment were vaguely cognizant of their own lack of discipline (or of their perverse incentives), leading to a 30-year drive to render the Central Banks independent of political pressure. Alas, when push came to shove, this independence was promptly trashed for reasons of expedience; under "The Maestro", the American central bank became nothing more than an appendage of the White House. His massively pro-cyclical policy alone accounts for much of the current distress. The BoJ is now joining in the fun – for the ECB, it is only a matter of time.

Falling Plaster

T&B would assume that any reader getting this far is already fully cognizant of the hair-raising statistics regarding the European debt situation. A full 30% of Spanish tax-revenues goes to paying interest on the sovereign debt; Portuguese debt/GDP will hit 125% this year – both countries are in deep recession; France is likely to hit a debt/GDP ratio of 100%; Italy owes 2trn Euros and has seen no growth for a decade; 27% of Spanish are unemployed (at least, officially) with the situation growing worse by the week; the French budget deficit hit 4.8% in 2012… we could go on like this for quite a while, but to what avail? It should be intuitively obvious that the likelihood of the Southern European countries being able to pay down their debt without outside help (either major German support or Eurozone inflation substantially exceeding the sovereign interest rates) is precisely nil – hopes for a rapid increase in the GDP denominator allowing them to grow their way out belong to the realm of fantasy[4]. One of the several perverse effects of the Euro is that, when the ECB prints money, it does not flow South – PIIGS bank lending rates are several points higher than German rates, further increasing the distress of Southern European companies which have been literally starved of liquidity, resulting in a chain of non-payments with the State the worst offender.

While we can only guess at what political decisions will follow the next crisis, or whether the markets will seize up first, taking matters into their own hands, there is a meaningful possibility that the Eurozone breaks up – either into two currency blocks (South and North Euro) or into a German-led Northern Euro, with a bevy of national currencies to the South-West. In either event, given that the Germans are viscerally opposed to inflation, it is likely that the Northern Euro would become the sole strong currency of the West, with seriously deflationary effects. One way or the other, Germany has another hard slog ahead.

Life after Debt?

Appearances to the contrary, T&B is not crazy – and we certainly do not imagine that an exit from the Eurozone would be easy, non-traumatic, or would be automatically followed by a major rebound. No, the problem is that an exit from the Euro seems not so much *desirable* as *inevitable* – again, at least within the existing political context. It comes down to a question of pain now, versus pain later. The politics adds a further element of unknowability to an already fraught economic context – our best guess is that the legacy political establishment will opt to put off the inevitable for as long as physically possible, thus exacerbating the ultimate pain. The unravelling may well occur when one of the Southern Eurozone governments falls (by election or otherwise) – perhaps Greece, Cyprus or Portugal, leading to its disorderly exit. Once the taboo is broken, several others would likely seek to push through the same door.

It is clear that, as in Russia during 1998 crisis, a substantial currency devaluation in any of the PIIGS would have to be accompanied by a sovereign debt restructuring (its Euro-denominated debt would jump to several hundred percent of GDP, expressed in the new successor currency) as well as bankrupting the financial system. While Russia was able to remain current on her external sovereign borrowings by the expedient of defaulting on domestic (GKO) debt – this option would not be available to Spain or Portugal, which would need to write themselves debt forgiveness in

[3] *But, the reader will argue, austerity measures have been introduced almost everywhere – true enough, but these are typically both too little and too late. A dose of austerity would have been far more useful during the boom times – at present it may actually prove counterproductive.*

[4] *This is not an historicism, but rather a recognition of the immutable laws of mathematics, in particular, compounding interest.*

proportions similar to that applied in the Greek (non)-bailout.

Meanwhile, back in Washington

The Eurozone debt crisis has conveniently distracted attention from the slower-burning US debt crisis; several recent papers purport to show how the US will smoothly grow its way out of the infernal mathematics – we are not convinced, and would note that raw optimism is their main export commodity. Government spending will inevitably rise given gradually increasing poverty, the inability to control medical costs[5], the influence of the military-industrial complex, and moderately negative demographics. As we have noted previously, given a dysfunctional political system unable to redistribute economic pain in an equitable and broadly acceptable fashion, the US will almost certainly opt to inflate away its debt burden. Either the fiscal repression already in place (negative real interest rates on risk-free assets) will be further enhanced, or the Central Bank will simply monetize the Federal debt – perhaps directly.

Even as regards Northern Europe, there is no certainty that the debt load can be managed by austerity alone – which is itself deflationary, increasing the debt/GDP ratio. Furthermore, a New Deutsche Mark would be an extremely attractive currency, with a tendency toward rapid appreciation, further stressing the countries of the hypothetical New Currency Union. The new Nord-Euro Central Bank would be compelled to busily print money so as to avoid triggering an avalanche of currency inflows by appearing to be (like Switzerland at present) the sole virgin at the monetary orgy.

A non-catastrophic outcome is quite possible, but certainly not foreordained. Inflation is a dangerous way of deflating debt bubbles – while a few years of moderate inflation may be the least bad of the various possible outcomes, the danger is that it spins into truly-deadly hyperinflation. Thus far, fiscal repression has been strikingly successful (absent fiscal repression, why would anyone buy 10Y US risk at yield substantially below the rate of inflation?). Maintained long enough, net negative real yields would allow governments to decrease their debt burdens; thus far, the Central Banks have been able to maintain control of their yield curves by buying their own sovereign bonds. What damage net negative real rates will wreak on the underlying economy is a question for the future.

Where could we be Wrong?
We Struggle to see....

The debt sustainability numbers say what they say – there is not much to quibble with – even if the PIIGS were to accept permanent and ever-deepening austerity, the progressive rise in debt/GDP appears inexorable.
Most of the credible alternative outcomes would involve Germany accepting a one-off debt mutualisation, probably in return for the debtor nations ceding control of their fiscal policy to some European (i.e. German) institution – not an easy sell, either in Germany or in the PIIGS.

Another variant, of course, would be to inflate away the European debt. In theory, Germany does not have control over the ECB, which could begin to monetize à la Bernanke. Absent fiscal repression, this would require a substantial element of surprise, preceded by a stealth extension of debt maturities (since otherwise, markets would demand higher rates to compensate for faster inflation) – this is almost certainly impractical. Of course, enhanced fiscal repression could be tried – forcing European investors and institutions to accept multi-year yields well below the rate of inflation – as is currently the case in the United States. In the case of Europe, this would require well-implemented and highly restrictive capital controls along with further measures to harness the financial system. We do not imagine that Germany would be anxious to sign up, but given the alternatives…

Another Day in the Death of Cyprus

We have little to add to what has already been written on Cyprus. One is reminded of that phrase which so aptly summarized the American devastation of Vietnam – "*The village had to be destroyed in order to be saved".* The Cypriots, lured into complacency by a misguided faith in the EU, have been compelled to sacrifice any economic future for their country to the imperatives of German

[5] *The problem here is not government payment of medical costs – the problem is that someone must pay for them, and they are simply not affordable – the US manages to spend 40% GDP more than its developed world peers for measurably worse health outcomes.*

electoral politics. The sins are not of their own commission – Cyprus did not have the real estate or credit bubbles of other Southern Eurostates – what it did have was a banking system which invested large sums of depositor money in the "risk-free" securities of an EU sovereign issuer – Greece. Once the Greek restructuring was crammed down, it was only a matter of time before the Cypriot banks defaulted. The egregious nonsense in the press about "dirty Russian money" was apparently intended to distract attention from the real causes. The Cypriot banks' Russian business of was profitable up until the end – and if some part of the deposits was untaxed in Russia (all relevant Cypriot taxes having been paid) that was an issue for the Russian tax authorities – certainly not for the EU!

As in the case of Greece, where European taxpayers saved some 250 billion Euros though at a near-term cost of 3 trillion, we suspect that the EU has once again scored a spectacular own-goal with the Cyprus bank bail-in, having permanently discredited itself in the minds of European savers by initially seeking to haircut deposit insurance. Why, especially given the cacophony from Brussels, anyone would now trust further EU assurances and keep deposits of any size in a southern European bank eludes us. No doubt, the larger deposits are already flowing towards more predictable climes, worsening the already parlous credit and bank-liquidity situation in Southern Europe, and forcing the largely German-funded Target II system to provide increasing liquidity. Penny-wise/pound foolish!

From a political standpoint, what was most striking about the crisis mismanagement was that the fig-leaf of "European" guidance was simply dropped; it was clearly a German operation from start to finish, with the EU political leadership kept in the dark until the end – even little Finland appeared to have more influence than France. Of course, not just Italy but also France currently lack governments (President Hollande reminds us of that character in one of Pirandello's novels – a knight who was actually an empty suit of armour, though who somehow managed to walk and talk) and France lives in terror of an attack on its own markets, in which case they would require massive German support; she cannot now afford to antagonize her putative saviour. Germany has unambiguously stepped forward as the economic overlord of Europe – with potentially significant consequences down the road. This has all been covered *in extenso* elsewhere – there is little new that we can add.

On the other hand, one of the unintended consequences of the rape of Cyprus has been generally missed – **the major damage to the EU-Russia relationship**.

Here T&B must step into the purely subjective mode (apologising for any offense by this necessarily broad-brush characterisation to our Russian friends) – noting that, while Russians are no less cynical than the next man, counterintuitively, they are "romantic cynics" i.e. they actually believe what they say, to an extent which we have largely abandoned in the West. When two years ago T&B had the opportunity of asking President Putin why he was talking so much about Europe when China was obviously the future, Mr Putin replied that Russia was an integral part of the European community – that one could not conceive of Russian culture without the influence of Goethe and George Sand (his choice, not ours) nor of a Europe without Dostoyevsky and Tolstoy. The point here is not whether he was right or wrong, nor whether these "soft" factors were particularly relevant to Russia's politico-economic alignment – the fact is that he very sincerely believed in what he was saying. Disappoint a romantic badly enough and he is likely to take matters far more personally than would a cynic.

A recurrent theme in Russian relations with the West has been a sense of disappointment – indeed, of betrayal. Russia voluntarily dismantled the Soviet Empire, expecting to be welcomed by the West with open arms. Their experience has not been a happy one – having been promised security, cooperation, and a warm home, Russia instead found herself staring across her Western borders at NATO armies, while the West did everything possible to draw former Soviet states into a potentially hostile military alliance. The Americans openly sponsored anti-Russian "coloured revolutions" throughout the region and at least covertly encouraged Saakashvili's ill-fated invasion of South Ossetia. Until very recently, Washington had planned to station antimissile defence batteries along Russia's borders, counterintuitively claiming that these were intended to stop incoming Iranian nuclear ICBMs (we would note that unlike Pakistan or North Korea, Iran has neither ICBMs, nor

nuclear devices, *a fortiori* none that is missile-mountable). All of these initiatives have failed, but the memory remains vivid. Western press coverage of Russia would have made the old Soviet Pravda blush, and the Russian side can only become deeply sceptical about the morals of their erstwhile post-Soviet role models. Ultimately, there will be a price to pay.

Deposits by Nationality
Some More Unequal than Others

Rightly or wrongly, the Cyprus affaire is perceived domestically as an overtly anti-Russian move. Reading the European media, one would have to assume that the money of Russian depositors was somehow deserving of less protection than that of other nationalities. The fact that some part of the money had not been taxed in Russia (no one claims that Cyprus taxes were evaded) apparently gave the European authorities the right to nullify the sort of protection that bank deposit holders normally expect. Certainly, to call the European explanations for confiscation of Russian money "politically tone deaf" would be too kind – they were frankly provocative.

We would invite the reader to try an experiment: take any recent article on Cyprus – substitute the work "Jewish" for "Russian" – and then see how it reads… "*Cyprus banks have laundered the untaxed money of Jews*" – *why should European tax-payers guarantee the deposits of rich Jews*", "*the Cyprus banking sector was stuffed with Jewish oligarchic money*" etc. – no self-respecting publication on earth would touch it, rightly considering it racist and fascist. When it comes to Russians – similar considerations do not apply.

Mr Putin was clearly not amused. The very next day the FSB raided several of the German-funded NGOs, unscheduled military exercises were undertaken in the Black Sea, and, reportedly, Western diplomats have been cold-shouldered in their pleas for help with Iran, Syria, etc. Perhaps the silver lining for Russia is that those citizens who moved money abroad for the perceived safety of the EU will presumably think twice next time. No one has lost money in Sberbank…

Of Diplomacy and Own-Goals
Worse than a Crime… a Mistake!

If there has been a single overriding theme of T&B over the years – it has been our repeated warnings that the West Inc. was committing one of the more spectacular blunders in diplomatic history by driving Russia into the arms of China. Not for the first time, we note what any bright 12-year old should intuitively realize – that if there is a threat to the continued dominance of the Atlantic Alliance, it is not from Russia, who threatens precisely no one (except, occasionally, herself) but rather from Russia's great Eastern neighbour.

Despite of the culpable nonsense one encounters in the press[6], other than a fraught history, there are few objective factors dividing Russia and China, who very much need each other – Russia needs Asian markets – China needs Russian resources.

As has been the case for the past several hundred years (with only a couple of exceptions, generally of short duration) Russia is a fundamentally conservative power, concerned not with overturning the current global division of power, but rather, of carving out for herself a larger piece of the pie – precisely as do her Western peers. Not so China, whose meteoric rise to become the world's preeminent global economic power is by its very nature profoundly disruptive and threatening to the status quo.

[6] *T&B still has a copy of a decade-old e-mail correspondence with a then-obscure Stanford academic, Michael McFaul, who confidently asserted that "*Russia was so afraid of China that they would be obliged to beg the Pentagon for a strategic alliance – at whatever price Washington choose to impose*". Failure must have gone to his head, and said academic, rather than falling into justifiable obscurity, was named US ambassador to Russia by Obama. There is a reason that most countries entrust ambassadorships only to career diplomats – not to political donors or to political activists: after a deplorable start (ambassadors are not expected to assume activist roles in the host country) followed by a sharp yank on his leash, he quieted down, but the loss of trust on the Russian side has continued to do further damage to bilateral relations.*

The Eternal Russia
- Can She Dance? Part II

T&B is sometimes accused of being a Russia uber bull[7]. We are nothing of the sort. Our viewpoint is best summarised by our repeated assertion that that "Russia is not, and never will be China – quite fortunately, it is not Belgium either. Russia is now a middle-sized, middle-income, middle-European country with both greater-than-average potential, and some major problems". Long gone are the days when Russia had the world's best parties[8] and was either the world's best – or its worst – financial market, sometimes both in the same year. For that reason, T&B is currently devoting more of our time and attention to Europe – that is where the black swans go to nest. The simple truth is that, in Russia, nothing very dramatic is likely to happen anytime soon.

We issued our "T&B – Can She Dance?" in the early-2000s, asserting that the spectacular recovery from the depths of the 1998 crisis had proven that the Russian bear could walk – but, now, could she dance? Russia's rebound had been very impressive, but it was largely attributable to broad-brush measures – fiscal probity, monetary discipline, import substitution and the end to the egregious asset stripping by the owners of the extractive industries. The question was whether Russia could build upon the momentum, modernising the economy and attacking the deeply ingrained problems of poor corporate governance, bureaucratic incompetence, corruption, short-termism, and the hunter-gatherer mentality which was the legacy of the collapse of the USSR. With little tradition of entrepreneurial activity, and limited trust in anyone not of one's own innermost circle, as well as a substantial natural resources dependency, Russia tended to rely on very large-scale business, with a stunted SME sector.

The above problems are not unique to Russia, and one encounters at least some of them throughout the developing world. The record in has been mixed.

On the one hand, since our writing, Russian agriculture has enjoyed a spectacular recovery – from the world's largest grain importer to one of its top exporters, along with substantial restructuring of the oil and metals industries, as well as of the banking system. Unemployment has dropped to one of the lowest rates in Europe, while popular consumption is resilient, supported by a rapidly increasing supply of credit. Despite widespread misconceptions, a major anti-corruption campaign is now underway (which has already yielded several highly-placed scalps) and we have personally witnessed a shift in business/legal practices, as court decisions are no longer systematically for sale. Moscow is finally seeing the sort of multiplication of small service businesses seen in Eastern Europe two decades ago (there are a good 30 lower/mid-market Sushi places within walking distance of our Kurskaya apartment – as opposed to zero a decade ago). After more than a decade of trying, the merged RTS/MICEX will finally allow the direct participation of those foreign investors not yet scared off by the abuse of minority shareholders.

Corporate governance remains not so much horrendous as mixed, capricious and entirely unpredictable. Investors in Russian-law traded markets are dangerously dependent upon the goodwill of the majority investors – whether private or state. Another scourge of post-Soviet Russia – short-termism and the lack of long-term capital – is largely unchanged; yes, the time-frame has shifted from a few weeks, to a few months, to perhaps a year-and-a-half, but try raising 7-year finance in Moscow… Pension reform has been repeatedly botched, savings are still channelled into real-estate or short-term government debt, while there is a severe shortage of risk-capital or non-collateralised bank lending.

Russian growth is currently hampered by the slowdown in the West – in particular, the ferrous metals and coal sectors have been badly impacted by a collapse in European demand. Finally, despite the nonsense in the press, one of the likely economic threats arises

---

[7] *Or, more irritating still, a Kremlin "apologist" – what utter bollocks! T&B is an enthusiastic, if occasionally critical, Putin fan, believing him to have been, quite literally the saviour of Russia – and this at a time when our adoptive country was very much in need of salvation.*

[8] *Provided, of course, that one had a taste for a mix of Star Wars, the late Passolini and a zest of Marquis de Sade…*

not from any lack of democracy, but from its excess: in the first decade of the millennium, the Putin government did not feel much need to buy popular support – after the appalling experiences of the 90s, the Russian public was delighted to finally enjoy some basic stability – a functioning economy and essential public services. That has now changed, as Russia is slowly moving in the direction of the European social welfare model, with an increasingly wealth citizenry having preoccupations beyond physical survival, and coming to expect far more from the State.

As regards FDI, there is a certain irony in the fact that, while investors shy away from Russia, they get dollar signs in place of their eyes when talking about China – this despite the fact that a good 90% of foreign businesses in Russia have been printing money, as opposed to only a tiny minority in China. Russia is Europe's only high-growth automobile market, while European fast-moving consumer goods, pharmaceuticals and personal care companies are generally having a spectacular run of it. This disconnect is at least partially attributable to the pernicious and dishonest press coverage – generally discounted by businessmen with existing operations here, but which tends to frighten off would-be entrants. Despite this, Russia enjoys the second highest FDI/capita of the BRICs.

The combination of mendacious press coverage and populist Russia-bashing by Western politicians has triggered a sharp push-back from the Putin administration, taking an increasingly hard line toward what it considers to be foreign meddling, in parallel with a very real realignment towards China and the BRICs. This is a mixed blessing for investors – on the one hand, macroeconomic stability will be much enhanced by Russia's focus on the world's premier growth markets of Asia – on the other, it is very unlikely to promote privatisation, economic diversification or strong initiatives in favour of Western investors.

While the Russian macroeconomic profile is one of the most boringly stable of the G8, the rate of deceleration in economic growth has disappointed – we are far from the "*three fives*" of 2011, i.e. 5% inflation (now 6%-7%), 5% unemployment (still there) and 5% growth (now 2-3%). Indicators for sovereign debt, fiscal balances and the current account remain excellent; the banking system has improved greatly and systemic risk is lower than in the Southern European countries, with more comprehensible balance sheets (less leverage, and very limited dependence upon wholesale credit markets or government support.) On the other hand, we find the rapid growth in consumer lending somewhat worrisome, and the entire sector is capital-constrained, with an excessive reliance upon short-term funding by the CBR. The Basel-III requirements now being introduced will further enhance safety, but at the expense of the rate of growth

The Central Bank is confronted with the need to cut rates in order to stimulate investment, while being constrained by stubborn inflation, attributable both to the very low unemployment rate and to high capacity utilisation. Further reform of both the banking sector and the capital markets are desperately needed to fund investment, creating domestic pools of long-term money while limiting capital outflows.

The Great Russia Discount – Fact and Fiction

The "Russia Discount", i.e. the fact that Russian assets traded at less than half of the valuations of their emerging markets peers, is both an absurdity and fully justified by recent events, depending upon which part of the market one is looking at.

Since 1998, T&B has argued that the Russia discount was an anachronism, offering smart investors the opportunity to make a great deal of money as Russian assets gradually converged with their underlying value. Those who positioned in Russian long-dated sovereign fixed income in 1998 multiplied their money 15-20 fold (coupon reinvested) over the ensuing decade, during which Russia boasted the world's best performing debt markets.

On the equity side, this trade worked well enough until 2007, but as repeated disappointments in terms of dividend flows, corporate governance, transparency and predictability began weigh upon the markets we gradually tempered our enthusiasm for both the equity and the local (i.e. rouble) debt markets, while remaining very bullish on corporate, subsovereign and sovereign London law bonded debt. Despite some wild price action during the 2008 global crisis, the Russian Eurobonds have performed impeccably.

Is Russia an Investible Market? Yes and No…

The fundamental misconception about the Russia Discount is that it reflects a meaningful sovereign default risk – that the supposedly parlous state of the Russian political system and the dangerously mismanaged economy mean that all Russian assets should trade at a very substantial discount – obvious nonsense!

In fact, Russia has one of the most orthodox budgetary and monetary policies in the developed world, with current account and budgetary surpluses and gradual disinflation over most of the past decade. The Central Bank has proved ready to step in with targeted actions in periods of exogenous stress (2008).

As regards commercial banking, while regulation had been somewhat lax before the 2008 crisis, it is now increasingly proactive and well conducted. The deposit insurance program has been tested and found reliable, and Russians no longer rush to their banks to withdraw their deposits at the first rumour of trouble. Taxes are very low by global standards, although social charges on labour have increased well beyond the optimal level.

There remain, of course, some very fundamental problems – a shortage of long-term capital, the absence of an active interbank market forcing banks to rely on the CBR, and a large but shrinking number of very small banks, the actual purpose of which is not usually clear; none of these factors threatens Russia with a systemic crisis imperilling sovereign solvency. As regards political risk, we would rate it lower than in many – perhaps most – of the Eurozone countries[9]. Issuer practices in the Eurobond market have generally been exemplary[10]. Non-specialists are usually surprised to learn that the Russian state borrows short-term (2Y) at 1.26%, and major Russian corporates fund themselves cheaper than their European peers.

So all is well? Alas, no.

The legal protections afforded to investors in domestic Russia assets, both debt and equity, are gravely lacking. Companies can largely do as they damned well choose, at best egregiously abusing loopholes in the legislation – at worst, simply stealing the assets.

On the debt side, while Eurobond protection has been excellent, even in the wake of the 2008 global crisis (when several of the Russian commercial banks found themselves in a parlous state, yet refrained from defaulting, restructuring, or even attempted to abuse their bondholders) domestic debt restructurings are reminiscent of nothing so much as of a pack of particularly nasty dogs tearing into a garbage sack – the biggest, meanest, best-connected dogs came away with whatever the choicest morsels, while the others go hungry. In the wake of the 2008 crisis, domestic bond markets were shambolic, with a string of defaults, the largest being the factoring company Evrokommerz, which Troika had foisted onto the market, then looked away as it was pillaged by its management – investors in the local bonds recovered precisely zero. There were numerous other such cases – perhaps less extreme but almost systematically failing to offer any equitable redistribution of assets.

The situation in the equity markets is unfortunately reminiscent of the local debt market, with occasional instances of egregious investor abuse, with shockingly little recourse available to the victims. One such case now threatens some of the largest and most experienced investment funds in Russia with substantial losses.

---

[9] *Readers of the FT, the Economist etc. will remember that just a year ago, they were being warned of the gathering storm of anti-government protests in Russia – which were about to sweep Putin from the Kremlin. They will note that this culminated in the last "Million Man March" which missed its target by a mere 990,000 men…*
We are curious as to whether any of our readers is aware of any journalist actually admitting that he had gotten it comically wrong… we are not. Unlike T&B – who acknowledges and learns from our mistakes – our press takes its readers to be fools – or at best, as having the memory span of your typical goldfish!

[10] *The one major default was by IIB, a pocket bank of the notorious Pugachev who simply absconded with the loot – subsequently aided and abetted in every way by the UK authorities who are delighted to benefit from money stolen anywhere outside of their own backyard.*

TNK-BP – How to Steal an Oil Company – Part III

The initial 1997 version of "How to Steal an Oil Company" by James Fenkner, then with Troika, dealt with Khodorkovsky's outright theft of investor-owned assets from which he subsequently assembled the Yukos oil company. Of course, if you can steal it, it can be stolen away from you; as Robert Johnson sang, "the woman I love – I stole her from my best friend – the joker he got lucky – stole her back again*" and Khodorkovsky's asset was torn from his clutches just a few years later. Alas, the innocent parties were punished along with the guilty – i.e. Western investors who had been despoiled by Khodorkovsky were soon to be joined by a new crop of Yukos investors whose holdings were wiped out as the stolen goods, which had meanwhile received a new coat of paint and an air of legitimacy, were taken away from Yukos to form Rosneft.*

History is now passing the plates for a third time, as Rosneft has decided to tear out the throats of those poor innocents who believed that, in buying the shares of TNBP, they were actually acquiring a minority share in a well-managed and highly profitable asset with a couple of well-respected and honourable partners, BP and the Russian AAR consortium. Said investors are now learning that, in fact, they own precisely nothing following a change in the majority owner. Indeed, when BP was compelled to sell to cover the costs of the massive corporate raid by US authorities after the Gulf spill, Rosneft outmanoeuvred the Russian oligarchic interests, who unable to raise finance sufficient to compete with the national champion, chose to sell-out at a good valuation.

As is typical in Russia in such cases, the minorities appear to have been left high and dry. As we go to press, it has been announced that rather than paying out its huge cash reserves via the accustomed dividend, TNBP is going to "lend" the money to Rosneft to help finance its own acquisition! Rosneft has baldly affirmed that TNK is now simply a Rosneft subsidiary, and they can move the cash wherever is convenient – making it clear that it has no intention of spending good money to compensate the minorities. Share prices promptly plunged by a further 40%.

Red in Tooth and Claw

Last year, in private discussions, when a friend argued that Rosneft would never despoil the investors in TNBP since they needed continued access to global financial markets, and thus for them to simply grab the asset (legally or otherwise) would look terrible, we replied that they would do whatever they damned well choose in the assumption that foreign investors would look away and pretend not to see.

Of an irascible temperament, T&B generally becomes irate with any of our peers who become moralistic about business. Capitalist economics is not about justice, equity or fairness – our countries think nothing of starving Latin American peasants to keep our morning cappuccino affordable, any more than the late-19th Century British hesitated to devastate Chinese port cities to preserve their God-given right to sell opium. The American invasion of Iraq had little to do with Democracy, and much to do with oil and power politics[11]

In short, business, like statecraft, is about maximisation of power and wealth, raw and brutal, although given the game theory imperatives of profit maximisation, there has gradually evolved in the West an intricate system of law and practice aimed at maximizing overall benefit for the participants. As a general rule, once men (or countries) have become wealthy, they become increasingly concerned with wealth preservation, and are willing to sacrifice some measure of their freedom in return for security. Thus, over the years there has evolved a system of laws and practices for the protection of investor rights, with sanctions ranging from the social to the financial (and indeed, penal) for those contravening them too egregiously. Russia is clearly not there yet and individuals can still abuse the system for their own benefit, despite a net loss to the overall interests of the inner circle.

---

[11] *Indeed Perhaps what T&B likes best about the Russians is their relative lack of hypocrisy – they may act in a fashion no better and no worse than their foreign peers, but at least they are likely to simply snarl "we did it because we can do!" rather than bothering us with the clever, convoluted and dishonest explanations one gets fed on in the West.*

This leads, of course, to the fundamental problem of the Russian equity market – almost without exceptions, investors in Russian traded equities are "minorities" – i.e. control of companies is vested either with the state or with a controlling holder. As an investor, one has to hope that one's own interests are (and will continue to be) aligned with those of the majority owners. As regards the owners of TNBP shares, until recently their interests very much were aligned – both BP and AAR needed the cashflows, and payment of the minorities' share of the dividends was never in question. Alas, the minorities were not consulted when control of "their" asset shifted into the hands of a company with vastly different ethics and incentives.

This is not to imply that all Russian stocks will ultimately share the sad fate of TNBP – the majority will not. Some of the major business groups make a real effort to keep their minorities warm and dry, and there has been at least some improvement in the overall quality of corporate governance. In these cases, while corporate deal-making is not necessarily in the best interests of all, at least the cash flows and ownership of assets are vouchsafed. The problem is that the controlling parties face little sanction if they decide to sacrifice the minorities for their own greater good.

State companies are a distinctly mixed bag – until present, they have generally been run for the benefit of the "stakeholders" i.e. management. Mr Putin is now attempting to force a higher degree of transparency as well as the payment of reasonable dividends. It is distinctly disappointing that the most recent outrage is being perpetrated by a State-owned champion – Rosneft.

The fundamental problem is that these events seem **totally arbitrary** and largely unpredictable – today's hero will reliably become tomorrow's villain, and vice versa. As the financial press never tires of reminding us, Investors hate uncertainty – and as regards Russian corporate governance, they get it in spades. We continue to shy away.

Hope dies Last

As we go to press the situation is evolving – and our pessimism re: the likelihood that anything or anyone could stop Sechin from doing as he chooses may be misplaced. For the first time we are seeing substantial push-back. Indeed, along with some of the top Russian investment funds bringing discrete pressure, Deputy Central bank chairman Sergey Shvetsov was stepped forward with statements highly critical of the mistreatment of the minority investors. Stay tuned - hope dies last!

T&B - How to Trade it – Exercise Caution in all Things

T&B's general risk-on stance (don't fight the global Fed) has been well rewarded over the past semester, as markets have recovered from each bump with renewed vigour, quickly reverting to a buy-the-dips mode. That said, we are very cautious on equities (ex Japan, given the aggressive devaluation of the Yen), since price performance has been subtended solely by Central Bank monetization, and we are reaching a point of diminishing returns on monetary creation. We find that all the learned discussions of technicals and the various methods for valuation – be them forward, backward or indeed, inward-looking, have all the relevance to actual market performance of the fleas on the camels of the Sahara. This has been a monetary story, full stop.

Given our concerns for the decreasing efficacy of monetary stimulus, our buy list has shrunken yet further. China has been a bit of a disappointment – again, the fundamental problem in Beijing is the total divorce between the equity market and the underlying economy. Someday this will be corrected, probably quite sharply, but we have not been able to spot the entry point yet. While some of the smaller Asian markets – in particular, Thailand and the Philippines – have continued to sprint, valuations are becoming seriously stretched. We would stand back.

Thus, we are back to our usual fixed income list for our client accounts – properly leveraged, intermediate-duration corporate EMD would have yielded at total return of about 25% over the past six months (about 13% outright) – not bad in the current context, although we would expect diminishing returns from here. Ranked in terms of risk – from lower to higher, we like:

-Russian second-tier bank subs – RUSB, Nomos and Promsvyaz still constitute free money, for reasons we have discussed

repeatedly (and are disinclined to discuss again - please see previous editions). We would note that with the new Basel requirements being instituted, the new hybrid instruments, though less exposed than their western counterparts (given the much lower trigger points – 2% capital adequacy) should take some time to gain acceptance. Thus, the old-style subs, an endangered species, will gradually be bought out of the market at a premium. More conservative investors may choose to go with Alfabank, which in our view, presents a risk profile at last as good as that of the US or European majors – indeed, the greatest risk to Alfa would be a collapse of their Western counterparties.

-Kazakh subs. Large swaths of the Kazakh banking system are essentially bankrupt – this has not bothered them in the least for the past several years, and we see little reason it should bother them now. There is not too much left to buy – we still like KKB, though yields have compressed quite dramatically; BCCRD is now fully priced. We would wait to buy ATF 2016 on a correction – Unicredito has sold its Kazakh adventure back to the gentlemen it originally purchased it from – at about 20% the entry price. We expect a one-notch downgrade in ATF ratings, but there is no reason to assume the new owners have spent a half-billion dollars to promptly bankrupt their new asset, nor that the Kazakh regulators would allow them to do so, given how much it has cost to refloat BTA and Alliance. Instead, we would expect them to clean it up, put some lipstick on it, and then flog it off to some other unwary European – never underestimate the shortness of memories in this market.

Risk-tolerant investors may also wish to consider the Alliance bank and BTA issues – both of which have performed very strongly after their respective restructurings. Both banks now seem (pseudo-) viable - a fine moral-hazard trade.[12]

-WindIM. The bonds of Wind, a large Italian telecoms owned by Alfa's Vimpelcom, have shot the lights out, soaring about 30 points in six months. The asset is constrained solely by the (comprehensible) fears of a total meltdown in Italy. With Vimpelcom and the Alfa group flush with liquidity, there is a non-negligible possibility that they will call the bonds (significantly above par) mid-year 2013. Though the bonds have tightened very substantially, they are still very wide to VIP – we think the yield pickup still justifies the risk.

-PdVSA. We have traded out of PdVSA, but would be looking to buy back in once the YTM drops back into the low two figures. We believe prices have not come off further because of the insane hope still cherished by some denizens of Miami that a regime change will come about at the next election – it is not going to happen, and there will be some disappointed investors looking to sell. We may then find ourselves on the bid.

-Ukraine. We are currently out, perhaps wrongly so. We find Ukraine's economic policy, if any, to be incomprehensible to the mere mortal intelligence; however, Ukraine has a long established tradition of pulling rabbits out of hats, and for all we know, will continue to do so. We do not find that the reward justifies the risk… caveat emptor.

-Argentina. *If our long experience in markets has taught us anything at all (a big "if) it has been that when the entire analyst-journalist coven goes hyper-bearish, it is almost invariably time to get in. Bloomberg has, typically become little more than a propaganda organ for the hold-outs, with a steady stream of negative news. Of course, had one purchased PdVSA at the same point in the media-cycle, there were 40 points of upside to be gained. Unlikely here, but we think the risk-reward is finally becoming favourable.*

The ultimate high-risk trade in our market, we think that the yield on Argentina justifies the very real risk for investors not constrained by mark-to-market, i.e. there is some likelihood of an adverse court ruling in New York causing Argentina to go into technical default on the restructured debt, with investors being offered to swap into local law instruments in order to defeat the evil vulture funds. While in this event selected sovereign assets will be available in size, 10 points below where they trade today, we think that the market is already pricing in a catastrophe scenario – perhaps wrongly so. First of all, it is not impossible that the New York court issues a surprise positive judgement (with Argentina agreeing to reopen the swap to the vultures, but on the same terms as previously), leading to a massive rally in prices, or at worst, that an appeal to the US

12 *The alert reader might retort – and what is not a moral-hazard trade, anymore?*

Supreme Court (backed by the Obama administration) could delay resolution for a further six months to one year. Given their extremely high carry, there is potential upside.

Furthermore, even in the worst-case scenario of temporary default, we assume that bond service in one form or another would be resumed, perhaps quite rapidly, via a swap into Argentina local-law assets. We do not see investors boycotting the swap and thus effectively refusing to receive the payment that Argentina fervently wishes to make.

In terms of choice of assets, we stick to the Provincia de Buenos Aires or to the London Law Argentina Euro Pars or Discos, which could, at least in theory remain current through a default on the New York law assets. Another option is the Euro-denominated GDP warrants, which are trading at only about 1 ½ times the expected payment the next time Argentina sees some economic growth (probably when Brazil bounces back, though a sharp rise in global food prices could also do the trick) with a potential upside *in fine* of about 8x.

***All disclaimers apply** – and then some. As they say in the prospectuses – do not invest money you cannot afford to lose!*

Currencies – T&B is always amused when investors tell us that they "do not do currencies" – knowingly or otherwise, we all do currencies (the exceptions being Buddhist monks and the destitute). While our old friend Marc Faber recommends hedging dollar risk with gold, T&B prefers Chinese RMB as a store of value. Traded either via NDFs or as a deliverable (CHN) in Asia, the Yuan offers reasonable upside (2%-3% per annum), but, especially, the safety that comes from owning the currency of the next economic superpower, and one which is distinctly NOT working the printing presses.

Elsewhere, for those of a more speculative bent, we would remain short Yen vs. USD, flat/short Euro, short GBP, and might buy some Palladium on the dips. A note of caution: the sky overhead is filled with flights of black swans endowed with very fat tails - in particular, the European Community has once again confirmed its ability to surprise, generally not in any positive fashion. We would thus be concerned with the risk of near-term havoc causing a return to the panicky and hyper-correlated markets we have known several times this decade. Trim your margin, and keep some cash for the opportunities down the road.

We would invite anyone smart enough to identify a good hedge against a resumption of the Euro-driven risk-off, preferably with cheap OTM optionality, to share it with us. The best we have come up with so far is a trade on the spread between German and French rates – which could be expected to blow out if and when another crisis hits.

Good luck – we will all need it.

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

T&B was brought to you by

www.elalephcruising.com

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

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

PLEASE JOIN US ON THE T&B WEBSITE - www.truthandbeauty.ru - where you will find back issues, articles of interest, and some lively debate. Readers are encouraged to contribute their views, or suggest articles or research to post.

This message is provided for informational purposes and neither the information nor any opinion expressed herein constitutes an offer, or an invitation to make an offer, to buy or sell any investment funds, securities or any options, futures or other derivatives related to such securities.

Investment in emerging markets bears a high degree of risk, and is not suitable for all investors. This report is based upon information we believe to be reliable, however it is provided solely as an intellectual exercise, and no investment decisions whatsoever should be based upon it, in full or in part. In particular, investing in securities, including Emerging Markets securities involves a great deal of risk and investors should perform their own due diligence before investing.

Past performance is not necessarily a guide to future performance. Some investments may be subject to sudden and large falls in value and on realization customers may receive less than they invested or may be required to pay more.

Changes in foreign exchange rates, interest rates, or other financial parameters may have an adverse effect on the price, value or needs of customers. We would recommend that investors take financial advice as to the implications, including taxation, of investing in any financial product.

Some investments may not be readily realizable and valuing the investment and identifying the risk to which customers are exposed may be difficult to quantify.

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!

Eric Kraus © 2013.