

Truth and Beauty...

(and Russian Finance)

- The Purifying Blade -

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Russia and the West

During a recent press conference in Paris, increasingly irate with the famously tendentious and hypocritical French press, Vladimir Vladimirovich Putin finally blew up, petulantly lecturing a reporter on the evils of hard-line Moslem fundamentalism, before inviting him to Moscow for a circumcision, which— so guaranteed Mr. Putin – would be carried out in a way which ensured that “nothing would grow back.”

T&B is often vastly entertained by the total absence of political correctness in Russia, and Vladimir Vladimirovich Putin is Russian down to his fingernails. Nevertheless, in this instance, we think that he should have at least enquired as to whether the reporter in question (we assume it was a “he”) was not already circumcised. Religious issues aside, circumcision is not a procedure which benefits from repetition. More to the point, this incident is instructive both concerning Mr. Putin’s psychological makeup, and Russia’s current relationship with the West.

THE END OF THE HONEYMOON

T&B has long lamented what it perceives as the inability of the West to comprehend most things Russian. In 2000, several years after the crisis, Western perception was still of starving pensioners, long lines before empty bakeries, shoot-outs on every street corner, and the (somewhat premature) demise of the Russian middle class. Gradually, and especially following the September 11 outrage, the West began to come under Putin’s spell, and we briefly basked in the renewed sympathy. Now, alas, public opinion seems to have defaulted to type—the US is piqued by Russia’s odd notion that her interests are not always identical to those of Washington, while the European press seizes upon the Chechen imbroglio to express its stereotypical scorn of the cruel Russian bear.

Fortunately, from the investors’ standpoint, this is all something of a non-issue. Russia benefited little, if at all, from the waves of adulation showered upon first Gorbachev, then Yeltsin, in the early 90s. If anything, real reform and new directions were found during the deep chill which followed the scandals of ‘97 and the crash of ‘98. Somehow Russia survived the loss of both the precious advice of the IMF and the fast money from the West. Now again, the mendacious chatter of the French press and the empty pontification of the council of Europe will irritate, but should cause no real harm.

As for the President, Mr. Putin views the conflict with the Chechen bandits in a fashion not entirely dissimilar from George Bush regarding the Taliban – neither men seem particularly nuanced in their views. While much has been made of the difference between the two terrorist bands; we think that these differences are outweighed by the obvious similarities. Vivaldi, Bush has the luxury of fighting an enemy, which despite one spectacular incursion onto American soil, is based in far-off lands. He has understandably received enthusiastic support from virtually every country in this fight against a particularly vicious enemy. Russia, on the other hand, engaged in a life-and-death struggle with the wolverines stalking her southern flank and manifesting disinterest in any compromise, is not granted the benefit of any doubt.

Reasonably flexible and open to discussion on most other topics, Vladimir Putin lacks any sense of humor regarding the Chechen issue; Western journalists who have had the opportunity to observe the President up close find this to be the one topic where he is totally inflexible. We continue in the forlorn hope that, by bringing the army under some semblance of civilian control and building an ethnic Chechen administration capable of combating the terrorists, this conflict can be gradually wound down. Again, we do not believe that it poses any threat to overall Russian political or macroeconomic stability.

Global Finance

COUNTDOWN TO ARMAGEDDON: AND THEN THERE WERE ~~SEVEN~~ FIVE

In our last issue, T&B predicted a 50-basis point reduction in US rates by year end/early 2003. We had expected the Fed to conserve ammunition, so as to avoid finding its back against the wall before the prayed-for uptick in business investment rescued the economy from its fatal embrace with the American consumer. In the event, the Fed surprised the markets, managing a situation we think hopeless with considerable panache. By cutting 50 basis points, while simultaneously declaring victory by shifting to a neutral bias, they hope to administer a sharp psychological boost, avoiding the expected buy-the-rumour/sell-the-news reaction. Alas, if only it were a question of psychology...

The market responded constructively to the cut, especially as subsequent economic releases seemed, at first glance, market-friendly. In fact, recent numbers simply confirmed the trend. The US

consumer is continuing to spend despite his growing debt burden; although headline PPP was up sharply, prices were flat ex-automobiles (where the new Detroit paradigm - lose money on every unit sold, make it up on the volume - is now proving untenable), "productivity" continues to climb. Unfortunately, this last number is something of a misnomer. The improvement in productivity is simply the reflection of continued layoffs, with companies squeezing more production out of their remaining staff, while cutting back on R&D and investment.

THE US DEFICIT

T&B misses no opportunity to reiterate its characterization of the current US administration as arguably the worst of the past century – at least insofar as economic policy is concerned. While modest in relative terms, in absolute terms the growing US deficit must now be factored into long-term investment strategies. In a matter of two years, US federal finance has gone from a situation where Treasuries were thought an endangered species to one where multi-hundred billion dollar deficits are likely to become permanent. In a deflationary context, these deficits will prove considerably more onerous than previously.

Contrainitively, while the US proposes an invasion of Iraq on the grounds that Saddam may intend to build nuclear weapons, North Korea's announcement all but admitting that it already has such weapons grabbed the headlines for perhaps two days. The story was subsequently allowed to die, with nary a threat of US military action. Perhaps the key to this seeming paradox is geological – Korea is not blessed with any substantial hydrocarbon deposits...

IRAQ. SADDAMED IF YOU DO, SADDAMED IF YOU DON'T...CONTINUED

A step back from the brink, as the Iraqi regime has accepted the UN resolution without condition. We reiterate our (minority) view that war is NOT inevitable. Having accepted the diplomatic process, the United States will be hard-pressed to justify what would appear as a war of aggression,

provided, of course, that Saddam does not make a mockery of the inspection process. Financial markets are apparently beginning to agree with us and the oil-price war premium is coming off. This is definitely a lesser of two evils. Russia can readily live with oil in the low twenties/high teens. The threat of an oil price collapse following a successful US occupation of Iraq is, on the other hand, rather more dire.

OIL PRICES – THE MISSING BARRELS COME HOME?

On oil prices, T&B has been systematically more bullish than consensus since 1999. While most of our competitors, both international and especially domestic, were predicting the long-awaited collapse in oil, we expected prices in the mid-high twenties on the basis of long-term petroleum dynamics, in particular the rapid increase in Asian consumption and depletion of OECD reserves. Thus far, it has proved a most rewarding position.

We are now alarmed to see the consensus view turning bullish, just as we are beginning to worry. Substantial strategic reserves have been constituted in the expectation of war, economic growth is dead (except, perhaps, for China) and while non-OPEC production continues to increase, OPEC discipline is pathetic. Mysteriously (perhaps simply tired of being made monkeys of by the market) the bulge-bracket is busily upping its oil projections, with JPMorgan increasing its 2003 Urals price estimate to \$23.8. Our best guess is that oil prices remain in the mid-twenties, however our degree of confidence is limited.

Currencies

EURO-ANALYSIS: AN IDEA WHOSE TIME HAS NOT COME.

As long predicted here, and by many, many others, the dollar is finally showing a sustained trend towards depreciation. The Euro is the main beneficiary, not because of any conceivable virtue of the European currency, but simply because, as global growth seizes up and capital is repatriated, Europe has no current account deficit to fund, while the US requires capital account inflows of well-nigh \$2 bn a day to balance its trade deficit. As US rates move inexorably towards Japanese levels without any appreciable increase in economic growth, the interest rate differential favours diversification out of the dollar.

We have long believed that, as a currency, the Euro was pure economic nonsense, pushed by a political caste of Eurocrats, generally ignorant of economic affairs and driven by the imperatives of maintaining their own power. Launched with great hoopla on the back of a hugely expensive publicity campaign scandalously funded with taxpayer money, the Euro quickly grabbed a substantial slice of the global bond market. Nevertheless, we thought it clear that the Euro would be a fair-weather currency, falling victim to its own illogic at the first hint of economic turbulence. This now appears to be the case.

Without drawing judgment upon the desirability of a United States of Europe, the establishment of a single European currency should have been the final consecration of total European economic and political integration; using it as a bludgeon to force such integration is breakneck in the extreme. It can work only by forcing deep recessions on countries in desperate need of monetary stimulus.

The oft-cited comparison with the US dollar is an excellent example of why it does NOT work. A somewhat federal country, the United States clearly benefits from having a single currency, reaping huge seigniorage from the world's reserve currency, while maintaining a gaping current account deficit for longer than would have been conceivable in any country not able to print dollars. Nevertheless, the dollar "works" because the US is indeed a unitary country, having a single legal system, language, culture and educational system. If San Diego tips into recession while Chicago is booming, workers pack up and move East. We have yet to see hordes of unemployed Dusseldorfers pulling up stakes and heading for Dublin or Lisboa, nor do we expect to anytime soon.

The situation of Europe's powerhouse economy, Germany, is truly parlous. Mired in recession and a deflationary spiral, Germany is saddled with very high real interest rates due to the imperatives of a one-size-fits-all monetary policy. Given Germany's primitive financial system and inability to reform structural impediments to growth (political weight of the unions,

labour inflexibility, restrictive regulation, destructive competition of state banks with private financial institutions, etc.) it is deprived of any obvious mechanism for adjustment.

It was obvious that, under the circumstances, something had to give; it was the Stability Pact, now a dead letter. The two largest economies in Europe are thus reduced to using the single most inefficient and antiquated means of reflation: massive deficit spending. Not only are these measures proving no more successful than they did in Japan, but their eventual effects on investment flows and interest rates are not expected to be felicitous.

Perversely, in a manner somewhat reminiscent of Argentina's poison-pill constitutional enshrinement of convertibility, the same Eurocrats who invented the common currency cleverly designed the process of adopting the Euro so as to render it effectively irrevocable. If it does, as we expect, prove unworkable, it will be of considerable interest to see how, if at all, it can be dismantled.

Investment conclusions

In the near term, given the lack of viable alternatives, we remain long Euros against both Yen and Dollars, hedging Russian dollar exposure with Euro swaps. We are skeptical of gold, which strikes us as just another commodity, and no other currency could conceivably absorb the outflow from the dollar. In the land of the hideous, the merely unsightly seem beautiful by default.

From a global perspective, our bearishness is unchanged. We believe that the world economy still has a serious unwind ahead. The obvious question then becomes: wither Russia? Indeed, T&B spends much time cogitating upon this very question, perhaps the single greatest concern evinced by our clients. We will return to it in our next issue, however, in brief (and despite a recent report purporting to demonstrate the total absence of correlation between the Russian market and Wall Street), as anyone with access to a trading screen knows, when the global markets start to tank, Russia joins in the fun. Despite this, Russian markets

have handily outperformed every global financial market this year, both debt and equity. Thus, if the global massacre resumes in earnest, we would want to be out of everything but Russian debt and selected illiquids; our strategy would then be sharply focused on awaiting a bottom so as to go massively long Russian blue chips. From the fundamental standpoint, we believe that, perhaps along with India and China, Russia is one of the economies best able to weather global storm. Investors able to do relative-value trades, i.e. long Russia / short global markets, should be well rewarded.

RUSSIAN CURRENCY CONTROLS

Many of our peers are showering (somewhat self-serving) congratulations upon the Russian government for moving towards liberalization of currency controls. Once again deviating from the strict liberal dogma, we agree in principal, but find such liberalization very much a two-edged sword.

T&B sees no objection to liberalization of capital outflows, provided that the Central Bank retains the possibility of slapping them back on in an emergency (and preferably, lets no one forget that they have retained this power). The trade balance is massively favorable, Russian capital is already being repatriated, and, as Oleg Vyugin correctly points out, even in the best of cases, capital outflow controls are only about 20% effective.

The danger, as we see it, lies with capital inflows. Russian capital markets suffer myriad problems: misallocation of resources, lack of intermediation, inadequate risk management, illiquidity, etc. One problem Russia is NOT faced with is the simple lack of money. While, arguably, FDI ex-hydrocarbons should be encouraged due to the management skills and technology it brings with it, given the anarchic nature of Russian finance, political liability, and perhaps, something of a national tendency towards excess, a renewed dependency on foreign inflows must be avoided at all costs. In particular, encouraging local entities to borrow cheaply in foreign currency in order to

play domestic markets is tantamount to buying a stiff drink for an ex-alcoholic.

With domestic rates still in the high teens and currency depreciation running at no more than 6-8% p.a., the CBR would be doing a grave disservice were it to allow investors to assume an implicit guarantee of stable exchange rates. On the domestic market, although given the traumatic experiences of 1998, foreigners are understandably wary of the ruble, memories fade fast, and with Russian domestic rates very attractive – especially as contrast the senior markets – it is only a matter of time before foreign hot money comes sniffing around again.

Since 1998, the Russian story has been one of gradual restructuring and domestically-led growth fed from domestic capital sources. We fervently hope to see this model retained.

Politics

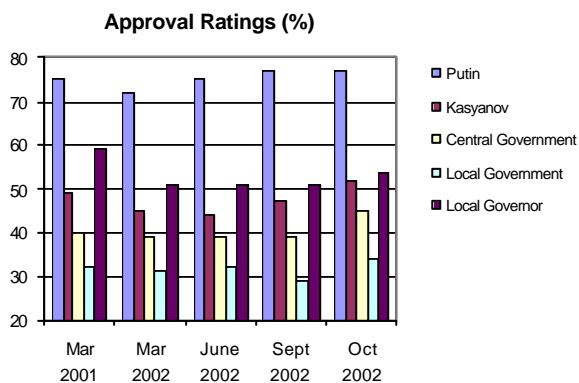
TOWARDS THE DUMA ELECTIONS – LOOKING FOR A REALLY GOOD PARTY...

The unarguable success of Vladimir Putin in unifying the command-and-control structure of Russia, reining in the oligarchs and regional power-brokers who previously rendered the country all but ungovernable, has masked a fundamental problem, that of political sustainability.

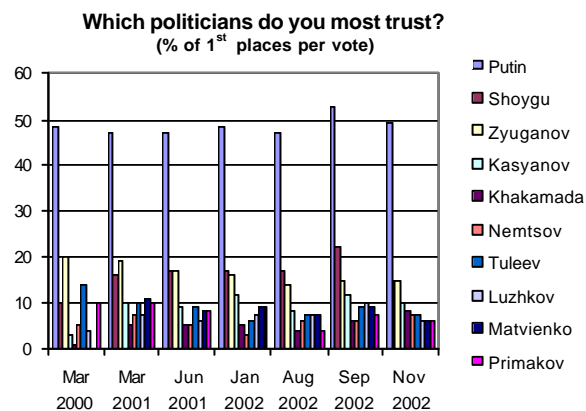
We have often argued that the main impediment to Russia attaining an investment-grade rating is the absence of an obvious mechanism for Mr. Putin's succession, as well as the archaic structure of the political landscape. What is needed is a "loyal opposition," one which could eventually allow alternation of power between parties, not questioning the fundamental nature of the state and the system of property ownership.

At present, the Russian political system is best described as a "managed democracy." Political power is heavily concentrated in the hands of one man, Vladimir Putin, who has assembled an *ad hoc* political party reflecting the imperatives of power in the Duma and the regions, rather than any particular political ideology. Given the chaotic situation inherited by Putin, this is readily comprehensible; his first imperative was the creation of a power base allowing Russia to be governed effectively. Indeed, in view of the extensive, painful and often highly unpopular reforms lying ahead, before damning this compromise on the ground of abstract political theory, one must first ask the question "what would have been the obvious alternative?"

Having passed the first hurdle, the issue is now one of rendering the advances sustainable – even the most carefully managed democracies are faced with the need for periodic reconfirmation by the electorate. The



Source: VTsIOM



Source: VTsIOM

immense personal popularity of Vladimir Putin renders him unassailable – more than two years into his term, his approval ratings are holding remarkably stable at 70-80% (and this, in a country which is not generally kind to its leaders – six months into their terms, his two predecessors rarely climbed into the two-digits).

Recent opinion polls suggest an increasing “feel-good factor;” Putin leads the pack, but there is a diffuse improvement in the approval ratings of Prime Minister Kasyanov, the Federal government, the governors, and even of the regional power structures. The obvious explanation: a gradual improvement in living standards as well as the improved conduct of the economy, providing an unaccustomed sense of predictability.

Equally significant, Putin’s possible competitors lag far behind; no one else polls better than 15%. His closest competitor, Zyuganov, is perched atop a wasting asset, as the elderly Communist electorate, nostalgic for the safe predictability of the Brezhnev years (and, perhaps, simply for the days when their sinews were springy and their limbs lithe) gradually dies off. Furthermore, his once monolithic Communist Party is threatened with a deep split (*vide infra*). The only foreseeable risk to political stability is thus the December 2003 Duma election.

The early history of Russian democracy was colorful in the extreme. At one point, the Russian body politic benefited from the aspirations of several hundred political parties, some of whom were truly exotic: the Beer-drinkers party, the various Monarchists and Christian revivalists, as well as at least one party advocating polygamy were particularly memorable. The Duma of the early 90s faithfully reflected the dislocations of Russian society; observing it – with its fist-fights, Communist grandstanding, and open corruption – was a bit like turning over a rock, curious in the extreme, but not for the squeamish.

Yeltsin’s almost miraculous 1996 come-from-behind victory was unfortunately not accompanied by the chance to elect a compliant Duma. The Communist Party and its then-allies, the Agrarians and People’s

Party, retained a commanding lead. Aligned against them was a fragmented right (Yabloko, Democratic Choice of Russia), Zhirinovsky’s clownish, corrupt LDPR, and Chernomyrdin’s personal vehicle, Nash Dom Russia. The result was, of course, legislative paralysis. Communist-initiated legislation generally encountered Yeltsin’s veto, which the Duma was unable to overturn. Nevertheless, while the constitution allowed the President to essentially manage day-to-day business by decree, the logjam in the Duma precluded any hope for passage of reformist legislation. With the government unable to reform the tax code, enact reasonable budgets, or control the debt spiral, the country lurched ineluctably towards financial collapse.

Like much else in Russia, the fundamental inflection point was the 1998 crisis. With the fall of the unfortunate Kiryenko (who deserved better than to inherit the command of ship fatally holed below the waterline), Yeltsin’s first choice for Prime Minister, the thoroughly discredited Viktor Chernomyrdin, was twice rejected by the Communist-led Duma; a third rejection would have plunged the country into a constitutional crisis with chaos threatening. With Russia already teetering after the default, rather than force a break, Yeltsin made a felicitous choice: Evgeny Primakov, a man of the past, but who was acceptable to a broad cross-section of the country, and who succeeded in providing a desperately needed period of political stability after the tempest.

In typical Yeltsin style, only six months after his appointment, as Primakov began to challenge the President, he was fired, to be substituted with the unexceptional Stepashin. Primakov allied himself with the equally Soviet Moscow mayor, Yuri Luzhkov, founding the Fatherland-All Russia party – a paternalistic, left-of-center, would-be “Party of Power,” grouping together the regional governors and potentates. Briefly, this party looked ready to win power, perpetuating the Primakov model of a socialist post-Soviet Russia.

Yeltsin, of course, had one last trick up his sleeve, and in August 1999 chose as prime minister the relatively

obscure chairman of the Security Council, Vladimir Putin. The 1999 Duma election, fought under the first Putin Premiership, was brilliantly managed by Dmitry Medvedev, Head of Putin's electoral committee and Alexander Voloshin, arguably the Kremlin's most influential *apparatnik*. Two major blocks opposed the Communists: on the liberal right, despite the refusal of that ultimate vestal virgin of Russian politics, Grigory Yavlinsky, to form alliances with anyone at all, Anatoly Chubais cobbled together a liberal coalition grouping the "Westernizers" under SPS – Nemtsov, Kiryenko and Khakamada.

The center was represented by the "party of power", Unity (Edinstvo), the Putin government's answer to Fatherland-All Russia (Otechestvo-Vsya Rossiya). Unity was nominally run by Emergency Situations Minister Sergei Shoigu, but was effectively under the control of the Yeltsin "Family", in particular Voloshin. Both Unity and Fatherland-All Russia were essentially ad hoc political groupings, each intending to be the party of power, and thus, a pole of attraction for opportunistic politicians having strong regional power-bases but lacking any national structure. Unsurprisingly, as it became evident where the real power lay, Unity stole Fatherland's thunder, and, soon enough, the major players were defecting to Unity almost daily with the Luzhkov-Primakov vehicle looking to become a hollow shell. With the Federal government increasing the pressure on Luzhkov's mayoral power base (the City of Moscow was still, for all intents and purposes, bankrupt) the Mayor, snarling and sputtering like a drenched cat, agreed to an alliance with Unity, effectively abandoning his national political ambitions in exchange for security of tenure in his Moscow fiefdom.

The election was, of course, a sweep. Despite a split due to Yavlinsky's refusal to bring his Yabloko party into coalition, the liberal right scored well, for the first time winning a significant representation in the Duma. The Unity-Fatherland block took an overall majority, reducing the Communists to relative impotence. The rejoicing was tempered only by Putin's surprise decision to give Zyuganov's party a disproportionately generous share of

plum Duma committee chairmanships. The right was bitterly disappointed, but it was the Communists who should have looked this particular gift horse in the mouth... Putin had, in effect, lured them into the river, with the manifest intention of stealing their clothes whilst they were out swimming (see below).

2003: ONWARD – INTO A RADIANT FUTURE

The 1999 Duma has lived up to the high expectations vested in it, passing perhaps more significant reform legislation than had been cumulatively enacted since the reign of Peter the Great. Results of Putin's campaign to rein in the regions have been rather more mixed, with some fairly unaesthetic compromises proving necessary. The government's overwhelming success in management of the economy is no longer controversial; the problem is now that, despite Putin's enormous popular appeal, little attention has been given to the imperative of building a stable political party capable of assuring a friendly Duma for his second mandate.

Paradoxically, the Communist Party leads in the opinion polls, still winning 31% support, albeit a gradual decay from historic levels of 35-37%. Given Russia's majority-weighted polling system, were this to translate directly into votes in the legislative elections, the Communists would gain an absolute majority in the Duma. Fortunately, a Communist victory seems about as likely as snow in August, this for three main reasons:

-Firstly, polls should not be taken as expressing actual voting intentions, but rather, the mood of the body politic. Historically, respondents to Russian opinion polls tend to use them as an opportunity to express protest at whatever they see amiss in the general state of things, but tend to be more moderate in their actual voting. As an example, although a year before the last Duma elections, the Communists polled well over 28%, they went on to win only 21% of the actual votes.

-Secondly, it should not be forgotten that state control over the main audiovisual media will give the Government parties a huge advantage, especially in the

regions, where television remains the primary source of information.

-Thirdly, the Communist party, in serious trouble, is ceasing to be a unitary force. As noted above, in the aftermath of the 1999 Duma elections, Putin showed inexplicable kindness towards Zyuganov's party, offering them key Duma chairmanships and offering Seleznyov the post of Duma speaker. Regularly consulted and flattered, Zyuganov was soothed into feeling himself a *de facto* coalition partner, slipping into a public position of "critical support." Needless to say, as soon as Putin had consolidated his position, the Communists were publicly and unceremoniously ejected from all but two token committee Chairs (from which they promptly resigned in protest). Furious and still bewildered, Zyuganov ordered Seleznyov to resign his post as Duma speaker; the latter demurred, and after a month on fruitless negotiations, the KPRF had no alternative but to exclude Seleznyov, who has now founded his own party, Russia's Revival. Seleznyov is reported to be seeking an alliance with Mikhail Gorbachev, and

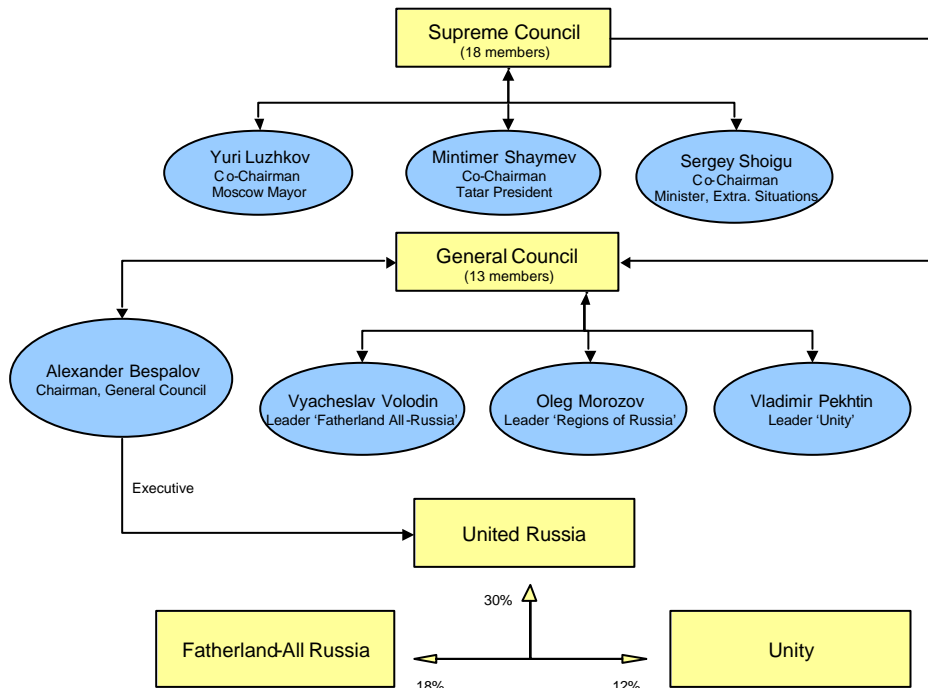
perhaps, to be moving to found a Russian Social Democratic Party.

Even within the Communist Party, Zyuganov is, for the first time, coming under challenge; Sergei Glazyev, who polled a respectable 20% in the Krasnoyarsk gubernatorial race, is bidding to replace the Chairman, and in this he is undoubtedly receiving strong support from the Kremlin.

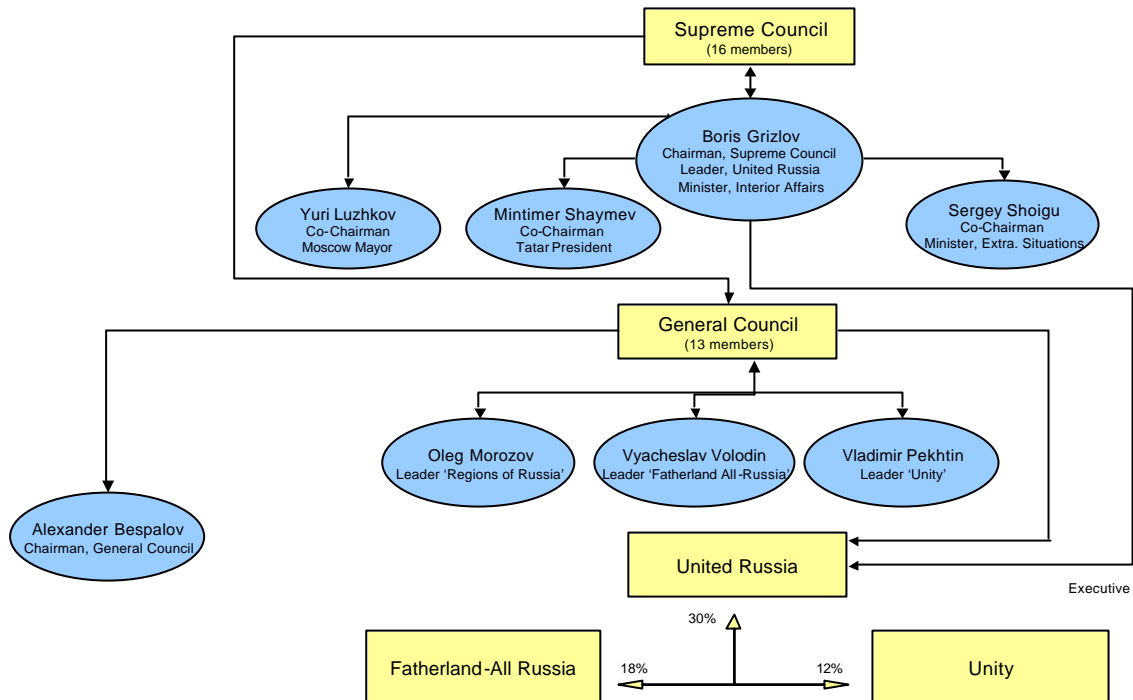
MEANWHILE, BACK AT THE RANCH...

None too soon, Putin appears to be applying himself to the transformation of Unity from an ad hoc grouping into a true political party. Bespalov, the current chairman of the General Council (United Russia's working administrative body), has been generally making a nuisance of himself, most recently floating a proposal to set a hurdle of 12.5% for representation in the Duma, this without the formality of first seeking Kremlin approval. More to the point, he has proved himself

United Russia: Before the Putsch



United Russia: After the Putsch



a mediocre, unpredictable politician. The government is bringing a bill before the Duma to permit ministers to also serve as deputies thus allowing constitution of a true governing party along European lines. Concurrently they are moving to restructure United Russia, creating a new position for Interior Minister Grizlov, Party Leader and Chairman of the Supreme Council, while, moving Bespalov to a largely ceremonial post.

Grizlov is politically adept, as well as being very popular, benefiting from strong public approval of the government's handling of the Nord-Ost hostage crisis. In his new position, he would have the power to replace any of the three co-chairmen, Luzhkov, Shoigu and Shaymiev.

THE RUSSIAN RIGHT – A BITE OUT OF THE APPLE

In the aftermath of the hostage crisis, the Liberal Right has shot up in the opinion polls, gathering a combined 19 per cent of the voters, up from 16% one month

ago: Union of Right Forces (SPS) gathered 11 percent, up from 5 percent in September, while Yabloko (Apple) under Grigory Yavlinsky gathered 8 percent, up two points. The sole factor preventing a consolidated party of the right from becoming a major power broker is the split between SPS and Yabloko. We have long lamented the none-too-bright Yavlinsky's obsession with political purity. This irritation is now increasingly shared not only by Nemtsov and associates, but also by the Kremlin, widely believed to have offered Yavlinsky several different positions within the administration, most recently Head of the State Construction Department. Unfortunately for the aging virgin, the positions tendered have been distinctly mid-level, and thus far, the offers have not been accepted. Given his long years of loyal service to the liberal cause, we deeply hope that something suitably prestigious (and preferably harmless) can be found for Yavlinsky (it is rumored that the Press Ministry may soon be vacant). In his absence, his Yabloko party could easily affiliate with SPS, allowing the constitution of a strong, experienced, and

pragmatic liberal block, this for the first time in Russia's history.

If we have interpreted the political noise correctly, we believe that Russia is moving towards a three-party model of parliamentary democracy: a Social Democratic party built upon the ruins of the Communist Party, a centrist presidential party, and a broad liberal-right coalition. If so, this marks a remarkable step towards political maturity.

Russian Finance

RUSSIAN DEBT MANAGEMENT – NOW, TELL US SOMETHING WE DIDN'T KNOW...

In a previous incarnation as Moscow Head of Fixed Income for a large German bank, on 27 September 1998, a little more than a month after the August default, T&B put out its first, tentative "buy" recommendation for Russian Eurobonds, this largely on the basis of an off-the-cuff remark by Mikhail Kasyanov^{*}. At the time, the Russia 28s were priced at 23-25; last Friday, they closed at 133.5. Not bad, for a fixed-income instrument...

Since that time, we have regularly reiterated our expectation of a gradual, inexorable tightening of spreads; nevertheless, T&B was wrong-footed by the spectacular run of the past two weeks. Whilst we had not excluded the possibility that strong resistance at 72.5 could be breached, absent inside information, there was no rational reason to expect a frantic 7-point run.

The initial explanations shopped around the market were totally lame: short-covering, diversification out of Latam debt (which, in fact, also had a good week...), the expected upgrade of Russia, high oil prices, an anticipated Fed cut, the end of the Brazilian electoral cycle, and the short-term bounce on Wall Street. Of

^{*} Mr. Kasyanov justified the terms of the despoliative GKO restructuring on the basis that, among other things, he needed to protect "European babushki and dedushki" (grandmothers and grandfathers) who held Russian Eurobonds. While we had been previously unaware that these instruments constituted a substantial part of conservative European retirement portfolios, we were deeply touched by Kasyanov's solicitude, rightly assuming that he intend to protect someone's nest egg...

course, the fact that most of these factors have either been extant for months, or were readily foreseeable, was conveniently neglected. This week, it was the Russian press that came closest to the truth, getting it half-right with a report that the rally had been triggered by the State Pension Fund buying long-dated assets through Vnesheconombank...half right! It was VEB indeed, although the State Pension Fund had little, if anything, to do with it.

Quite simply, flush with more cash than it knows what to do with, the Russian government quite reasonably decided to grant itself some debt relief, buying its long-term debt obligations out of the market. Indeed, the rationale for Russia sitting on massive currency reserves – yielding 1.25% – while servicing Eurobonds costing 12 ¾% never struck us as entirely self-evident. Until recently, perhaps the worst-kept secret of the Russian market was the fact that government-affiliated financial institutions (VEB, VTB, Sberbank, etc.) were massively buying MinFin IVs and Rf03s, so as to flatten out the 2003 debt hump (which, however, has recently been resuscitated, as a scarecrow to warn the Duma off a pre-election spending spree). Having bought up every scrap they could find, the obvious thing to do was then to target the long end. This they did, with truly spectacular results. As of this writing, Russian debt spreads are rapidly converging with investment-grade rated Mexico, and are now 350 bp inside of Ford Motor Company.

INVESTMENT IDEAS - DEBT

Our partially-covered straddle trading idea has, of course, worked out splendidly (though not as well as would have a simple cash purchase of the underlying asset, with concurrent sale of a put). There is now no reason to buy back the puts; given that the paper has flowed into the hands of the ultimate buy-and-hold investor (the Russian government), we do not expect any substantial back-flow. The FTO deal, apparently now closing, should be readily absorbed.

Ukraine – Keep some powder dry

Several months ago, we advised clients to take profits on the Ukraine Eurobonds. As spreads to Russia collapsed to near 150 bp, we saw no conceivable reason to assume the additional risk. Now, after a downgrade and with some nasty words with Ukraine's erstwhile American sponsors, the Ukrainian bonds are becoming temptingly cheap again. Debt dynamics are excellent, with a 2.5X debt service coverage ratio, and foreign reserves are up above \$4bn. With new issuance on its way, we would wait to see where things settle before rushing back in, but would look to buy Ukraine at a spread north of a 500 bp to the Rf 05.

INVESTMENT IDEAS - EQUITIES AND INEQUITIES

At long last, a bit of life has been coming back into the equity market, as there has been a drift from the oils, in particular "Yukneft" (the postmodern answer to the "Lukgut" of old) to the domestic stories. Alas, this has been happening against a backdrop of diffuse strength in senior equity markets. Since T&B does not believe that the lows of October are likely to hold, we fear that if the US market tanks, Russian equities may head into another period of, at best, drift.

We have been strongly advising clients to shift into RAO-UES, not because of any particular insight into the restructuring, but simply because we had heard rumors that UES management was buying, visibly and quite aggressively. Now of course, "UES management" has neither the wherewithal nor, for that matter, any pressing need to buy its own shares; this leaves various obscure oligarchic industrial groups as prime suspects. They, of course, would have an excellent reason to buy UES, since they could then swap these shares for stakes in the regional energos they so covet.

Taking this logic a bit further, the only thing keeping the oligarchs from making a meal of the energy monopolist is the fact that foreign fund managers scream like banshees at the first hint of asset stripping; their cries are now heard all the way to Putin's Olympus.

Therefore, by buying in such a way as to push prices up, the parties involved would allow foreign investors to step out with a nice profit. Kind and gentle, as always in Russia...

Market talk has MDM one of the names prominently associated with recent UES share price movements; they are also rumored to have bought NRB's stake in UES, with NRB, in turn, rumored to be involved in some big-ticket privatizations going forward.

As of this writing, the momentum seems to have cooled. Whether this is a strategic move by the buyer to allow the market to settle down before they have to pay up too far and too fast, or whether something else is afoot, only time will tell. We have heard suggestions that the concert parties may buy it up to 0.18. For investors tempted to play this one, we would suggest purchase of the UES Prefs. Cash yield could run as high as 8% at current prices (note: not 10%; most analysts omit to factor in the 20% withholding tax and expected currency depreciation, when calculating dividend yields) but most significantly, they are likely to be swapped for Ords, sooner rather than later.

Indeed, after several years of flogging it, the Pref-Ords trade remains one of our primary focuses. Russian Prefs should trade at a premium, not a discount. They never will, simply because they will be swapped for Ords before crossing parity. Therefore, much like shopping the year-end sales in Paris, this trade involves buying the Prefs of only those companies where one would buy the Ords; investors can also hope to benefit from the dividend yield while it lasts.

Our preferred plays here are Tatneft Prefs, UES Prefs and Rostel Prefs. Despite some concern with Tartar oil companies' high sensitivity to oil price volatility, we note in passing that, while every oil analyst in town hates Tatneft, and (most) love Surgut, thus far this year, our Tatneft Pref recommendation has yielded a cool 70% upside, vs. 10% for Surgut (both Prefs and Ords). Transneft Prefs, an old favorite, should be considered as a fixed income instrument, with good yield and very limited downside, but also, relatively modest upside. Bashneft Prefs are suffering from abandonment, and will

require considerable patience. The relative value trade, where feasible, is obviously a good option for those who can short, and who may not agree with our fundamental valuation of these companies.

Seduced and Abandoned – Bashneft

Bashneft has had a miserable month, dropping a further 8-9%. This little-known debutant was dug up in her native region by one local brokerage, which took a considerable proprietary interest, propelled her into good society, before quietly abandoning her to her fate. With the absence of support from her sponsor, we see limited upside in the near-term. Nevertheless, we suspect that Bashneft will again have its day, being that it is massively cheap to everything but Tatneft (with which it has substantial similarities).

Slavneft

Sovlink has issued a report on two Slavneft subs, Yaroslavl refinery and Megionneftegaz. With positive trading recommendations on the Prefs and Ords of both. Fund managers interested in trading with Sovlink should request an e-mail copy of this report.

Parting Shots

BEREZOVSKY – HELL HAS NO PLACE WARM ENOUGH...

In the previous issue of T&B, we engaged in some idle speculation about why, precisely, the government had chosen to go after Berezovsky this late in the day. Now we know. Putin had been subjecting the one-time power behind the throne to what must be the cruelest imaginable torture for an egomaniac: he simply ignored him. First, Berezovsky's famed "revelations" on the FSB proved a damp squib, then the party with which he was to storm Olympus unceremoniously ejected him, while his "multi-billion dollar fortune" is increasingly seen as a figment of his fevered imagination.

Reduced to impotent rage and venom, and reputedly suffering from excessive indulgence in fine Bordeaux

wines, Berezovsky was ready for anything, even treason, in a desperate bid to maintain some relevance. Immediately upon arrest of Ahmed Zakayev, the representative of Chechen ex-president Maskhadov, on charges of complicity and active participation in the murder of civilians during terrorist acts perpetrated in the 90s, Berezovsky baldly came forward with a very public offer to pay his legal fees. Such treacherous villainy surprises even T&B! The Russian government has issued an arrest warrant, and we reverse our previous stand, imploring the British government to return this sad apology for a human being to face his accusers!

MIS-RATING RUSSIA

Two contradictory stories here. On the one hand, the rumours of a two-notch upgrade by Moody's continue to circulate. We think them misguided, if only because, were it to do so, the agency would in effect be admitting to having been utterly clueless about the situation in Russia over the past two years. Having already demonstrated this to have been the case in 1996-97, we see no reason for them to reiterate the lesson now. Russia will indeed go investment grade, but not this year (nor do we think right after the 2004 presidential elections)

On the other hand, one of the self-designated international experts on global competitiveness has just rated the Russian business environment inferior to that of 74 other countries including...Argentina! We hope that the organization in question, linked to the deeply reactionary Heritage Foundation in Washington DC, should follow up with an exchange offer, allowing holders of Argentine Eurobonds to swap them for an equal face value of Russian debt. We could certainly find some offers...

A UNIQUELY RUSSIAN APPROACH TO THE “NON-PAYMENTS CRISIS”

A few weeks ago, Moscow was all ablaze with frenzied speculation about who would have been daring enough to kidnap LUKoil vice-president Kukura, T&B happily joined in, speculating that it had to be an inside job. One explanation, however, we had definitely not thought of, has now been provided by an unnamed senior LUKoil executive, contacted by Kommersant after Chief Investigator Alexandr Ovchinnikov claimed that the case had been broken, but refused to give further details. Apparently, the heist was carried out by no less than the FSB, itself commissioned by an unnamed government department which had contracted with LUKoil for delivery of oil, but was still owed a \$6M “commission” on the deal. Oddly enough, the sum demanded by the kidnapers, \$3M + 3M Euros fits perfectly with this story, though, given that it was a government department which gave the order, we assume that they would have added the VAT... only in Russia!

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