



Your first call...
For the second Tier!



Truth and Beauty...

(and Russian Finance)

After the ambulances go.

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BOYCOTTING CARLSBERG

We have been queried by several European journalists as to the possible effects of an increase in Western pressure over Chechnya. The answer is obvious: none whatsoever! Indeed, Western opinion on this issue is rapidly becoming totally irrelevant; we think the Russians right in treating it with contempt – try to imagine, just for a moment, the likely reaction in the US had Denmark hosted a conference for the Taliban in the week after September 11!

We reiterate our view that there is no near-term solution to the Chechen conflict, which will likely fester for many years to come. Russian public opinion shows no signs of pushing for a surrender – quite the opposite, recent polls have shown upwards 85% of respondents backing both Putin and the security services; we thus expect to see a robust Russian military reaction in the Caucasus.

Investors are remaining admirably cool headed. One local house has proclaimed that the Chechen situation is a major threat to Russian stability – another in a long series of calls which have generally proved almost comically inaccurate. Russia has lived through far worse; it will survive the occasional murderous folly (in terms of physical, rather than psychological impact, we would note that there were some 25,000 road deaths in 2001). Despite the events, the Eurobond market has seen a dramatic rise, with spreads compressing to historic levels, now only about 60 bp wide to investment-grade Mexico (and by the end of last week, more than 200 bp inside of Ford Motor Company!). Given that the Russian equity market has been rising in parallel with a general recovery in global

markets, it is hard to isolate out the effect of the banditry. We think that it has been essentially nil.

Our pessimism on the Chechen issue does not passively acceptance. We would hope to see the Russian government shake up the army command so as to improve its dismal performance in Chechnya; aggravation of the situation could be prevented by imposing tighter discipline on the troops, eliminating the senseless brutality and corruption which only serve to recruit more fighters to the rebel side. A well-funded, professional army would clearly do a better job. While Vladimir Putin has stressed that ethnic Chechens, the great

Winning the war, but losing the peace.

Several readers have suggested to us that the death toll could have been lower had the aftermath of the operation been handled more professionally. They are, alas, correct. On the one hand, it would have been an impossibility to set up a huge field hospital immediately outside the theater without tipping off the terrorists, and the special forces who carried out the heroic operation (had anything gone wrong, they would have been blown to shreds) were trained as commandos, not as paramedics. They were primarily concerned with removing the victims from the theater as quickly as possible, fearing explosions. Nevertheless, had proper first aid been administered on-site, rather than having the victims first transported to the nearest hospital, more of them could have been saved. Some of the unconscious were left lying on their backs rather than their sides (thus increasing the risk of aspiration asphyxia), and adequate Naloxone was apparently not available. The blame, as Mr. Bush correctly noted, lies with the butchers who committed this outrage, not with the rescue services who had never before dealt with a thousand victims overdosing on opiates, in the midst of gunfire, hundreds of kilos of high-explosives and heavily armed fanatics. One Russian official declared that Fentanyl could not kill people in normal condition. This is, of course, nonsense. There is an entire science dedicated to keeping alive people while they are drugged into unconsciousness – it is called anesthesiology! It is not usually carried out on hundreds of unprepared patients at a time, under battlefield conditions. In short, if the operation was amazingly successful, the follow-up was tragically mishandled.

majority of whom are loyal and hard-working citizens, must be protected, we are hearing increasing stories of their harassment at the hands of the local authorities - utterly unfair and totally counterproductive. The Moscow Times reports that one Azeri man was beaten to death by the police who were attempting to extract bribes from him and his colleagues. A reform of the police and the security services is also imperative; both corruption and senseless brutality have their costs.

Global Markets

ONE DAY IN THE DEATH OF THE NEW ECONOMY

After a moment's fumbling for its words, and some particularly Delphic pronouncements by Greenspan, the US Fed has signaled that it expected productivity growth to continue at the fiery pace of recent years. On cue, US durable goods figures came out the next day, showing a 6% plunge. After an initial sell-off, the market ticked up, assuming this number to mean that companies were not wasting money on capital

goods, and thus, that productivity could continue to grow, feeding not upon investment (i.e. the old economy), but, following the demise of the "new economy," upon good wishes alone. We wish them luck!

Once again, housing starts were up. If there was any residual doubt, this signifies that US economic expansion is now predicted solely on the over-leveraged consumer. This is going to end in tears, we think. The most recent beige book (finally) showed signs of a slowdown in spending; consumers may find themselves accepting the end to the era of unlimited growth, resigning themselves to living within their means. This would involve the paying down of debt, with a sharp decrease in discretionary spending. All the zero-percent financing in the world can't reverse that.

The most recent economic releases show that consumer confidence is now in free-fall, while unemployment is on the rise. The mortgage refinancing boom is reportedly drawing to a close.

Alan and the Seven Little Samurai

The US equity market has been on a roll, carrying a limp and seemingly lifeless Europa in its arms. The apparent reason is the expectation of one more hit of that ole' rate-cut amphetamine. It will almost certainly happen; we expect at least 25 bp before year-end. We thus resume our countdown – how many more rate cuts before we run into strong resistance at zero. Seven, as of today, and counting. We would NOT fight the Fed; the desire to short this bounce will be kept in check until after the next Fed meeting. Of course, the rate jolt will cause the body to twitch, but we doubt that it will raise the dead. On the fundamentals front, so many landmines lie buried, we hardly know where to start!

Earnings. No Great expectations.

Earnings are coming in better than expected, largely because companies have been busy cutting their earnings guidance. In those few cases where a real improvement is seen, this is due not to an increasing top line, but rather, furious cost cutting, resulting in job losses, demands for

discounts from suppliers and rapidly declining investment. Producers continue to lose pricing power and find themselves in desperate competition to win a larger piece of a constant pie. In the worst of cases, it is unsustainable even in the short term – Detroit is running hugely underfunded pension schemes, while pushing production with zero percent finance. Their credit ratings are heading south, rendering new borrowing problematic (and hugely expensive). This clearly does not provide a strong base for further growth.

The true threat to earning lies ahead. While some balance sheets may have been redressed in their Sunday best, there are some ugly things lurking just off the balance sheets, in particular, unfunded

pension liabilities, derivative structures, SPVs, and even those quaint trillion-dollar damage awards of which US juries are so fond.

Driving off a cliff

The automobile sector is the most striking example of cliff-edge finance. Interestingly, one of our American friends has explained to us that a growing proportion of US buyers take their cars on 3-year leases, to avoid being saddled with rapidly depreciating assets. When the leases expire, rather than restructuring the contracts to leave the cars with their old owners at their residual value, the manufacturers take the cars back, hoping to sell new ones, and dumping the used models in huge auctions which have all but killed the used car market. Clever, but hardly sustainable on the bonds; loss of access to the commercial paper market and a massive widening of spreads (above 10% for Ford) with the prospect of further ratings downgrades is going to render zero-percent finance insanely onerous. Sooner or later they will have to charge market rates. No prizes for guessing where sales will go!

CREDIT: A LIFE OR DEBT ISSUE

T&B continues to believe that the equity markets are but a sideshow. The true unwinding of the bubble is now underway in the credit markets.

Corporate credit: Bondage, and increasingly, (market) Discipline

While defaults as a percentage of total issuance are still running at below 10%, credit spreads on sub-investment grade bonds are near historic highs. Furthermore, the last two years have seen investors take major hits on instruments which had been investment-grade at issuance: WorldCom, Enron, Swissair and numerous others. Corporate bond portfolios are once again being impacted from a most unexpected quarter, with huge mark-to-market losses following Moody's downgrades of Ford and GM. The next wave, including ABB, may be about to strike.

The wave of ratings downgrades is showing a sign of abating. Downgrades outnumber upgrades 2- to 4-fold. Spreads for everything but the highest rated issuers are reaching historic levels. As would be expected, junk bond funds – only recently beneficiaries of diversification away from equity

funds – are now seeing massive outflows. The final effect is to close the bond market to many issuers. As these same entities have already been excluded from the commercial paper and equity markets, this leaves them highly dependent upon the banks. It is striking to note that, in the grim context, Russian bonds are again showing historic performance.

INVESTMENT CONCLUSIONS

Don't fight the Fed

Our friend Barry Hoffner, latterly of ING Moscow, has cogently argued that, as markets anticipate economic trends, most of the bad news may already be in the price; at least theoretically, it is not impossible that the current bounce in equity prices could be sustainable. Supporting this is the fact that corporate balance sheets are gradually being repaired, some debt is being restructured, and bank lending, while limited, has not collapsed. The US economy has a history of showing surprising resilience in the face of some massive blows.

T&B, on the other hand, believes that the worst is still before us. Coincident S&P P/Es are running to 30, not a promising level in a low-growth environment. Earnings growth, where it is occurring, is being driven by cost-cutting and cessation of investment, leading to non-replacement of depreciating assets; obviously, both of these factors will eventually run out. We think that the current bounce in equity prices was badly overdue, and we are frankly unable to predict when it will finally have run its course; a series of rate cuts will almost certainly delay the inevitable dénouement.

Finally, a gaping macroeconomic chasm lurks before us: the huge US trade deficit, which has gradually become the main support for global growth. Perhaps, Asian demand will take over; but how the US economy will deal with the inevitable correction we cannot even begin to assess.

Proficiency with chop-sticks

We believe that the current recovery in global equity markets is entirely due to the prospect of rate-cuts. While such cuts are advisable, indeed vitally necessary, we do not believe that they will solve the fundamental problems, and, given the arithmetic limitations, we expect to see global strategists becoming increasingly proficient in Japanese. Now that the market is no longer massively short, we will remain attentive to

attractive entry points to begin to short the most vulnerable sectors, in particular housing; given that the high volatility options, are very expensive; while awaiting the Fed, we will also watch for the options vol to settle down. If it does, we would look to buy puts, if not, bite the bullet and short the indices.

Treasury bonds are looking oversold; we continue to believe that the secular trend is towards falling rates. The risk of eventual monetization of debt leading to a sudden uptick in inflation is real but profoundly hypothetical. For now we are far more worried about the deflationary scenario. We do not know if it means anything, but in the recent treasury rout, certain spread products, especially emerging market debt, held up well – the treasury sell-off may have had more to do with technical factors and the actions or inactions of the Federal mortgage agencies than to a shift in interest rate risk perception.

Russian Politics

CHASING BEREZOVSKY: BUT WHAT WILL THEY DO IF THEY CATCH HIM?

Boris Berezovsky has been indicted for massive fraud against AvtoVaz in 1994-95. Anyone familiar with career of the man who was briefly Moscow's absolute power broker will be less than surprised; the beginnings of Berezovsky's possibly huge fortune were based upon appropriation of the cash flows of any company he controlled. The first of these was AvtoVaz, Russia's largest automobile producer, which he milked via LogoVaz, a company Boris set up to provide computer services, but which ended up controlling virtually the entire physical output of the factory.

The question is then not one of his guilt, but rather, of why the government chose to bring charges now. It is not impossible that the British will extradite Berezovsky, given an appropriately substantiated warrant. But, like a dog who continually chases cars, there remains that one vital question: *One day he shall catch it...but then, what ever shall he do with it?*

During the Yeltsin years, Berezovsky was intimately enmeshed with all levels of the Russian government. He is blessed with maniacal energy and an excellent memory. He could doubtlessly compromise many, many individuals still in power, who would like best to leave their pasts behind. Furthermore, this demonic, manipulative man

could most likely garner massive press coverage, both domestic and international, for the fascinating lies and half-truths he would doubtlessly tell.

In his comfortable London exile, Berezovsky seems to pose less and less a threat to anyone at all. His supposed "revelations" regarding the purported role of the FSB in the Moscow apartment blasts turned out to be nothing more than a re-hash of old stories; he brought no new elements, indeed, this already-discredited story was rendered even less credible in his retelling. Further, Berezovsky has just been chucked out of his own Liberal Party of Russia for having been caught in the act of desperately courting the Communist Party; the latter, unsurprisingly, spurned his advances in unfeigned disgust. The man is making a fool of himself. Why then not let him continue to dig his own grave?

Two explanations spring to mind. One is that the former *capo di capi* is up to mischief again, and could be posing some mysterious threat to the Putin government, which has thus launched a preemptive attack. But, far more likely, the wheels of Russian justice turn agonizingly slowly, and a judicial enquiry, started several years ago, may only now have reached fruition. Having started in the months following the Yeltsin resignation, when Berezovsky lost both his Duma seat and his political cover, investigators could only now have assembled a well-substantiated indictment. If so, they may thus feel no further need for political cover before proceeding against the disgraced oligarch. Never underestimate the power of bureaucratic inertia!

In any event, Berezovsky has more than one trick up his sleeve, if seriously threatened, he could probably get asylum in Israel (where he once held dual citizenship). We think a change from London's damp climate could be beneficial to him, and see no reason to hope for his return to Russia.

Russian Assets

FLIGHT TO QUALITY

T&B has been, quite frankly, surprised by market performance over the past few days. The weeks coming up to the hostage crisis saw the market becalmed in thin volume and a total lack of conviction; sentiment was certainly not improved by the crisis, yet, while the foreigners dropped out, the Russian accounts remained reasonably supportive. Although equity trading became increasingly nervous, prices fell only 3-5% during

the events, most surprisingly though, we saw a massive, still largely-unexplained rally in the bonds, leading to a sharp decoupling between the crunching debt spreads and the sluggish equity market.

The extent to which Russian equity prices actually respond to changes in DCFs (or some of the maddeningly complex surrogates invented by a couple of quantitatively-inclined local institutions) can be argued, however, it is abundantly clear that a collapsing risk-free rate must eventually feed into valuations. As always, T&B argued that this divergence would inevitably close up, however we did not see the near-term catalyst to make it happen. The best explanation we can offer is that Russia is catching a ride off of the updraft in global markets – if so, we would enjoy it while it lasts, but beware of a correction when NY next goes into the tank!

Despite the obligatory bearishness of some observers, the underlying Russian story is showing sure, steady improvement; even the rating agencies are beginning to catch on. The story is circulating that Moody's will upgrade Russia not by one but by two notches; most unlikely, we think; one notch seems quite enough, however Russia is definitely becoming THE safe-haven of the emerging debt markets.

OIL: SADDAMED IF YOU DO, SADDAMED IF YOU DON'T!

For once, we welcome every downtick in the oil price, since it seems to reflect the market's perception of decreasing war risk; we believe that the greatest threat to medium-term economic growth in Russia is the Iraqi situation. Not only could it lead to a substantial increase in Islamic terrorism, but a US invasion and occupation of Iraq would have wildly unpredictable effects on oil prices; at worst, this could constitute the sole realistic scenario where oil would durably drop outside of their current, beneficent range.

The terrorist outrage in Moscow further muddies the political waters. We expect the US administration to attempt to use this tragedy to pressure Putin into backing the US stance at the UN; equally, we expect this attempt to fail. Putin is no fool; the Chechens have received no support from Iraq; quite the contrary, Iraq is heavily beholden to the Russian government, and has no conceivable interest in seeing Russia destabilized. French diplomacy has apparently been particularly skillful, and a United Nations mandate sufficient to disarm Iraq without war and occupation is in view.

T&B is defaulting back to our previous stance, i.e. we will offer slightly better-than-even odds that a war will not occur. Ex- the UK, there are no allies: Turkey and Saudi are both terrified with Saudi making it clear that under no circumstances would they allow the US to use their territory for an attack; Turkey has just seen a landslide victory for an Islamic government. Finally, having gone before the UN, the United States can now less afford to ignore its views; financial markets clearly do not want a war which could prove exceptionally bloody and very difficult to end, and perhaps most vitally, Bush's party looks to do well in the November elections, having apparently succeeded in immunizing itself against the fallout from the egregious corporate governance scandals, and thus, has less need for convenient political distractions.

Emerging Market Debt

ARGENTINA

Our timid and very much hedged "buy" recommendation on Argentina is beginning to bring some joy. Although it is hard to get firm prices, there are beginning to be a few trades above the 20 level on the Eurobonds.

Bonds are trading solely on price and, like Russian MinFins in 1998 which were all priced at 6 cents – regardless of duration, the yield curve is wonderfully chaotic. There is no obvious cheapest-to-deliver asset, so trading accounts should either target the FRBs, the only bonds where there is any liquidity, or simply put up bids in the middle of the curve, and wait to get hit.

We reiterate our very speculative buy recommendation, however, this applies only to investors willing and able to await a restructuring, probably a matter of at least 18 months. We expect a haircut of a full 50%, along with a substantial reprofiling, however some of the bonds could be worth something in the mid-30s. Of course, investors must factor in the cost of carry,

deal risk and political risk. Against that, there is a potential upside of a good 75%.

BRAZIL

Brazil is also showing some life. Recent numbers are not at all bad. The current account surplus for September ran to \$1.3bn, thanks to a huge \$2.5bn trade surplus (i.e. Brazil is not Argentina). Of course, to put this in perspective, the Central Bank still expects a 2002 C/A deficit of \$11bn, followed by a deficit of "only" \$9bn in 2003. FDI continues to flow in, about \$12bn ytd; worryingly, capital flight continues unabated, and foreign trade credit lines are being withdrawn.

The bonds are responding well, with our recommended DCBs up almost 10 points (or about 25%). Most of the curve is now inside of the 2000 bp level, i.e. it has stopped trading at virtual default levels. Nevertheless, we are beginning to wonder whether this rally is not getting a bit ahead of itself; it could run for a few days more, but we would be inclined to take profits. Investors who still care to play should concentrate on either the cheapest assets (e.g. DCBs) or the long end of the curve (30s, 40s).

LIFE AMONG THE BOTTOM-FEEDERS: ECUADOR AND NIGERIA

Nigeria – Not all black.

Despite much huffing and puffing and hiring of investment banks, the P/N coupon was paid in full. Nigeria now seems to be backing away from the threat to demand restructuring of traded debt. Cynics may suspect that certain persons close to the government have done their size. We would run a modest position in P/Ns.

Ecuador is the new black-sheep of the market, having totally tanked, largely as a result of a murky electoral result. Without agreement with the IMF next year, Ecuador will be hostage to oil prices. Although there is some talk of renegotiating official debt, since they restructured the Eurobonds just 3 years ago, a further restructuring is not an option. At current price levels, risk-tolerant accounts

Saddam: Genius (well)-disguised.

For reasons we have never quite fathomed, Saddam is credited with evil genius and an uncanny ability to manipulate the world. This seems overly generous; the man appears more a blunderer whose ill-conceived and impulsive actions have brought disaster not only upon his country, but even upon his own regional ambitions. Saddam first embarked upon an unwinnable war of aggression against Iran (with at least tacit support from Washington); then, when this first adventure proved a bloody quagmire, proceeded to invade of Kuwait, possibly misreading signals from the American ambassador that the US would turn a blind eye. In fact, Saddam put the West in a situation where it was forced to go to war to prevent Iraq from exercising a stranglehold on Middle-Eastern oil. Saddam missed glaringly obvious signs that the West would drive his forces out of Kuwait, and, rather than beating a tactical retreat, allowed the destruction of most of his army and the curtailment of Iraqi regional power; fortune alone saved his presidency. Add to this the fact that he has subsequently done everything necessary to aggravate relations with the West, thus ensuring that Iraq remains under a debilitating sanctions regime, and one is not left with an overwhelming impression of "genius".

should be tempted – if the bonds give back a few more points, we would suggest investors look at the Ecu 30s, which offer the lowest price. At 2000 bp over, we are buyers.

Russian Finance

RUSSIAN EQUITIES - OUT OF THE BLACK

T&B sees a macro-driven market characterized by sectorial switching in and out of oils. As the hydrocarbons have single-handedly subtended the market for the past 6 months, it is only natural that they should be granted a bit of a rest. Earnings reports from both Sibneft and Yukos were mildly disappointing. Our friends from Sibneft are apparently back to their old tricks; having paid out huge dividends to its majority holders, Sibneft is now borrowing the same money back from them, at undisclosed rates, in order to bid for Slavneft.

The Slavneft auction is going to be seriously interesting. Market talk has it that as much as \$2bn will be paid for the 75% government stake. Both Sibneft and TNK have been busily raising funds, with TNK resuscitating its Eurobond, this time with an 11% yield. Since high oil prices this year have done wonders for their balance sheet, we suspect that this money is earmarked for Slavneft. The main beneficiary thus far has been Sibneft sub Megionneftegaz. Like in another recent privatization, all of the value is in the production sub; rumor has it that someone is buying it -- we wonder who that might be...

Elsewhere, investors are finally venturing out of the relative safety of oils into the wilder regions of the market – we are beginning to see demand in several of the second tier assets, forgotten until recently.

RUSSIAN BONDS – SLOUCHING TOWARDS SWITZERLAND

We are still searching for a convincing explanation of the massive move in Russian debt. Two weeks ago, we had assumed that much of the support was either local buying or flight to quality, i.e. investors pulling out of Latam and switching to whatever looked safe. In fact, the move in the Russian bonds has paralleled a general recovery in the emerging debt markets. We do not see a sharp increase in local purchases, so, besides the news from Moody's, we think that it is a mixture of short covering after they break through 72.5, an

off-tested resistance level for the Rf30s, and new money anticipating Russia's gradual progress towards investment grade.

Moody's has surprised the market (and T&B) by apparently suggesting that a 2-notch upgrade was conceivable, i.e. to BB+; if one notch was already priced in, two notches is most definitely not. Hardly a day goes by without someone asking us when will Russia go investment grade; Russia-bulls though we may be, we currently see no justification whatsoever for Russia receiving a triple-B rating. Progress over the past 3 years has been astonishing, but most of the road lies ahead. Putin must create a real political party with an obvious mechanism for succession, a loyal opposition needs to evolve, and a level playing field for businesses must be bulldozed, especially in the regions. Then, all we need to do is reform the courts, the police, and the bureaucracy...i.e. not this week, we think.

At a price of 77, we think that the Rf30s are fully priced, and we would step back, indeed, if there is any volatility, we would be tempted to sell covered calls. Longer term investors can simply keep buying; although we may well see lower prices this month, eventually, the 30s may well trade through par!

Afterword – The narrowing gyre

Dear Abby

Sometimes T&B feels like a “sob-sister” newspaper column for young, frightened finance professionals. We have lately been getting a good deal of correspondence bemoaning the purported breakdown of the moral fabric of society, the end of international order, and the further encroachments of things that go “bump” in the night. Once again, we are reading ominous quotes from the famously turgid writing of that renowned medieval French monk, defrocked not so much for heresy as for his penchant for the bottle and his strikingly unusual personal habits.

Someone is turning the tables on T&B! No one has yet to accuse us of Pollyannish overoptimism, however we do think that some sense of proportion is called for. The current situation IS ugly. The Middle East has been allowed to fester for several decades. It is hardly surprising that it comes back to bite us now. Without wishing to initiate any long correspondence on the subject of Israel and the Palestinians, anyone in their right mind should understand that a continuation of the present situation is simply not an option. Religious fundamentalism and intolerance is clearly on the upswing; again, this is NOT confined to Islam, though they seem to be hogging the headlines these days. We would add the threat of a US administration that T&B believes to be the worst American presidency of the past century. Finally, the global economy is under some strain, and despite several decades of rapid growth, the steadily increasing inequality in income distribution may not be sustainable.

Nevertheless, we are by no means certain that society ever HAD a moral framework. The rules have always been made, to a great extent, by the “haves” to keep the “have-nots” at bay. This is not expected to change, and indeed, it is now fashionable to make at least some attempt to maintain a humanitarian façade. Slavery, torture and the death penalty, while still extant, are gradually fading into oblivion.

As for the international order, if it looks bad now, then think back 60 years, to when the world seemed sure to fall into the iron grip of totalitarianism: at best, Communism, at worst, Nazism. The historically-minded will perhaps think back further, to the collective insanity of the Thirty Years War, a conflict between the Catholic and Protestant powers which reduced much of Mittel-

Europa to ashes, ravaging half the continent to such an extent that, in some parts of Germany, populations took the better part of two centuries to recover. Our Russian readers, of course, need look back just a few years to a far worse time, and characteristically, seem rather less worried about the current global context than do their Western peers.

Finally, although the global economy looks bad, it seems likely that the world will muddle through; baring a major blunder by the Western powers, T&B thinks it most unlikely that we will be confronted with a 1930's style depression... if we are wrong, of course, our readers are cordially invited to join us on our land in New Zealand!

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