

TRUTH AND BEAUTY (AND RUSSIAN FINANCE)

SPECIAL NOTE: THE FUTURE (REVISED)

Note from the author: The following 10 predictions were originally issued in May 2001 (if you keep old e-mails as a courtesy to federal prosecutors, this one can be found under the title "The Future," sent on the NIKoil research list). To some extent, it was issued for our own entertainment (there really was not very much to DO at Nikoil...) since, at the time, global trends looked fairly irrelevant to Russia (what a difference a year makes!).

They were intended to predict trends in Global Financial Markets through year-end 2001. Although we missed the timing on some of them, we appeared to spot a trend which is still unfolding.. It has taken rather longer than we expected, but the downturn is, if anything, deeper than we had initially dared to predict.

This is a second revision of our original predictions, updated as of February 1, 2003; a first revision was published on May 22, 2002. Our original text is in black, current comments are in red:

We are get a giddy feeling watching the capital markets: the curious mixture of mirth and impending doom one gets watching a (slightly tipsy) circus clown clamber onto the high-wire. We think that even some of the major players may have lost the plot (retail appears to have forgotten that WAS a plot).

...our ten New Years 2002 predictions, 7 months early:

Well, as I said, apparently, it took a fair bit longer than we had expected...

1. The last down-leg of the NASDAQ is in front of us, somewhere...we know neither when its going to happen, nor how severe will be the fall; indeed, we try to think as little about it as little as possible...it gives us the willies

We take the point! We are still expecting to see NASDAQ below 1000. The October lows are in imminent danger. We overshot to the upside, we are going to overshoot to the downside. US broad historical P/Es are 29; if you still trust brokerage's earning estimates, please call us, we have a great deal for you on some Moscow bridges...

2. As the night follows the day, sooner or later the Fed is going to run out of rope. The markets are likely to greet this with some displeasure.

When we wrote this, rates were about 2.50. They are now 1.25; we are betting on a couple more cuts before this is over...

3. The ECB will continue to shoot itself in the foot with unerring aim. Any residual doubts as to Wim Duisenberg's intelligence were put to rest by the way he handled the last rate cut, snatching defeat from the jaws of victory. Perhaps the major factor holding the dollar up is *what do you sell it against?*

Duisenberg has been gagged and trussed, but Euro rates are still too high – they should be at Japanese levels. The dollar is falling like a rock. On the other hand, European manufacturers are becoming seriously worried about Euro revaluation. Given the inability of Europe to reform, they should be!

4. Sooner or later the US current account deficit is going to turn around and bite someone. When it reverses, we can't think of too many mechanisms besides a crashing dollar to bring it back home. Having been wrong about the dollar for at least as long as we have been right about oil, we persist in the belief that either moles do dig down all the way to China, or it's just a matter of time...and the clock is ticking at the rate of a half-trillion a year..

Uh-huh. And guess what happens when foreign capital stops flooding in, and US treasuries start to collapse because of the outflows...

5. The US is heading into an L-shaped recession, and it is not going to be over anytime soon. Growth will likely remain mildly positive, but not what you were used to. As a result, anyone expecting a return to 25%+ returns on his US equity portfolio in the coming decade is suffering delusions. If you are moving into defensive assets like government bonds, you had better hope the Fed doesn't panic and drop the reins...a tough call.

Wrong. It was not L-shaped. We may have been lured into a false sense of complacency. It is beginning to look like a double dip.

6. The telecoms industry is going to get its plug pulled. Why any CEO supposedly in his right mind would spend a collective \$250 billion to offer people the chance to pay lots and lots of money to have VIDEO on their mobile phones continues to elude us. Apparently, the bugs in the software are still biting, so presently you can't even call your broker with a sell-order on a 3G handset – don't let that bother you, though, 3G is the FUTURE, and people will sacrifice anything (including the most elementary rationality) to get a share of the future!

As for the new carriers in the US, they are now perishing almost as fast as dotcoms, and with as little recovery value. Fortunately, the impact on US banks will be minor; the impact on the European banks, while not catastrophic, will be contractionary.

That was an easy one. In fact, it may now be getting a bit overdone, at least on the credit side. France Telecom was recently trading wide to MEXICO...does anyone smell an arbitrage?

7. Oil prices will remain higher than anyone (the present author included) currently predicts. Maybe it's the Chinese (demand growth), maybe it's the US refiners and energy sector (reflecting the grotesque misallocation of capital, away from real things towards Internet fantasies), but for the past two years – indeed, ever since *The Economist* penned its famous "Awash in Oil" confidently predicting oil prices at 5\$, oil has gone from strength to strength. Since the US summer driving season is about to get underway and US automakers are offering discounts on SUVs, it ain't over yet! Our one worry: the day *The Economist* predicts soaring oil prices, we will go short.

Oil has held remarkably well, due to a series of one-off factors superimposed upon a fundamentally bullish background, still not recognized by most analysts. Maybe it has something to do with a non-renewable resource amidst continued growth in population and economics...maybe God has simply come to love Russia.

8. At least one politically-sensitive, highly-indebted emerging country will get into trouble, causing panicky G7 governments to forget their sanctimonious prattle about "moral hazard" and throw money at it...this time, it will **not** be Russia.

Brazil, Argentina, Turkey... the competition was awfully tough...

9. Russian debt is still ridiculously cheap (if it were calculated solely on the basis of current account data, it should be trading inside of US treasuries...). We also believe that the Russian equity market is seriously undervalued as well; though we are willing to argue that one.

We have been regaling anyone willing to listen (and quite a few others) on the Russian Eurobonds theme since September 27, 1998. It does not make much difference which ones you buy; our Labrador Retriever could trade this market (she can't go short!). It is exceedingly rare that we recommend to ANY position for this long, but frankly, we would leverage it still further, preparing to HEDGE for US treasury risk from Q4.

Russian equities continue to do what they damn well please, and we would rather look for special opportunities than try to predict the index.

10. Some strategist will confidently predict that the US is going into a Japanese-type recession. It isn't. God knows the US has its problems, but the steadfast unwillingness to adapt to changing circumstances is just not one of them.

Given the current US administration, rational prediction is becoming a challenge. Still, if one thing is certain, it will not be a Japanese-style recession. The Japanese fund their gapping budget deficit with huge domestic savings; just how the US intends to fund its own twin deficits, we are anxious to learn.