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**STRATEGY**

**7 APRIL 2003**

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# (and Russian Finance)

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**ALL THINGS RUSSIAN**



**EMERGING DEBT AND EQUITY MARKETS**





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# All things Russian

*Situated somewhere near the bottom of the institutional feeding chain (i.e. we would rather our clients make money stupidly, than lose it intelligently…) T&B cherishes its long-standing role as the ill-mannered child who declares that the Emperor has no clothes. To mix an metaphor, we have several windmills to contend with this issue:*

## *THE IMMACULATE MISCONCEPTIONS*

### WTO: Just say No!

With considerable satisfaction we note that, at long last, one of our favorite international institutions has now decided that Russia would not, after all, join the WTO before 2007. Of course, T&B has been beating this point to death for the past year, maybe longer. We are now waiting for the above mentioned shop to endorse the second part of our view: that this is exceedingly fortunate, given that Russia would have much to lose, and virtually nothing to gain, by joining too soon!

We have said it before – we will say it again: most Russian exports (fuel, PGMs, raw materials, arms, pulp and paper, heavy machinery, etc.) are not subject to protectionist duties. Those few that are, in particular grain and steel, would continue to suffer limitations; US "anti-dumping" steel tariffs, and European agricultural protectionism, prevail regardless of any WTO rules to the contrary.

Import duties, on the other hand, provide vital protection for Russia's remaining manufacturing sector, at least by tempting foreign joint-venture partners into Russian production projects. For the automobile sector in particular, were barriers to be suddenly eliminated, GM and its ilk would have no further reason to invest in Russian JVs; it would be far cheaper and easier for them to cover the market with duty-free imports from existing plants in Eastern Europe. This same reasoning applies to furniture, white goods, footwear, etc.

Obviously, tariff barriers - kept too high for too long - remove the competitive spur to local industry, limiting consumer choice to poor quality goods sold at high prices. The key issue is thus for Russia to gradually dismantle barriers, pushing industry to modernize at a feasible, realistic pace. While we certainly do not support protectionism out of principal, applied blindly, the ideological commitment to "free markets" trumpeted by The Economist and like-minded fundamentalists can be catastrophic. Witness the total devastation of Mexican agriculture and rural society by NAFTA.

### Russian Growth: On Steroids

Surveying the Coalition of the Clueless, we find that most of the international houses inexplicably continue to report 2002 Russian growth as 4.3%, despite the fact that it is now almost universally acknowledged that this number is erroneous, given the recently-released backwards-looking investment figures. Russian growth apparently came in somewhere just above 5%. Given the utter lack of discernment of the global institutions concerning economies that we do know well, we have increasing doubts as to the validity of their analysis concerning those which we know rather less well.

On the other hand, the dynamic duo - Al Breach and Peter Boone - have increased the 2003 Russian growth forecast of their eminently respectable institution to a Chinese-style 6.5%. T&B was perhaps a bit too timid in its 2003 forecast of "at least 5%"; we do, at least, have the consolation of having issued the second-highest broker forecast - admittedly, Al was probably closer to the mark. For what it's worth, in the absence of a total meltdown in oil prices, we now expect 2003 GDP of 5-6% - given the capricious, almost whimsical nature of Russian statistics, quibbling about a few basis points seems rather silly.

Encouragingly, the Russian PMI services index just came in at a sizzling 59.1. This confirms our basic assumption – Russian growth is being driven by domestic liquidity and rapidly rising incomes. Unsurprisingly, output growth is far faster in the non-traded sector, especially the services, where ruble overvaluation has less impact.

Russian macro numbers remain boringly excellent. Projected debt/GDP ratio for end-03 will be some 35%, less than that of France, Britain, the EU average – and approximately one-quarter that of Belgium! While these countries borrow at rates allowing them to put the problem back almost to perpetuity, Russia can now also rollover debt internally at strongly negative real rates, and internationally, spreads are on par with the bottom of the investment-grade sovereign pack (and well inside many investment grade corporates, e.g. Ford Motor Company, one of our future candidates for default…). Debt service/GDP ratio should decline below 5% by year end. Meanwhile, net foreign reserves are exploding: currently $55bn, and still increasing by several billion per month.

There are two thin clouds in this otherwise blue sky – inflation and ruble valuation. Inflation will probably overshoot the CBR target of 12% for the year. Unlike the situation in 2001-02, the prolonged inflow of forex has saturated the ability of the market to absorb further monetary creation; the Central Bank is faced with the choice between rapid ruble appreciation and an acceleration of inflation. They appear to have chosen to hold the ruble relatively steady, allowing inflation to take the marginal pressure. The ruble is still cheap to PPP; unfortunately, it is unlikely to stay that way; continued currency revaluation will squeeze both manufacturers and mineral/hydrocarbon exporters.

## Catching Switzerland: Russia to go investment grade?

The question of a two-notch Russian upgrade is one of those rare issues where T&B is stubbornly less bullish than the consensus. Most of our peers are predicting an imminent elevation of Russia to investment grade, in some cases citing private conversations with rating agency analysts. Although we lack such privileged sources, we continue to disagree, not expecting a two-notch upgrade until we see further progress in Russian reforms, and, far more relevantly, a substantial maturation of the Russian political system.

An investment grade rating implies that a country is sufficiently safe and stable so as not to present a medium-term risk of catastrophic credit event. The graduation of emerging-market countries to investment grade status is fraught with risk – while for Eastern Europe these upgrades have gone relatively smoothly – elsewhere, it has been otherwise: until last year, now-defaulting Uruguay was rated triple-B; despite Mexico's investment grade rating, its debt spreads are at a par with Russian levels.

While issues of "level playing fields" are perhaps more important to soccer leagues than to emerging markets investors, for Russia to actually deserve an investment grade there would need to be at least a tentative answer to that great and fearsome question: what would happen were Vladimir Putin to disappear? Although Russian macroeconomic indicators are better than those of some G7 countries, political risk cannot be totally discounted. In reply to an earlier paper, one of our peers pointed out that, previous to Yeltsin's choice of Mr. Putin for Prime Minister, neither we nor anyone else we know had even <u>heard</u> of the man – but,that is exactly the point: Yeltsin's choice of Putin was a matter of the most unexpectedly good luck for Russia. To reply upon a <u>series</u> of miracles seems a trifle risky!

The party of power  "Unity" is anything BUT (unitary, that is). Indeed, it is an amalgamation of a personal Putin vehicle with Luzhkov/Shaymiev's Fatherland. Given Luzhkov's legendary greed and lust for power, this is an inherently unstable combination. The shambolic legislative course of UES reform has been largely attributable to the Moscow Mayor, who obviously intends to grab Mosenergo by whatever means, fair or foul. With the likes of Luzhkov and Shaymiev still lurking in the woods, and neither an heir-apparent nor any obvious mechanism for presidential succession, predictability is sorely lacking.

Make no mistake **-** T&B has been a Putin enthusiast since well before his elevation to the Presidency; we would be delighted to see him remain in office until sometime mid-century. Unfortunately, our wishes are not systematically granted, and, at least under the current constitution, the day after the next presidential election Mr. Putin will become a lame duck[1]. An attempt is now being made to breathe some life into Unity in the run-up of the Duma elections – perhaps it will be successful, and it will become a real political party – but we would rather not bet on it.

**I'll take a double, please (standard, that is)**

Rosneft President Bogdanchikov, on his way to the London Russia conference, was stopped by British emigration authorities. With no regard for customs regulations, they proceeded to make photocopies of his private business documents, for good measure tearing several pages out of his personal diary. T&B is certainly no fan of Bogdanchikov's (indeed, considerations of libel law have precluded our writing our true thoughts about him) however, this is an outrage. Despite the fact that he happens to be Russian, Mr. Bogdanchikov is entitled to the same protections as anyone else; British law allows customs authorities to view documents in order to establish their carrier's true identity – but was there ever any doubt? Try, for a minute, to imagine the international uproar had the boys at Moscow Sheremetevo tore out whatever looked interesting in BP President John Brown's diary, surreptitiously copied his commercial secrets, then sent him packing? The mind boggles…

[1] Lame duck: an office holder who cannot seek reelection.

### US - Russian relations

Many of our peers have expressed great surprise at Putin's sharp criticism of the American war on Iraq. Maybe they should subscribe to T&B! Of course, anyone bothering to listen to Putin's few public statements in the run up to the war, or to the rather more frequent declarations of FM Ivanov (who, lest anyone forget, happens to report to Mr. Putin!) has little reason for surprise. To understand what Putin thinks, the easiest solution is to listen to him… for a politician, the Russian President is remarkably straightforward.

Foreign commentators sometimes forget that the entire world is not totally cynical. Putin, in particular, is deeply idealistic (this is not necessarily a compliment – there is nothing quite so dangerous as misplaced idealism), while having a clear and pragmatic view of Russia's current place in the world. Russia is no longer a Great Power counterbalancing the United States – it thus needs a law-based, multipolar world, rather than one built upon the rule of the fist.

There has been no beating around the Bush – the consensus view is that Russia's relationship with America is absolutely vital – indeed, far more important that her supposedly "secondary" relationship with continental neighbors France and Germany. When T&B enquires as to why this may be, we are told that "America is the world's sole super-power (gosh, we hadn't noticed…), has the largest economy (no, in fact, the European Union has both a larger total population and a larger GDP), the widest global influence, and, for all it matters – the best beaches!"

Being unused to such dizzy heights, T&B retreats back to more mundane indicators, noting that Russia's trade surplus with the EU is ($19.5 bn) i.e. twenty times its surplus with the US ($1bn). Similarly, the US is not among even the 5 largest investors in Russia; indeed, while European investment is increasing rapidly (BP, etc) US investment flows are actually declining. The US has talked airily of a new energy policy with Russia, obviously intended to put the fear of God into their ex-allies in Riyadh. Whatever the future of the US-Russia project, the fact is that Russia already shares one of absolutely overwhelming importance with Europe: Gazprom. With the world's largest gas reserves, Gazprom is Europe's top supplier and a key player in European energy. German money has been flowing in to upgrade the transmission network, and Ruhrgas is increasing its holdings in Russia's energy giant. This probably outweighs the economic or geostrategic importance of any far-Eastern tanker port.

T&B typically distrusts the consensus, although, in fairness, we may be missing something… We still await a rational, concrete answer. In any event, most of Putin's liberal advisers share the Americano-centric view – they are almost panicky at the thought of a cooling in relations. We will here reassure them: Great Powers have interests, not friends – and America is unambiguously a Great Power. No real harm has been done to American interests by Russian criticism of their Iraq policy; since the US currently does precisely what it chooses in the world and its body politic seems quite tame, only Tony Blair may have something to resent. Any American pique at a lack of Russian support for their Iraqi policy will evaporate like the morning dew – at least to the precise extent that Russian cooperation in the diplomatic or energy fields will seem desirable to the Bush administration.

### *RUSSIAN POLITICS – WAITING FOR A MIRACLE*

Despite the enormous strides in economic management and rule of law under Putin's watch, the Russian political system remains deeply dysfunctional. The right wing is hopelessly split between the Chubais-Khakamada-Kirienko block and that vestal virgin of Russian politics - Yabloko's Yavlinsky; the left is sinking into irrelevance under Zyuganov, while the center remains an intellectual vacuum; it is still very much a one-man show! Except for the Communists and Yabloko, political parties are *ad hoc* affairs, with the electoral code allowing deputies to shift allegiances at will.

The limitations of change-from-above will eventually be reached. The totally justifiable cynicism of the Russian citizenry concerning the honesty and devotion of their civil servants renders the establishment of a true social contract something of a challenge. Before citizens will trust their government, much less have a feeling of "ownership," a huge transformation must be effected; currently its level of efficiency and honesty is dire beyond belief (see "A Concrete Jungle, below)

**A concrete jungle**

It sometimes seems that the entire Moscow finance community, both Russian and foreign, is engaged in the purchase and refurbishment of Moscow real-estate. Conversations at dinner parties have shifted from trading coups and the antics of the buy-side, to mortgages, estate agents, builders, architects and bureaucratic fixers.

These transactions usually involve the purchase of one of the few remaining “kommunalki”, large rotting old communal apartments inhabited by as many of six families, each of which owns one or two rooms, while sharing kitchen and bathroom facilities (not surprisingly, the relationship between the inhabitants of these apartments could most charitably be described as “bitter hatred…”). Prices range around $1700-$2000/sq. M (i.e. $170/$200 sq. ft.) for good buildings in the center of town (up from, say, $800 just two years ago), with fit-out costs (usually involving total replacement of floors, ceilings, windows, walls, plumbing, electricity, doors, etc) and bribes running to a further $800-$1000; rental yields run 15-20%, with mortgage financing costing 10-12%. Sounds tempting?

Redoing a kommunalka is quite an experience! The building code and administrative requirements seem to have been drafted by a close disciple of Franz Kafka following a dose of bad mescaline! The Soviet Union had more than its share of regulatory agencies; with the break up of the Empire, these agencies did not disappear – they simply “privatized” themselves, and were supplemented with several new layers of bureaucracy created by subsequent “liberal” governments. Laws and regulations are similarly layered; old ones are not repealed - new ones – frequently contradicting the previous ones – are simply added. It is, for example, prohibited to build a bathroom above someone else’s kitchen – perhaps quite sanitary when only thin wooden floorboards separated the stories, but a bit silly when they are interspaced with 40 cm of pre-stressed ferroconcrete!

One Russian friend of ours is currently privatizing a “cherdak”, i.e. the attic space above her apartment. This undertaking involves her participation in an openly rigged investment tender, then getting the “winning” dossier past no fewer than seven (7) committees, each of which demands permits from as many as ten other institutions (firemen, architects, energy monopolies, sanitation officials, etc..), sometimes, indeed, more than once.

Of course, every single piece of paper involves the payment of a bribe - from a few hundred rubles to a few thousand dollars. Beyond that, everything - from planning permission to getting the local police off your builder’s backs - is strictly fee-for-service. Permission for a truck to deliver a load of steel required a $100 backhander. Installation of a 380V 3-phase electricity line cost $4000 (of which $150 – maybe – was an official payment to the electric company) and the local police take a flat fee of $100 per month.

Perhaps most extraordinarily, Russia must be one of the only places where one must pay a bribe to do things which are perfectly legal; the benefits of corruption do not usually extend to being allowed to break rules - that would be risky for the bribe-taker. It is, of course, possible to complete this entire process without bribery – just that, the usual span of a human life is rather too short.

All of this supports a vast Moscow bureaucracy, most of whom earn official salaries of some $250 which somehow stretch to the purchase of late-model Mercedes and vast country houses. Most worryingly, our friend seems to consider this to be a normal cost of doing business. People in other lines of business inform us that they are confronted with the same problems on a daily basis – again, they expect nothing else, and have evolved coping strategies to make the best of the opportunities offered by corruption and graft.

## *OIL PRICES*

We have just enjoyed dinner at an upmarket Moscow restaurant, having won yet another bet on oil prices remaining above $26 by end 1Q 2003. This has become something of a tradition, but we fear it may have been the last one for a while. Not that T&B expects oil prices to tank – our best guess is that they remain somewhere within the OPEC $22-28 range, but it is only that – a guess; for now, we must decline any further bets.

With more unknowns than a Tarkovsky movie: Iraq, US military plans for the post-Iraq world, Nigeria, Venezuela, G7 economic growth, Saudi Arabian stability, OPEC unity, Russian oil politics, etc, the underlying fundamental driving factor -

rapidly growing Asian consumption and declining G7 production - could be at least temporarily drowned out by market noise.

There is a small but non-negligible possibility that Russia will be driven to cooperate with OPEC once again; if so, the steadfast protection of the Transneft monopoly will be the only thing holding us above the abyss… given their leviathan greed - as well as the opportunity that tanking oil prices would afford them to acquire new production assets on the cheap, given half a chance, Khodorkovsky and some of his brethren would increase output ad infinitum, driving oil prices into the low single-digits.

Fortunately, the word on the street is that OPEC is pleased with its current relationship with Russia; information exchange is smoother, and planning discussions are rumored to be far warmer than in the past. While we would give 5:1 odds against this relationship being put to the test over the next 12 months, the improvement in relations adds a much appreciated element of safety.

A vital point is that Russian budgetary and trade-account inflows are protected by the 6-9 month lag in Gazprom inflows, which are only now beginning to reflect the ramp up in oil prices over the past half-year. Even with a highly unlikely collapse in oil prices, there would be no risk to the fulfillment of the 2003 budget.

### *CORRUPTION – CATCHING NIGERIA*

Since sweeping into power, Putin has cleared out some of the most corrupt among the top bureaucrats – indeed, with a few very noteworthy exceptions, the guys at the very top of the Federal institutions are reasonably honest. Unfortunately, the strata immediately below them would provide tough competition for the ghost of Soni Abacha! Of the fleet of black Mercedes 600s idling in front of any top Moscow restaurant or nightclub, one can assume that 30-40% belong to government bureaucrats. Obviously, any attempt to push through debureaucratization will be combated hand, tooth and nail by these same functionaries, fighting to maintain their livelihoods.

All hope is not lost. The courts <u>are</u> gradually improving – at least in Moscow – and judicial reform has started. One friend of ours was recently stopped by a Moscow traffic policeman who did <u>not</u> demand a bribe (yes, this really happened!) The worst pillage of Gazprom has stopped, the awesomely corrupt Tax Police has been disbanded, and there has been a series of high-profile busts involving the ministry of fisheries, tax officials, etc. No doubt with the strong encouragement of Putin (and, perhaps, with a passing thought to the dire conditions in Russian prisons) St. Petersburg governor Yakovlev – widely believed to have plundered the Federal budget allocated for the city's 300th anniversary celebrations – has announced his intention not to seek reelection. All men live in hope…

# Emerging Debt and Equity Markets

### *RUSSIAN EQUITY MARKETS – SEEKING NEW LEADERSHIP*

Three months into the year, the Russian blue chips remain adrift. Russia tends towards extremes – its equity market is generally either the world's best, or its worst. Over the past month the RTS has been among the worst, although year-to-date it falls somewhere near the middle. Nevertheless, reliance on the RTS index can be misleading. With foreign players conspicuous by their absence, most of the turnover has been driven by purely local factors: oligarchs and other domestic players shopping for cheap assets. This, obviously, benefits the second tier only, some of which is thus outperforming hugely.

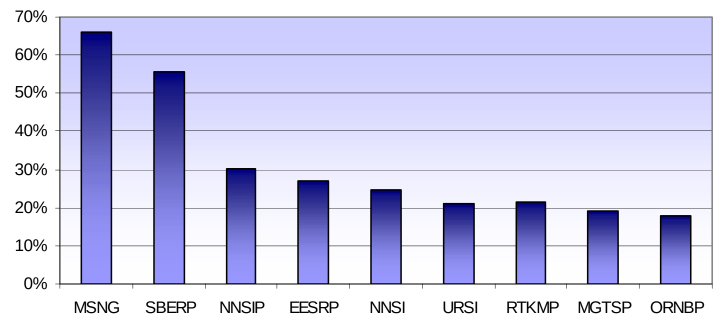
Returning to the broader index, most brokerage reports view the current doldrums as simply the mechanical result of a decline in oil prices. We accept that this may provide a partial explanation, but remain somewhat skeptical. Russian equity prices did not follow the oil price up; we see little reason for them to follow it down, unless investors are pricing in a fall in oil to below $20.

All else failing, several local institutions have become quite proficient at charting. Unfortunately, while their charts almost always provide clear explanations for what has <u>already</u> happened, their <u>predictive</u> value has proved wretched, almost comically at variance with actual performance. This may have something to do with the fact that even the most robust proponents of charting claim only that they work in very liquid markets, un-manipulated and characterized by a large number of independent market participants…not exactly our vision of the RTS!

T&B believes that if a single term were to characterize performance of the first tier of late, it would be "neglect". International investors are currently looking elsewhere. They will, of course, be back, and there will be plenty of time to pick up the chips when they do. For now, the game is purely local.

It should be remembered that huge outperformance of the RTS index over recent years has been largely driven by a very few equities: Yukos and Sibneft - which have seen a sea-change in management and production technology, and - at least for the former - in corporate governance and transparency. More recently, Mosenergo, Sberbank Prefs, Volgatelecom, Uralsvyazinform, Sibirtelecom, and MGTS Prefs have also driven the index.

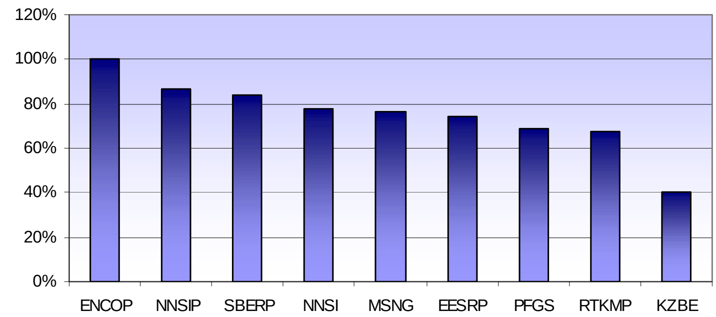
**RTSI Best Performers 3 Months (increase in %)**




*Source: Bloomberg*

On the other hand, over the past 6 months, almost all of the outperformance was to be had in the second tier; the mainline oils - in particular - have been fairly dismal.

**RTSI Best Performers 6 months (increase in %)**




*Source: Bloomberg*

Anyone making money in the Russian market this year either has superlative trading skills, or was invested in the second tier. Given our bias towards the latter, we will here turn our attention to opportunities among the locals.

**RTSI 15 Best Performers (12 months)**

| Stock | 12 Month Change |
|---|---|
| Krasnoyarskenergo Prefs | 111.32% |
| Purneftegaz Prefs | 92.00% |
| Sberbank Prefs | 87.78% |
| Purneftegaz Ords | 59.32% |
| Megionneftegaz Ords | 41.67% |
| Rostelecom Prefs | 41.50% |
| Sberbank Ords | 37.18% |
| GUM Ords | 35.48% |
| MGTS Prefs | 34.38% |
| Sibneft Ords | 30.56% |
| Orenburgneftegaz Ords | 29.27% |
| Uralsvyazinform Ords | 29.23% |
| Kuzbassenergo Ords | 25.76% |
| Tatneft Ords | 25.04% |
| Orenburgneftegaz Prefs | 25.00% |

*Source: Bloomberg*

## Energy – In the oligarchs were trust

Several of our recommended second tier energos have been simply smashing, and, in our view UES Prefs continue to represent easy money. The story is here of almost biblical simplicity: regardless of the arcana of sectorial restructuring, several of the oligarchic structures – perhaps endowed with more money than good sense – continue their fast and furious buying of the energos. First the good ones were snapped up, now, some true dogs are finding warm homes. MDM in particular is undertaking a $300M ECP program, presumably to raise a war chest to continue their shopping spree. Owners of energy assets fitting with MDM's long-term strategy – whatever that may be – are likely to be offered some very attractive exit prices. Another major financial group has created an energy subsidiary, and is actively cobbling together a diversified holding.

Of our energo picks, NNGEP and NVNGP, PMNGP and Kuzbass have done extraordinarily well; our long-term pick Lenenergo Prefs have also done reasonably well (+39.9% over six months) while lagging the takeover targets. Their 14% dividend yield (based on stock price as of 1 March 2003) has surely provided some comfort. Interestingly, the shares declined by a good 7% the day they went ex-dividend. A normal phenomenon in other markets, this is the first time we have seen this happen in Russia; it suggests that the market is maturing - investors now look at companies in terms of earnings and dividend flows, not merely as gambling chips. (See Sovlink's desknote: *Novosibirskenergo, Electrifying Value*)

Mosenergo, on the other hand, we missed completely! Someone has been buying it up; we wonder if his name is Yuri…The record date for the AGM is April 11, and we would be hesitant about holding it beyond then.

### Telephones – A party line

Our strong recommendation of the fixed line phone sector – in particular Sibir, Ural and Volga and Rostel Prefs – is proving very rewarding. Although the results of several have disappointed due to write-off of old bad debts slightly decreasing their net profit (and thus, their dividend yield) these were one-offs, and no one held it against them. We expect continued outperformance. (Please see Sovlink's recent company snapshot: *Uralsvyazinform*)

### Mobile Phones – Cell-ular-itis

For several years, T&B has been skeptical about the mobile sector. Until this year, it had rewarded us by systematically underperforming the overall market. Now, however, as P/Es have gradually shrunk, and given the near-term recovery in global TMT (another dead cat bounce?) they are doing rather better, up respectively 10% and 13% on the year. They have thus outperformed the RTS, while underperforming our recommended fixed lines: Rostel Prefs, Ural, Volga and Sibir.

Nevertheless, a new factor could render MTS rather more attractive: Sistema has issued a $350M Eurobond so as to buy out DT's stake in MTS, bringing their own share to 51%, allowing consolidation. The shadowy Luzhkov-related structure will certainly wish to capture MTS cash flows so as to service the debt, and thus, a shift in cash flows from capex to dividend payment cannot be excluded. Investors with a hankering for mobiles may wish to own MTS; T&B will stick to the landlines.

### The Consumer sector – A total eclipse of the Sun (Brewing)?

T&B has systematically avoided stocks in the consumer sector; don't get us wrong – given rapid growth in Russian incomes, we love the sector - it's the stocks we hate. WBD is a bit pricey for our tastes, and it has continued to drift aimlessly; Sun, on the other hand, has been totally eclipsed, tanking by more than 20%. It may be getting oversold, but we have never understood how to value it, and will not attempt to call a bottom. Anyone who has actually tasted Red October chocolate will understand our reticence to own the stock. For the remainder of the sector, in the absence of obvious take-over interest, we see no compelling reason to be invested.

### The Automobile Sector – The Kamaz-Sutra (or, several positions you do NOT want to be in…)

In a recent research report, Sovlink outlined the reasons to shun the Russian automobile sector: overcapacity, overstocking, rising costs, outmoded plant and models, and severe competition from used imports (see Sovlink's desknote *Russian Automobiles: Running on Empty*). The only conceivable reason to own these hounds is in the hope of a buyout by a strategic investor. While this has certainly been a winning strategy in the case of Avtovaz, T&B has no specific information regarding the likelihood of continued buying; considering the capex needs and likely profitability of the sector, smart Russian money may go elsewhere. We steer clear.

## *EMERGING DEBT MARKETS*

In a situation eerily reminiscent of the Argentine death-spiral, we find most of the US and European bulge bracket firms glibly bullish about Turkey's chances of avoiding an economic meltdown, while some of the smaller firms and the strategists covering other markets (including T&B) are deeply pessimistic. Could this have something to do with the fact that our respective institutions are exceedingly unlikely to win any Turkish government bond mandates, and thus, we are free to speak our minds without fear of reprisal?

Our buy recommendation on several Latin American debt markets has proved spectacularly successful, with the magnitude of the rally exceeding our bullish expectations. Our recommended Ecuador 12 and Brazil DCB and Euro-denominated bond trades have gone ballistic with the rerating of emerging markets debt in general, and of Latam in particular. Indeed, despite Chavez's talk of a debt restructuring, even Venezuela is holding well. We would be cautious at this point; any sudden contraction in risk tolerance could send the flock scuttling back to the safety of Russian bonds.

Argentina is in a class of its own. Macroeconomic fundamentals - in particular GDP growth – are showing a spectacular rebound from the catastrophic levels of last year. Overall economic activity is rising at an annualized pace of 7%, industrial production is rising at an amazing 31%, with construction rebounding by an annualized 71%, albeit from its catastrophic crisis level. In the meantime, inflation is far below even the most optimistic estimates – by current trends, it could fall below 10% this year. At the same time, tax revenues are rising sharply, with international reserves increasing from only $1bn to $10.5 bn.

T&B has not been back to Argentina recently (and we have grown deeply skeptical of the analytical coverage by the bulge bracket), but, on the basis of the reported numbers alone, the recovery is beginning to look superficially a bit like the Russian rebound of 1999. Currency devaluation has sent the debt/GDP ratio soaring (a 1998 peak of 121% in Russia, vs. 160% in Argentina now). While some of the same means are being employed - including sovereign default, imposition of capital controls, and massive devaluation, the similarities should not be overstated. Russia never defaulted its foreign debt, nor did she chose to renegotiate the IMF loans (allowing her the luxury of politely ignoring the typically disastrous advice of the Fund.) While the Argentine banking sector has taken a severe hit, it has not simply collapsed as did its Russian counterpart. Unlike Russia, Argentina has not yet found political stability – thus far there is no obvious winner of the upcoming elections, though Menem holds the poll position.

Argentine debt prices are showing some signs of life. While we had recommended bottom fishing at prices below 20, we expect that a debt restructuring will take at least 18 months and the currency devaluation has sent debt/GDP ratios into the stratosphere – some 160% of nominal GDP. On the other hand, perhaps one argument for Argentina to restructure its debt more rapidly would be that the better the economic numbers, the less the haircut on debt NPV likely to be granted.

Given the fact that the debt is currently not serviced, we are in no particular hurry to position at these levels. Nevertheless, in view of the impressive economic recovery now underway, investors with access to cheap funding and willing to accept the opportunity costs should accumulate Argy debt, in particular the non-dollar sector, on any dips; we expect the onset of W/I trading late next year.

### In conclusion

In that most other markets have been extremely choppy (March was reportedly a miserable month for hedge funds) investors are understandably wary of the sustainability of any rally, including in the EMBI. In particular, much has been made of the fact that the price on Brazil Cs is approaching its 5-year high of 83. We think this is somewhat misguided – Brazil spreads are still almost 200 bp wide to their 5-year trough. While new issuance, notably from Brazil and Mexico, is expected, given the extremely unattractive risk-free yields and the paucity of compelling investment opportunities elsewhere, we think it likely that – absent some major unforeseen event in a core emerging market – continued strong inflows will drive the rally somewhat further. The EMBI remains our preferred asset class - we would stay long, while keeping a nervous finger near the sell-button.

## *RUSSIAN DEBT*

Russian debt has, as predicted, bounced off of its mid-term lows, however the rally lacks enthusiasm, and it is underperforming Latin America. This is to be expected: Russian risk is now fairly priced. With prices supported by domestic buying, it constitutes a highly defensive asset class, underperforming in rallies, outperforming during sell-offs. The Eurobonds now offer an excellent leveraged carry trade, however their price upside is distinctly limited. We would recommend that investors continue to sell the vol, taking advantage of the very high implicit volatility of Rf30 options; with a $4.00 premium, sale of 90-day straddles is attractive. Investors with new money to put to work are directed towards the long end of the corporate curve: Sibneft 09s and especially Gazprom 13s remain attractive. The new Sistema bond could also bear looking at.

We close on a cautionary note. We have heard rumours of new Eurobond issuance by one money-losing automobile manufacturer and by a totally non-transparent, seriously mismanaged local bank/broker, in the pocket of one of the top oil majors. If either (or, god forbid, both) of these succeed in pulling it off, then the market has become frothy indeed. On a more positive note, we would welcome an opportunity to short either or both of these issues, though given the domestic wall of liquidity, only on a duration-matched relative-value basis.