



## Life after Debt - Russia's New Millennium

By Eric Kraus

I got a lot of response from my recent letter on South Africa. Today we turn to another emerging market country. Since the late 90's, what country's equity market has performed the best? At first thought, many might say China or India due to the robust economic growth that has taken place. Still others might weigh in with countries such as Brazil or Dubai because of their booming commodities and tourism sectors, respectively. The answer is Russia with it boasting a 37 fold increase since 1998!

Every few months I get a lengthy but very thorough and enlightening newsletter from Eric Kraus called "Truth and Beauty" about the Russian economy and markets. Eric works in the finance industry and is an accomplished money manager. His writing reflects his positive views of the Russian markets along with a candid appraisal of the problems. But his writing on Russia is quite different from the views we get in the Western press. I asked him to give me a brief synopsis of his views for my readers. This is truly Outside the Box, and a balance to what we normally read.

If you want to subscribe to his letter, you can write [Nadia@nikitskyfund.com](mailto:Nadia@nikitskyfund.com) and she will add you to his list.

John Mauldin, Editor

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When John - a man who does as good a job as anyone on earth rendering arcane economic theory accessible to non-specialists - asked me to write a brief review of Russian financial opportunities, I shuddered. I write a Russian strategy review entitled Truth and Beauty (*and Russian Finance*) which runs to a good 25 pages per month. Frankly, explaining Russia to the outside world is no less a challenge than explaining the arcana of Fed policy....or Einstein's General Theory of Relativity. And

in just five pages...I hardly know where to begin...

Since the beginning of the Putin era, the kind reader will have been repeatedly warned of Russia's impending collapse. Hair-raising stories in the financial press told of dysfunctional government, criminal oligarchs, industrial decline, corruption and chaos. Yet oddly enough, since 1998 Russia can boast the world's best-performing equity market (the RTS Index has appreciated from 58 to >1930, i.e. more than 37-fold!) as well as the fastest GDP growth rate of any country outside of Asia. Why?

Neither of the two usual explanations: "it's just a bubble," or "oil prices!" hold much water. Markets can temporarily move out of sync with their fundamentals, but they tend to snap back fairly fast - witness the Russian Bubble of 1996-97 (or NASDAQ 2000). For a "bubble" to grow continuously for almost a decade would suggest that it had an unusually strong skin. As for oil prices, certainly, they have been the icing on the economic but then oil prices are high for Venezuela and Saudi Arabia too, yet their markets are in the tank. Furthermore, relatively high oil prices in 1995-96 did not benefit Russia - the notorious Russian Oligarchs pillaged their own country, pumping their export revenues abroad. As Russia starved, a few unscrupulous operators such as Mikhail Khodorkovsky became fabulously rich.

The resultant 1998 debt-crisis marked a watershed - over the ensuing years, Russia prepaid the lion's share of her foreign debt, while the economy has doubled in size; at \$310bn foreign exchange reserves are now the world's third largest; inflation has fallen into the single digits for the first time in 20 years while Russia is rated investment-grade by all rating agencies.

Russia's spectacular recovery from the crisis was made possible by some tough belt-tightening. First, they stopped borrowing. Under Putin the tax system was revamped, with a **13% flat tax** on income (Russian immigration forms are available on request!), provoking a huge increase in tax receipts. The government ran massive trade and budget surpluses, and the \$100bn "rainy-day" Stabilization Fund meant to buffer the effects of commodity price volatility is now large enough to last an entire monsoon; Russia could maintain 2006 budget spending unchanged for four years at any oil price - Including zero.

With real revenue per capita growing at more than 10% per year, there is an explosion in Russia's middle class - retail distribution is growing like wildfire as vast shopping malls mushroom up around the major cities, consumer lending is rising to European levels, mobile phone penetration has surged to over 100%...and with several hundred thousand new automobile registrations each year, traffic in St. Petersburg and Moscow's is grinding to a halt (*ah, for the good old days, when one could have safely stopped to have a picnic in the middle of any Soviet street...*) For the first time ever, the average Russian can enjoy the things that Americans have long taken for granted: buying a car, a new washing-machine, and escaping the cold Russian winter for a quick flight to the beaches of Egypt.

## Politics

While investors in the G7 countries can usually pretty much ignore the politics, in the developing countries, this is often the top economic consideration. Thus, to

understand the current situation, we need a brief historical overview:

Unlike America, which has enjoyed two really good centuries, Russia's last millennium was - to put it mildly - *difficult*. It began with the catastrophic Mongol invasions, proceeded through Tsarism, devastation in the Napoleonic Wars, a largely wasted 19<sup>th</sup> Century, then the Bolshevik revolution, with renewed devastation in the two World Wars - where Russian losses dwarfed those of any other combatant.

By the mid-1980s when Mikhail Gorbachev came to power, the Soviet Union was showing the strain. Collapsing commodity prices, rising popular expectations, the Afghan war, and an increasingly-restive Eastern Europe were major challenges to the Communist Party. Yet vitally for the understanding of current Russian policy, the Soviet Union had seen off far worse crises since the 1917 Revolution; and in 1986-89, while it was shaky, it was nowhere near collapse. **Instead, the Soviet Union was the first empire in history to voluntarily legislate itself out of existence.**

While this voluntary liquidation was greeted as a millennial event in the West, for the average Russian, it was a period of intense misery. Prices soared as the rouble lost all value; with the social and industrial infrastructures collapsing, hunger stalked the streets. Russia was repeatedly humiliated on the global stage. Although well-intentioned Western leaders had vowed to respect Russia's security concerns, nature abhors a vacuum; the temptation for NATO to forget Reagan's promises and advance NATO's forward bases up to Russia's borders "just in case" proved irresistible. For ordinary Russians, the good-hearted Western powers and indeed, the very term "democracy" gradually became synonymous with hunger, chaos and national humiliation.

Economically, the 1990s were a lost decade. Russia had neither the historical experience of capitalism nor the institutions necessary to support a sudden liberalization. Instead, privatization benefited only a tiny fraction of society as the brutal "Oligarchs" gained control of entire industries by corruption and violence. Some of these same men are now belatedly spinning themselves as "*heroes for democracy and transparency*." That many in the West are ready to believe such fables demonstrates the power of well-managed PR!

At Yeltsin's invitation, the Russian regions gradually broke away from central control; the regional elite - generally Soviet-era bosses-turned-privateers - built their independent kingdoms. The supposed Russian "free press" was firmly under the thumb of the Oligarchs who first demanded that their tame journalists ensure the dubious reelection of a desperately unpopular Boris Yeltsin in 1996, then, after winning the election, turned their fire on each other in the "Banker's Wars", helping to bring down the "Young Reformers" government and ushering in the 1998 financial crisis.

When Yeltsin's surprise resignation on New Year's Eve 2000 catapulted then-Prime Minister Vladimir Putin into the presidency, the latter found himself at the helm of a badly-holed ship. The Western press gave Putin little chance of success, predicting that, like Yeltsin before him, he would be hamstrung by the all-powerful Oligarchs and their closest allies, the corrupt regional governors.

In fact, Mr. Putin was made of far sterner stuff than anyone suspected. He quickly moved to break the power of the most arrogant of the Oligarchs, while reducing the regional governors to dependency on the Kremlin. Tax and fiscal policy were totally revamped, reform legislation pushed through a newly-compliant Duma, vital energy resources were at least partially reclaimed by the State (like in every other major oil exporter) - and suddenly, Russia was back in business.

### **From Politics to Geopolitics**

Many in the West have voiced concerns about the supposed loss of democratic freedoms - some perhaps sincere, but others clearly to advance their personal agendas.

Yes, Russian democracy remains very imperfect, although it is not intuitively obvious why Vladimir Putin, who regularly polls above 80% approval ratings, is any less "democratic" than was Boris Yeltsin, who rarely managed to make it into the 2 digits! Perhaps the systematically negative tone to Russian coverage by the foreign press since 2000 may have something to do with the fact that, while Yeltsin craved the approval of the West, Vladimir Putin has been far more focused upon courting his Russian electorate.

In any event, of the most successful emerging countries which rose from grinding rural poverty to first-world wealth in a single generation, - first Singapore, Korea and Taiwan; now China, Vietnam and Russia - none was remotely democratic, at least during their early transition phases. Of course, as countries become richer, their rising middle classes gradually demand more political representation. Russia is not there quite yet.

The good news, on the other hand, is that any talk of a new cold-war is totally misguided. The Cold War was a confrontation of ideologies - today, like China, Russia has no desire to spread her politico-economic system to the rest of the world. Instead, Russia has entered into the hyper-competitive global capitalist game, and Mr. Putin intends to see Russia regain her status as a major economic, energy and diplomatic power in a multipolar world.

Comparing Russian with Chinese diplomacy, the Chinese appear happy to let Russia take the diplomatic flack, while they sit back, quietly and skillfully advancing their pawns. Russia, on the other hand, insistently demands her place at the top table **because Russia feels herself to be a stake-holder in the current geopolitical system**. No one in the Russian government is crazy enough to imagine that Russia can rule the world...nor even half of it. China, of course, may have other intentions.

It would be sheer madness for the West to continue antagonizing the Russian Bear, snatching defeat from the jaws of victory by pushing Russia into China's welcoming embrace.

### **Economics**

From the investor's standpoint, Russia's recovery can be divided into three phases:

-In the immediate aftermath of the 1998 crisis, Russian Eurobonds offered yields of 50% per annum (Russia never missed a payment on her external debt). It was easy money, at least if one believed that the whole country was not about to disappear off the map!

-By 2000, the bonds were getting pricier, and it was time for a look at the blue chip natural resources stocks - mostly oil and gas. With Russia's top oil company, Lukoil trading at \$6 (a P/E ratio of less than 2), and shares in the world's largest gas company - Gazprom - going for pennies, it was akin to shooting fish in a barrel. Significantly, Russian domestic investors who - until then - had wisely avoided their own equity market were quick to recognize the new opportunities; they, and those few foreigners willing to make the leap of faith, enjoyed rich pickings.

-Now, seven years later, although the Russian RTS market index still trades at a tempting discount to its global emerging peers, the lowest-hanging fruit has already been picked. The blue chip equities still represent good value, but investors can no longer hope for 3-digit annual returns. Given the high taxation of oil exports, the Russian oil companies are becoming utilities - offering modest but unexciting profits at any realistic oil price, and the sharpest investors are looking further afield.

### **Russia's New Asian Century**

Sometimes the accepted wisdom is right. The global economic center of gravity is currently shifting from the G7 countries towards the industrial powerhouses of Asia - also enriching countries such as Russia, Argentina and Brazil which supply the "Dragon economies" with the commodities they so crave.

Smart investors are surfing this wave. The commodities cycle turned in 2000 - although in nominal dollars commodities now seem expensive, their real inflation-adjusted prices are just now rising off of their historic lows. With Asian economies firing on all cylinders, commodities are set to run right off the charts.

The main engine for Russian economic growth will remain the supply of raw materials to the Asian dragons: not just oil and gas, but also metals (precious and industrial), ores and minerals, chemicals, fertilizers and forestry products. After 50 years as the world's top agricultural importer, Russia has become a significant exporter.

That said, as the Russian economy diversifies and Russia becomes a middle-income country, the best investment opportunities will be found the fastest-growing industries - companies oriented towards satisfying domestic demand: retail, construction, real estate, banking and insurance, telecoms, automobiles, etc. Yes, serious problems remain: creaking infrastructure, very uneven corporate governance (ranging from "international standards" to "simply dreadful"), too much bureaucracy and - like the world's other two fastest-growing economies, China and Vietnam, widespread corruption. Yet, over the past 8 years, investors have been richly rewarded for taking the risk - provided that is, that they are present on the ground in Moscow, run properly diversified portfolios, and keep a finger on the pulse.

Russia is a vital part of any emerging markets portfolio, and investors wishing to

prosper over the coming years must have some exposure to these powerhouses of global growth. While US-listed ADRs allow direct purchase of the Russian blue-chips, it would be unfortunate to miss the mid-cap opportunities, and for those not inclined to follow the market full-time (including nights and weekends), it would be best to invest via funds. The Russian bear is back, flaunting his new horns!

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