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Truth and Beauty...

(and Russian Finance)

- The Hypothetical Prophets[*] -

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[*] The Hypothetical Prophets could be best described as an intellectual rock band in Paris of the early 80s, led by my Anglo-Czech friend, Karol Beer. They were among the earliest grafittists, spray painting the word Сталинград in odd, inaccessible places around Paris, especially in the Metro tunnels. They have nothing whatsoever to do with the theme of the present paper.

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Global Economy

Smell the peanuts on his breath!

Anything that is not sustainable will eventually not be sustained.

Kraus

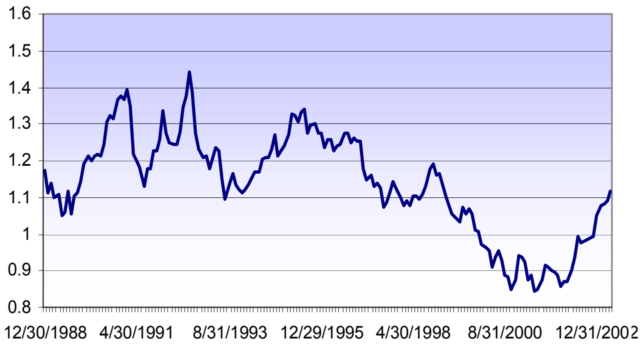
Several very colorful terms spring to mind to describe the current state of the global economy – unfortunately, none of them are suitable for use in a family-oriented publication such as T&B! Thus, we shall settle for the more neutral "dismal".

The expected post-War bounce has been a massive disappointment, indeed, even T&B, which repeatedly argued that any bounce would be strictly of the dead-cat variety, has been faintly surprised at the bloodless reaction. We repeat that the build-up to war provided a convenient fig-leaf of an excuse for a global economy which wished to head South for some very fundamental reasons – the unwinding of major macroeconomic distortions. The primary culprit is the totally ludicrous situation whereby almost the entire increase in global demand has come from the United States, which cheerfully printed the world's reserve currency, paid out in exchange for consumer goods which it no longer manufactures. At one point, the US was consuming a ludicrous 80% of the world's total savings to fund a 6% GDP current account deficit; as the dollar starts to tank in earnest, the absurdity of the situation becomes patently obvious.

A second unwind is the 10-year bubble in which companies have been run to maximize short-term shareholder value, i.e. pumping out cash rather than investing. Much of the increase in wealth over this period was strictly of the paper variety, e.g. goodwill, asset revaluation, etc. Unlike physical assets, valuation-based enrichment creates virtual assets which have a disconcerting tendency to subsequently vaporize.

As a result, the one macro trade which we have seen as truly a no-brainer: short dollars (and Yen) against virtually everything else – has performed splendidly. We first recommended a short dollar/long Euro position at 0.88, watched the Euro drop to 0.82, before recovering to a current 1.1340, still heading north. Is it all over? We think not. Graphing performance of a "synthetic Euro" shows a low for the previous cycle of 1.44 Euro/$ in 1992; the current account imbalances were then a great deal smaller, and there was then not yet any real alternative to the dollar.

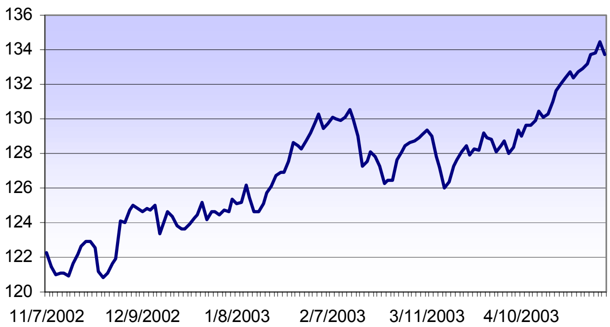
EUR / USD (end 1988 - current)



Source: Bloomberg

T&B continues to recommend short dollar and short Yen (Yen against the crosses only), long Euro and long "commodity" dollars: Canadian, New Zealand and Australia. We particularly like the short Yen-long Canadian/NZ/AUS crosses because of their large positive carry.

EUR / JPY (6 months)



Source: Bloomberg

We are still hearing two of the same counter-arguments we heard two years ago: however parlous the state of the US economy, Europe and Japan are still worse, and, more naively, that the money must go somewhere.

-As for the first, we agree – Europe's love-affair with its past is becoming outlandishly expensive, and Japan is the longest-running train-wreck since the decline of the Spanish Empire in the 17th century. If growth rates determined currency parities, we would be dollar bulls – they don't, so we ain't!

An Elephant in the Elevator

Think of the world economy as a small town, with a main street, and its own bank. There is only one very big customer. He has an overdraft from the bank and he shops enthusiastically, keeping the factories busy and the merchants happy; the bank is initially unworried since he uses part of the overdraft to pay interest on the loan. In the short term, of course, everyone benefits. Unfortunately, the overdraft is growing, indeed, the curve eventually begins to look exponential. Bankrupting its biggest client would tank the bank while sending Main Street into depression – and things have worked fine *so far* – so everyone looks away and pretends not to notice the elephant in the elevator; Like Ionesco's Rhinoceros, no one really remembers how he got there and everyone hopes that if they just ignore him, somehow, he will simply go away.

-As for the second argument, No, money does not have "to go" anywhere… it is quite happy where it is, thank you! The owners of money, on the other hand, are now increasingly concerned with wealth preservation, depriving themselves of the purifying experience of dire poverty. An investment by a Euro-based investor into the high-growth US equity market 3 years ago is now worth, in Euro terms, about half of what it was when he made it! Should he double down? Would you?

Equities: So far, So good?

On the other hand, until now, the equity markets have surprised us with their resilience. Maybe we have got it all wrong. Maybe the "wall of money" will reanimate a cat T&B still believes to be dead…maybe death itself IS optional. But, with total US corporate profits down to a historically small share of GDP and a clearly slowing economy, we retain our bearish bias. We will refrain from trading upon it until we see signs of the US markets topping, since technically, 960 on the S&P looks attainable. The European exchanges are essentially an appendage of the US; where goes the Dow, the DAX shall follow!

The US Economy – In Search of the Hypothetical Profits

The flip side of the unarguable dynamism and flexibility of the American economy is a disconcerting tendency towards optimism when none is warranted, i.e. the widespread notion that "Death is Optional". The hangover from the 1990s bubble has not yet been absorbed. Although companies have been impressively repairing their balance sheets and a credit crunch has been avoided, the offset is that they are currently being run strictly for cash, with huge cuts in staffing and R&D, as well as an end to discretionary Capex, upgrades and growth plans. This, of course, is ultimately self-defeating, impacting employment and the sustainability of growth, both long and short-term.

Under Fire – The US economy

The underlying story is that profits, expressed as a share of GDP, have literally collapsed over the past decade. Estimates vary, but, even stripping out changes in accountancy, it would appear that real profits have dropped by about one half. Pricing power has been lost, and gross spending has been redirected from job- and profit-creating business investment toward consumption. The entire process has been fueled by the creation of "fiat wealth" i.e. the revaluation of assets.

The fundamental challenge facing the US economy is the fact that the entire edifice is balanced upon the slender back of the heavily overleveraged, now-insecure consumer. If consumption falters, all fall down. The US corporate sector is desperately cutting costs, i.e. laying people off (improving "productivity") and/or reducing salaries, so as to fix balance sheets and fund dividend payments. Add to this the expected decline in employment by increasingly financially-stretched local governments, and you have a consumer who should logically feel like a rabbit on the first day of the hunting season. Consumer confidence numbers remain constructive. We think it a lagging indicator. Like the Coyote in the Road Runner cartoons, the US consumer has run off a cliff; sooner or later, he will stop and look down…

We thank our friend Chris Wood for pointing out in the last issue of *Greed and Fear* that US companies are now borrowing to pay dividends, i.e. dividend payout as a percentage of after tax profits has reached a generous (but obviously unsustainable) 146%. Given the collapse in profitability over the past decade, the reason that they have cut Capex becomes self-evident: they

What is to be done?

T&B has argued repeatedly that further Fed cuts are relatively futile, while outright monetization would be deadly dangerous. Thus, we have been asked: and so what would YOU recommend? Rate hikes? Fasting and purges? A return to nature?

T&B is indeed, at something of a loss – 6 years ago, when Greenspan made his famous "Irrational Exuberance" speech, there WAS something to be done – a sharp interest rate hike would have been hugely unpopular – and totally justified. Now, we doubt if there is much that monetary policy can do. Certainly, fiscal stimulus is unwarranted, especially in the feed-the-rich form proposed by the dismal current administration. The huge ramp-up in military spending now underway is the economic equivalent of manufacturing high tech goods, then dumping them in the Atlantic Ocean – a short-term fix but long-term value-destructive. Very low rates, and a sharp devaluation of the dollar are to be welcomed, despite the major dislocations they will provoke. So would a robust, renewed commitment to free trade, and, more controversially, support for the indebted US states and cities, as well as poverty-alleviation programs to keep the poorer consumers from ceasing to consume at all. Given the priorities of the current US administration, we are likely to see none of the above.

can no longer afford it – no "wall of money" will cause them to borrow in the absence of investment opportunities profitable in risk-weighted terms.

We believe that two of the worst problems now facing US companies can be laid squarely at the door of the conservative orthodoxy: exploding health care costs (+17% Y/Y) and, arguably, the growing pensions debacle. Many years of benign neglect of the health care sector has meant that the US currently spends a far larger share of its GDP on health care than ANY other industrialized country; despite this public health statistics are distinctly mediocre, and some 60 million people have no medical insurance whatsoever! In purely financial terms, it translates to an explosion in medical insurance costs for the corporate sector.

In the Line of Fire – Bullet Points

- In 1Q03, the cyclically-sensitive components of GDP: consumer durables, capex (-4.4%) and construction (residential and non-residential) actually fell by 0.1%, annualized.
- Expressed as a percentage of GDP, gross profits have collapsed since the early 90's. Talk of 17% growth in 2003 with the economy going nowhere seems a trifle fantastical.
- US unemployment is growing faster than the statistics suggest. Given the rapid cut-off of benefits, the discouraged unemployed stop registering, dropping out of the statistics. US employment numbers thus show stickiness, both on the way up and on the way down. As companies cut costs, labour decreases. Wage cuts are now increasingly widespread throughout the economy.
- The increase in real disposable income fell to an annualized 1.1% in 1Q03, leading to an actual decline in the savings rate, despite slower spending.
- At 74.5%, capacity utilization has fallen to near its all time low. This certainly does not encourage investment. While tech spending has indeed improved, this appears to be more "maintenance" than expansion. Non-residential construction is in free-fall.

Voodoo Economics Part II

The problem with the left is it reads only the left. The problem with the right is that it does not read at all!

We recently engaged in a conversation with a young colleague, who was convinced that the Laffer curve worked wonders under Reagan, whom he believed to have succeeded in cutting taxes, raising spending, and still reducing the deficit. This, of course, is nonsense. The US ended the Reagan years with budget deficits which took a generation (and some very robust political will, not likely to be repeated) to resorb. We think it a slam-dunk to happen again. The next generation will doubtless be grateful!

- Fiscal expansion by the Federal Government is more than offset by the badly stretched State and Local governments, which are now slashing spending.
- Low rates will NOT sustain consumer spending. Only FALLING rates will do that; most of the new money, which consumers have recently spent, came from mortgage refinancing; this, of course, tapers off when rates stop falling.
- The tanking dollar will eventually lead to an increase in industrial production, restoring some pricing power and a welcome touch of inflation; the J-curve effect suggests that this will be a multi-year process.

SHOOTING AT AMBULANCES – JAPAN AND EUROPE

Europe

T&B, will be, as usual, rather less prolix about the European economy – not because of any imagined “pro-European” bias, but rather, because the root problems are so obvious as to render discussion both frustrating and essentially pointless:

Beginning in the 30s – and seeing robust development after WWII – the European Social Model constituted a great step forward for Mankind. Alas, sometime in the heady-growth of the 1960s, it became enshrined, both constitutionally and in nations’ psyches – the sheep believed they had legislated the wolves out of existence! It has ossified - No one can afford it – Everyone knows it doesn’t work – Everyone is terrified to touch it. If this particular elephant bloats any further it will burst the elevator!

Random shots:

- An employee in Italy costs almost 100% **again** his wages in social taxes (and this is <u>before</u> income tax!). In France, total social charges are “only” 75%. When governments wish to discourage something, they tax it heavily, like cigarettes. The taxation of employment has thus been quite successful – in discouraging job creation.
- The European health sector is relatively…healthy (though, with the proviso that young French doctors make rather less than do French plumbers). The pension system is NOT. It is a time bomb, ticking away. Every self-respecting politician hopes it will blow up in somebody <u>else’s</u> hands.
- In Germany, it is rather easier to bankrupt a company than to lay off excess staff. One way or another, the banks have ended up owning a distressingly large proportion of the companies, and we expect the government to end up owning the banks (especially after, as predicted by our friend Adam Cleary of ING, a soaring Euro helps to push the export sector over the brink).

The European Central Bank is clueless beyond human comprehension. Wim Duisenberg makes Hubert Hoover look like George Soros! That – while staring down the barrels of threatened economic depression – they can go on quibbling about a couple tenths-of-a-percent more or less inflation leaves us speechless! Given the total absence of room for fiscal stimulus, Europe desperately needs interest rates at Japanese levels NOW.

Japan

While for non-specialists, Japan seems hopeless – for the true specialist, it presents a mystery worthy of the Miracle of the Loaves and the Fishes: how the hell could it have held up for this long? Suffice it to say that our real interest is grounded in that same morbid curiosity regarding the contours of the first collapse of a G7 economy in living memory that sent one of our esteemed colleagues rushing off to Tokyo in the forlorn hope of catching the earthquake just as it hit. He is, of course, now back in Moscow – in the great tradition of Noo theatre, Japan does things s-l-o-w-l-y. It has been a long-standing short for us; it still is. The Yen is a marvelous source of cheap funding, but we would be wary of funding dollar assets, preferring Euros.

Emerging Market Debt

Chili SIN Carne

In our last issue, we suggested to our readers that anyone who had followed our trading recommendations into the EMBI universe owed us lunch… two weeks later, you can make that TWO lunches! Our concern is now shifting towards collecting our well-deserved meals, and we would suggest that clients risk missing dessert by starting to position themselves for the end of the rally… it is clearly not over yet, but remember that all really good longs eventually become great shorts!

Performance in the emerging market debt patch has again been spectacular. Our recommended Argentina is up 30-50% (and we will definitely take profits here!), "sterling credits" such as Venezuela and especially, Ecuador, have gone ballistic, and, perhaps more justifiably, Russia is off the charts, with spreads heading for the 300 bp level. Indeed, it is becoming increasingly difficult to find anything remotely credit-worthy yielding 1000 bp over. Friends on the London desks tell us that, like in 1997, there is now a bid for Sudan, Liberia, Cuban and North Korean debt!

Several factors have driven this rally:

- Massive inflows into emerging market debt funds. JPMorgan estimates monthly inflows reaching $500M for US mutual funds alone; for 2003, these funds have grown assets by 17% due to inflows, with a further 11% due to appreciation and cashflows. The real volume of new allocations from international funds, hedge funds and institutionals is probably several times greater.
- Improving economic fundamentals in the main countries. Despite deteriorating fundamentals in some peripheral EMBI countries (Uruguay, Philippines) some of the largest Brady countries such as Brazil and, of course, Russia, are seeing constructive changes.
- The "Russia effect". Spreads on Russia 2028 have collapsed from 5000 to 320 in less than 5 years. We wonder how many holders of Argy debt are asking themselves, "why not here, too?" (we could, of course, name several excellent reasons).
- Ultra-cheap finance. All-in repo rates ranging between 1.5-3.5% make the carry trade look compelling.
- Lack of competing opportunities, plus an excellent track record. Emerging market debt has outperformed every other major financial asset class for any look-back period over the past 7 years. Speculative money which once chased tech stocks is thus now chasing EMD!

Truth and Beauty does not like to go bearish on its favorite asset class, but we fear that this will eventually end in tears, indeed this is increasingly no longer a "prediction" but rather, it is becoming a statement of the obvious. Unlike Internet stocks, there is (perhaps fortunately) a mathematical barrier keeping spread products from trading to insane levels – the EMBI is not about to start trading INSIDE of treasury! The question is thus one of timing; leave too soon and you miss a great party – leave too late and you end up a "long-term investor…"

> Time for a reality check: Does anyone really wish to own 30-year Mexican obligations paying a thumping 2.5% percent more than the equivalent US Treasury Bond? Has Mexico gained the unparallel privilege of printing dollars? A little secret: T&B suspects that there are precious few hold-to-maturity investors in the Mexico 31s! Instead, given ultra-cheap repo financing, everyman and his dog is hanging on for a few hundred basis points of "safe" yield, with the reassuring expectation that a greater fool will always be there to take the bond off their hands. Does this remind the kind reader of something? Although the US treasury curve could still play some silly tricks with yields dropping another 10-20 bps, T&B might still be trying on its shorting shoes, if only as a hedge.

THE ASTEROID WATCH – WHERE IS THE NEXT HIT COMING FROM?

Even in the absence of an obvious catalyst, if allowed to grow too big, bubbles will eventually collapse under their own weight. The last several rallies in the EMBI class have ended following obvious endogenous or exogenous shocks. In 1997, the unwind was triggered by the Asia debt crisis spreading to Hong Kong. In 1998, the Russian debt crisis tanked the entire class. The 2002 correction was caused primarily by fears of a melt-down in Brazil, although macroeconomic concerns in Ecuador, Veny, etc. also contributed.

We are seeing a fundamental discontinuity in the market: while the Treasury curve is priced for continued slow growth, or indeed, for outright recession, the EMBI is seemingly pricing in a benevolent economic environment with steady expansion of global demand – one of them cannot be right! T&B believes the treasury market is essentially correct, and we are thus concerned for the sustainability of emerging country debt burdens in the context of global weakness. Nevertheless, we doubt that it is this fundamental disconnect which will prove the triggering factor.

Truth and Beauty spends much time wondering about where the next blow will come from. Some candidates:

- Treasury. Obviously, prices on spread product are a function of the US (and, increasingly, the Euro) treasury curves. Several observers have warned about the vulnerability of US long bond prices; certainly, predicting the effects on long rates of a hypothetical dollar crisis is challenging; in the absence of any overt signs of inflation, and given T&B's expectation of a double-dip recession, we do not expect the hit to come from this quarter. Certainly, Euro and Yen rates are not set to rise anytime soon!
- Macro-crisis. A dollar crisis remains a possibility; a tanking dollar could cause severe collateral damage to the European financial sector, sending Europe into deep recession. We believe that the US equity market is still priced for mayhem. Finally, we have no idea which country (or, perhaps more accurately, which commodity) the Bush administration will choose to "liberate" next. A crisis may be averted, but we do not sleep easy these days – our long term buy-list remains: canned foods, firearms, and land in New Zealand!
- Deterioration of economic fundamentals in one or more of the Brady countries. The debt market has proven robust enough to absorb severe volatility from the relatively peripheral Venezuela, Ecuador and Uruguay, but the EMBI was a good deal cheaper at the time they got into trouble! God forbid we see anything really ugly coming out of Brazil, Turkey, etc. Other potential meltdowns include Philippines, Veny, and a failure of the Uruguay debt swap. Russia, as usual, is boringly safe and predictable – alas, it is priced for it, too!

In summary, the rally seems set to continue until something catalyzes an unwind. Given the current level of froth, this unwind may well prove dramatic. Investors fleet of foot may continue to play the current rally for the last points – mathematically, there is still substantial upside in the likes of Veny, Ecuador and Uruguay; but they should bear in mind that they are currently entering a fundamentally expensive market, and it is thus an increasingly speculative play. Do not invest money you cannot afford to lose!

Beyond Good and Evil – Can't Pay…Will Pay!

In the aftermath of the Argentine default, and with Uruguay heading for a forced restructuring likely to earn it a Selective Default rating, we are hearing much cluck-clucking about the "moral obligation" for countries – like gentlemen – to pay their debts. This seems a trifle self-serving. Like many of our readers, T&B has a non-negligible financial interest in poor countries continuing to service their debts – simply, we do not elevate this to a moral principal. Indeed, from an ethical standpoint, these countries have perhaps a still-greater obligation to feed their hungry children. Some will argue that, in the long run, the best way for them to meet this latter obligation is to remain connected with global capital flows. In some cases, this may be a valid argument, however we would suggest that the discussion should be one of tactics, not of principles; debt service should not be confused with moral imperatives!

TRADING RECOMMENDATIONS

Russian sovereigns. Sorry. Given the insatiable local bid, they are probably going to continue to gradually tighten, but at 320 bp over, they are too rich for our ascetic tastes! Depending on their world views, investors would be advised to move into Latins, Russian Corporates, or cash.

Russian corporates. Given the fact that everyone is getting squeezed out of the Russian sovereign curve, the corporates are obviously the place to be. They are relatively liquid, and spreads are tolerably narrow. Perhaps the only thing preventing global funds from plunging wildly into this sub-class is the fact that haircuts are deep and repos expensive – Russian corporates thus remain reasonably cheap to their fundamentals, and downside should be limited. Cash investors should clearly favor them over the sovs.

Our Gazprom 13s recommendation has worked out nicely; even at 107.5, they still offer 466 bp over, not bad for quasi-sovereign risk in these troubled times! For the hardier investor, at almost 700 over, we would strongly advise loading up on Sistema 08 before they converge with the rest of the curve! On the other hand, several Russian banks are reportedly lining up to issue new debt; frankly – in the words of one much wiser than ourselves – we would much rather eat nuclear waste!

Latam. For those adrenaline-starved souls who wish to stay in the Latin game, T&B expects to see further strong performance by Brazil, Colombia and (God help us!) Uruguay. Our former top pick, Ecuador, is no longer cheap – and one good IMF review doth not a Summer Make! Venezuela has major event risk – and trades like it. Trading accounts could still have fun with the 27s. Please note that, except for Colombia perhaps, our Latin calls are short-term trading picks; try not to get left holding the bag!

Protection strategies. The flip side of the collapsing spreads is, of course, that the bonds are getting temptingly cheap to short. If we were inclined to do anything so base, we would be looking hard at the long end of the Mexico curve (which, at these levels, is almost a treasury hedge!) and possibly Philippines. As for Turkey, we are by no means convinced that it is out of the woods, but our cautionary remarks against shorting it have proved well-advised – it has rallied impressively, for all the wrong reasons – for now, we will stand back and watch! We think that investors tempted to hedge treasury might pay a couple of points more and short the Mexico 19s, 26s, etc.