

Truth and Beauty...

(and Russian Finance)

- The Asian Strategy -

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Global Economy

Do you believe in miracles?

Although T&B had warned of the likely reversal in the treasury market, we had certainly not expected the current rout, nor the impressive shift in sentiment from fear back to greed. US economic indicators are currently coming in somewhat better than we had expected, while the bearish consensus of a few months ago is giving way to a more bullish view from the strategists at most bulge-bracket firms (of course, unlike T&B and his bearish brethren, their fat bonus cheques depend upon their persuading their clients to buy lots of global equities...) Under the circumstances, any market observer not convinced that he is gifted with divine sight must challenge his own assumptions; we must therefore consider the possibility that we were simply wrong, and that the global economy is returning to "new paradigm" growth rates, after a brief interlude of stagnation.

Upon sober reflection (it is far too hot to drink in Bali) we have chosen to reiterate our previous call, with the proviso that the unprecedented fiscal and monetary stimulus being aimed at the US economy may well prove adequate to postpone the pain until after the US Presidential elections. Those signs of growth we now see are predicated upon massive fiscal and monetary stimulus; such stimulus simply cannot be maintained indefinitely (except to see annual US budget deficits run well into the two figures, with the current account deficit soaring into the trillions!) The effect of the Bush tax cut is fairly trivial compared with the overhang of leverage throughout the economy, while the mortgage refinancing boom is now history, with the expected bonus of low oil prices nowhere to be seen. Only the weakness of the dollar (now temporarily interrupted) should provide more durable stimulus (and even there, the effect is sharply limited by the fact that most of the US' trading partners fix their currencies to its own). We have grown wary of predicting the timing, but we still believe that a "second-dip" lies ahead.

US TREASURIES: WHEN IS A BUBBLE NOT A BUBBLE?

The US bond market has recently been crushed, with the most violent back-up in yields (normalized) since 1982. The 10-year yield, which had been plumbing all-time lows, turned around and backed up a mammoth 130 bp in the space of

a couple of weeks. Although T&B had warned that the treasury market was overbought, neither we (nor anyone else we know) had forecast such a radical reversal. In particular, given our bearish medium-term view and our expectation that the Fed would prove capable of managing the bond market somewhat better, we expected, at worst, a back up of some 30-40 bp. In fact, the market wiped out more than a year of gains in the space of a few weeks, bringing yields back above the levels of July 2002.

There are two possible interpretations: either the market suddenly came to the realization that the US is on the cusp of a sustainable recovery, with a return to the new-economy growth miracle of the 90s; or, we are in the presence of a conjunction of dangerous technical factors which have undone a year of careful Fed nurturing of the bond market – with the Fed having apparently lost control of long rates, posing a serious risk to the underlying economy. Our readers will have no difficulty guessing which option we choose...

We read a great deal of analysis in the press and competitor research regarding what the yield curve is "trying to tell us." Much like the recent equity reversal, when an improving economy was assumed primarily on the basis of the fact that the stock market was going up, while the rise in the market was attributed to... an improving economy (!), currently, the historic steepness of the yield curve is interpreted to mean that the US is heading for sustainable growth well above 3% per annum, the level required to increase employment and eliminate the deflationary risk. In this interpretation, the drop in bond prices is attributed to the increasing allure of equities (hogwash! there is sufficient liquidity to support both; indeed, both bond and equity prices had previously been rising in tandem - now, with bonds plunging, equities are, at best, trading water).

Financial journalism is not much more help. On alternate days, the wires helpfully inform us either that bonds are tanking because of rising growth expectations, or conversely, that they are rising because their yields have become compelling. Bollocks!

The sea-change in the bond market began in the immediate aftermath of the Fed meeting, triggered

by disappointment with the (in fact, totally predictable) 25-bp cut, as well as by some moderately bullish comments by Greenspan. Since then, every mildly positive economic release has caused treasuries to plunge, while the more fundamentally-important bearish signals – in particular, the drop in total payrolls - have been conveniently ignored. Assume for a moment that our reading of the numbers is erroneous – we are here looking for the smoking gun – even assuming real evidence for an economic turnaround, it is absurd that, tacit the video game attention-span of the current generation of analysts, in the space of one week their fundamental view should shift from the dire fear of a deflationary spiral to a forecast of a roaring recovery!

In fact, as confirmed by relatively flat equity markets, we believe that growth expectations are largely irrelevant, and that the factors driving the collapse in the treasury market are primarily technical – but first the growth story.

US ECONOMIC GROWTH – IN THE LONG RUN, WE’LL ALL BE AUSTRIANS

It is one of those wonderful ironies that the US, the standard-bearer of global capitalism, currently governed by what is arguably the most radical-right faction in power in any industrialized country, should find its economic policy totally condemned by the conservative orthodoxy of the highly conservative Viennese school of economics: Von Hayek, Maes, etc. In brief, the conservative school argues that US growth prospects have been damaged by under-investment in productive assets, as well as a financial bubble leading to over-consumption, over-leverage, and the creation of “fiat money.” This easy money encourages misallocation of capital, with over-consumption necessarily accompanied by under-investment. Considerations of space (and of the reader’s patience) do not allow us to fully review the evidence here – interested readers are referred to the Richebacher letter (Agora Press), recent work by Mark Faber, etc (please e-mail to T&B for further discussion or references).

What is unarguable is that US economic growth continues to be predicated on the greatly over-leveraged consumer. The most relevant employment numbers (a decrease in total payrolls of 44,000) have shown no improvement; the small increase in reported capex is due primarily to replacement of worn-out equipment (in particular, computers); it can be expected that the effects of the Federal tax hike will be at least partially obviated by increased state taxes. Durable goods

orders have been driven largely by military spending.

Significantly, the strongest growth indicator thus far has been the impressive increase in “productivity.” This number looks great until one enquires about what it actually means... in fact, US manufacturers cut the number of hours worked by 4.4%, while still managing to boost output by (a modest) 2.2%. Again, this does not require any increase in real “productivity” of workers; simply laying off staff involved in R&D, administration, or business development would have had precisely the same statistical effect. This is confirmed by the observed decrease in total payrolls.

Most relevantly, over the past 18 months, economic growth has been driven almost exclusively by the housing market, and especially, by the extraction of cash from housing via mortgage refinancings (refis). Housing is obviously the most rate-sensitive sector of the economy; with the refinancing game dead in the wake of a 130+ bp reversal in the 10-year bond, we expect the depressive effects of the back-up in long rates to flow through to housing starts and consumer spending with a lag time of 3-6 months.

Again, we are ready to be proved wrong. Certainly, the numbers are proving less dramatic than we had expected. T&B would nevertheless stress that what anemic growth there is, is being artificially maintained in the presence of the most stimulative fiscal and monetary policy in recorded history! There are simply no levers left to pull: with rates at 1%, further cuts are limited by the number zero; further tax cuts would send the US budget deficit spiraling beyond the 6-7% already predicted for next year by Morgan Stanley’s Stephen Roach. Surely, even the US’ fondness for credit must eventually encounter some limit.

Thus, we opt for the second option, i.e. that the major factors driving the sell-off in treasuries are essentially technical:

THE DEFEASANCE TRADE. UNDO THIS BUTTON.

Fully half of the growth in US consumer spending over the past year has been driven by home mortgage refinancing, which apparently spun off a bit over one trillion dollars last year. As rates fell, the number of refinancings soared, leading the mortgage agencies to buy up huge amounts of 10-year treasuries. Of course, as soon as rates start to back up, the refinancing game dries up; the

agencies are then forced to start dumping treasuries given the soaring expected duration of their loan portfolios.

BUDGET DEFICITS: YES, DOROTHY, SIZE DOES MATTER!

With the help of some (largely inherited) economic weakness, along with huge dollops of military spending and tax cuts for its wealthy political constituency, the Bush administration has succeeded in turning a \$200 bn dollar surplus into a \$450 bn dollar deficit – and that for the current year alone! While the administration has conveniently reinvented the laws of economics to show that (contrary to a half-century of Republican orthodoxy) there is, in fact, no “squeeze out” effect from government borrowings, the market has heavily discounted this self-serving tripe, and – quite rightly taking fright at the new supply - driven rates up sharply.

TAX CUTS – A VERTICAL PLAYING FIELD

For whatever reason, most analysts seem to have missed the impact of the change in US tax laws: bonds are still taxed as ordinary income, i.e. up to 50% (including state, city, etc) vs only 15% for equity dividends (note that tax liabilities of US mutual funds flow through to resident investors). This change has triggered a one-off shift from bonds to high-yielding stock.

CAPITAL FLOWS – TRAVELING EAST, AT SPEED

We think that the relevance of the above factors is dwarfed by the one great imponderable: by far the largest buyers of US treasury and agency debt have been the Asian central banks. Japan continues on an increasingly desperate policy of forced yen devaluation; this has received the overt acquiescence of the US as it leads to Japan accumulating vast quantities of dollars which are recycled into treasuries. China is accelerating its export-driven growth model, and building huge currency reserves (although the Chinese will, eventually, allow the renminbi to rise, they will do so at the time of their own choosing – Beware! the consequences of an increasingly rich and self-assertive China no longer compelled to purchase devalued US paper may not be as benevolent as some commentators expect!).

T&B can only assume that the absurdity of this situation will eventually become clear to the

governments in question. Even if they do not dump their bond holdings, the simple cessation of new purchases (and the Japanese are rumoured to have started to unload agency bonds, which have indeed widened sharply in recent weeks) or a shift into Euro assets would drive US bond rates towards the stratosphere, obligating the Fed to directly intervene, monetizing the debt.

THROUGH A GLASS, DARKLY – MARKET IMPLICATIONS

T&B believes that the massacre in the treasury market has largely played itself out, however, in the near-term, given the burgeoning US budget deficit – absent direct intervention by the Fed or a sharp worsening in the US numbers - we do not expect to see the bond retest its recent highs. Therefore, while we find ourselves in agreement with Chris Wood's call to buy bonds¹ at current levels, in the near-term we would not be surprised to see further volatility.

Except under a disaster scenario, having widened out considerably, spread product, in particular EMBI paper, is once again looking attractive. Given current uncertainties in the treasury market and some curve-flattening in some EMBI countries, we would favor the short end, but would remain ready to buy longer-dated paper if treasury rates resume their fall on the back of disappointing G7 growth.

We continue to believe that the (rather modest) rally in G7 equity markets has discounted rather too much good news, and that a renewed correction lies ahead. What is open to question is whether the Bush administration will succeed in its goal of pushing this correction out until after the 2004 elections, or whether it will be compelled to go to the polls with a plummeting market.

Demonstrating the danger of extrapolating current trends out to infinity, Europe is surprising by showing some signs of life. The bubble there was never inflated quite as far as in America, and, amazingly, the crisis has succeeded in spurring the governments of France and Germany into finally undertaking substantive reform. Thus far, this reform remains partial, inadequate, and hesitant, but by no means should it be underestimated; it represents an extraordinary inversion of the trend after a half-century of increasing bureaucratization and socialization.

¹ Buy Bonds. 31 July 2003. Greed and Fear, CSLA Hong Kong research publication.

CURRENCIES – FIT AS A EURO

It should be obvious that the current global economic imbalances must eventually correct. No single country can continue to absorb 80% of total global savings, nor can the budget deficit of the country issuing the world's reserve currency rise towards the double-digits. Given the burgeoning budget deficit, the US current account shortfall for 2004 is currently predicted to rise from \$1.5 bn per day to over \$2bn (Morgan Stanley).

What is far less obvious is where (and when) the correction will hit. We believe that the dollar valuation is the most likely break point. As foreigners eventually decline to fund the US' twin deficits, the Federal Reserve will be faced with a choice between outright monetization and helplessly watching rates climb to economically destructive levels. Given the absence of pain-tolerance of the American body politic, we think their choice obvious – monetization! The dollar should eventually resume its slide against the Euro and continue the current trend towards forfeiting its role as the sole global reserve currency. Having tested the 1.115 level against the dollar, the Euro is now establishing an apparently-firm base around 1.13. Thus, we would either favor Euro assets, or would hedge the full currency exposure for dollar assets.

Russia

Seen from afar

YUKOS - THE SNOW (JOBS) OF AUGUST

The Yukos PR machine appears to have broken loose from its foundations and is spewing out startlingly hysterical invective, leaving even those journalists best disposed to Yukos increasingly skeptical (only those local papers in which the Menatep group holds a substantial ownership stake still broadly hew to the Yukos line.) Yukos' wild tales of Siloviki wanting Kasyanov's scalp are on the way out, and they are now peddling a new story – that the raid was solely aimed at blocking the Sibneft merger (which, reassuringly but somewhat confusingly, they assert to be still on track – which we believe it is). Since it is widely believed that the Sibneft merger was pressed upon Yukos by the Putin administration in an attempt to avoid seeing a foreign major buy Sibneft, we find their latest story about as credible as its predecessors...

Another new myth apparently floated by Yukos is that ChevronTexaco wishes to buy a stake, reportedly valuing the firm at a modest \$25bn. Valuation issues aside, even if an American major were crazy enough to want to become entangled in a major Russo-Russian cat-fight to the tune of several billion dollars, the simple fact is that they would never be allowed to... the Kremlin could easily enough block any merger of which it did not approve (Khodorkovsky take note: like in chess, one cannot castle out of check!). What this story does illustrate is the fact that, like Gusinsky before him, Khodorkovsky still believes that his salvation will come from the Americans... frankly, we thought him much smarter than that!

Not that T&B is going to be able to shine much new light. The recent declarations by Kasyanov and background briefings by Voloshin suggest that there is disquiet in the Presidential Administration. The Prosecutor's office snapped back at Kasyanov for interfering with a judicial investigation (an investigation which, we are asked to assume, initiated itself – *deux ex machina* – without a hint of political encouragement?... Please!). Everyone has a theory, some folk have several² – T&B still

² Amusingly, the most recent, the Berezovsky-backed Belkovsky story, is largely based on the purported transcripts of "intercepted phone conversations". Of course, NO ONE in power circles in Russia ever says anything significant on their

sees nothing to challenge our initial take on this issue: Khodorkovsky had outgrown the role of oligarch, and was bidding to take control of the Russian government – Putin said “nyet! – you can drill for oil, but NOT in the Duma!” The three golden apples, Transneft, Rosneft, and Gazprom, are fated to remain forever out of Khodorkovsky’s greedy reach.

T&B initially expected this to blow over in a couple of weeks... were we ever wrong!

It appears that this gave far too much credit to Khodorkovsky’s common sense and desire to hold onto his not-insubstantial attainments. It is now becoming increasingly difficult to imagine a happy ending to this moral tale; the language being employed is far too strong - Yukos has openly challenged the Russian State.

As has been the case in numerous other countries in which judicial independence is subject to serious reservations, once started, the judicial machinery rapidly assumes a life and a will of its own, proving far more difficult to stop than it was too start. Significantly, the attack on the Oligarch is proving wildly popular with the Russian populace, which, understandably, has little love for the robber barons. Mr. Putin’s already sky-high approval ratings have risen a bit further still, but, far more significantly, the previously dire Unity Party is now gaining in the polls.

T&B foolishly accepted a wager with one local strategist, betting that Khodorkovsky would not be forced into exile... indeed, we gave him odds that Khodorkovsky would stay put, thinking it easy money, indeed! We still hope to win our bet, but must now contemplate the alternative scenario: if, like Berezovsky and Gusinsky before him, Khodorkovsky finds himself faced with the stark choice between prison and exile, the maturation of the Russian market would indeed be put back, perhaps by 18 months. Nevertheless, the Russian transformation could readily survive the reduction of even the most powerful of the boyars. With or without its founder, Yukos remains a world-class company; at around \$12, we continue to rate it a “buy,” recommending that clients who have not done so already tender their shares for the buy-back, and that they consider using the proceeds to purchase new shares.

mobile phone (except, of course, when they wish to see it in print!) Should it prove impossible to have a face-to-face, the movers and shakers borrow their driver’s or girl-friend’s spare phones for real conversations. Still, the Kompromat.ru website provides much entertainment for conspiracy theorists.

RUSSIAN ECONOMICS – LIVING WITH UNCERTAINTY

Some local strategists – perhaps cranky and blue at having to toil away in semi-deserted offices whilst their more fortunate brethren are enjoying the August sun – are writing all manner of wonders about the Yukos *scandale*. Apparently, Russia’s sterling reputation has been frightfully tarnished, foreign investors are rushing to take their capital home, scuttling carefully nurtured investment projects, while capital flight is back with a vengeance; as a result, economic growth is, or so they claim, terribly compromised. Typically, in almost the same breath they report that several foreign majors badly want to buy a stake in Yukos (but then, consistency is a virtue of small minds...) Menacingly, one of them now threatens to cut his forecasts for Russian GDP... our terror hardly knows any bounds!

Of course, T&B has become so accustomed to reading doomsday scenarios about Russia that, when they died down amidst the boringly bullish consensus of early 2003, we actually began to worry... reassuringly, doom and gloom is back!

Churlishly, we note that some of these same commentators previously warned us of the massive damage to be wreaked by, *inter alia*, crashing oil prices, ruble revaluation, socioeconomic turmoil, excessive capital outflow (now, inadequate capital inflow...), inappropriate monetary policy, under-investment, the absence of a proper banking system, the strength of (now, the weakness of...) the oligarchs, political turbulence – in short, more plagues than could be expected in a Nostradamus rewrite of the Bible!

As of this writing, Russian GDP growth is running neck-to-neck with China’s; despite the oncoming elections, the budget surplus has reached record levels (a macroeconomic stabilization fund is beginning to fill up); and, while growth in reserves has slowed, this appears to be the result of an intentional policy of the CBR; until two weeks ago, most of the doom and gloom crowd was decrying the onset of Dutch disease due to excessive capital inflows. Real (i.e. PPP-adjusted) mean purchasing power is estimated at better than \$7000 (i.e. within spitting range of Portugal), while growth in consumer expenditures is nothing short of explosive.

Measurement of economic growth being something of a challenge in a country where the grey component is variously estimated at between

25% and 40%, we note that one of the few statistical series we do trust – the Moscow Narodny PMI – is at a 20-month high of 54.1%, with rapid growth in production, orders (domestic and foreign) and employment. Not to despair – we remind the gentle reader that money is made by trading against mispricings, misconceptions, and especially, emotional biases, be them bullish or bearish. Russia still offers fertile ground!

OIL – DESPAIR GUSHES UP ETERNAL!

We have just read yet another learned dissertation explaining why oil prices are about to cave. While we find it mildly irritating that so many analysts continue to believe in a mystical reversion to the mean of prices, it is utterly infuriating that they compound their error by persisting in calculating their “long-term average price” for oil in **constant** dollars. This is, of course, egregious nonsense. By the same logic, the price of just about every commodity, from antimony to zirconium, is now trading at huge multiples of its 100-year average! Even if one believes in an obligate reversion to the mean (and T&B does not, except in a stationary universe...) then one should, at the very least, calculate said mean in inflation-adjusted dollars, rather than in totally meaningless nominal dollars!³

We would be more worried had we not been warned of an oil crisis, repeatedly, over the past 5 years. The so-called “one-off” factors keeping oil prices high are somewhat reminiscent of the “one-off” factors excluded from pro-forma earnings reports by certain US companies. If you have a “one-off” every quarter, perhaps it should no longer be considered a “one-off,” but rather a recurring factor. As noted previously, oil tends to grow in unstable places. Any commodity with a very tight supply-demand balance, which is dependent upon the simultaneous preservation of political stability in places such as Nigeria, Venezuela, Iran, Iraq and the Middle East is obviously going to see some volatility. Given the military situation on the ground, the notion that the US is going to impose its will on Iraq and flood the markets is obviously confined to the realm of

³ Although this point should be obvious, it apparently is not. The simplest way to demonstrate it is by taking it to a logical extreme: imagine that the Western world had lived with 25% annual inflation since 1981 (uncomfortable, but certainly conceivable). By the logic of the constant-dollar school, a barrel of oil costing \$30 in 1981 should now cost less than one dollar, i.e. well below the extraction cost of even the lowest-cost producer! This is clearly absurd. The historical price for any commodity must be calculated in terms of value, i.e. inflation-adjusted currency (the real price will also, of course, reflect the supply/demand equation as well as changes in extraction costs.)

fantasy (even if they could do so, they would quickly be confronted with collapse in Saudi... and given their current experience in Iraq, the enthusiasm for foreign adventures of even the most radical factions in the US government now seems to be on the wane...)

G7 oil production continues to decline, new ex-OPEC oil finds tend to cluster in politically unstable and geologically challenging areas (thus pushing up capital and production costs) and, while Russia will continue to grow its output, the Putin administration favors a gradualist approach, as opposed to the “pump out every drop” approach pushed for by Yukos. As correctly noted by BP’s John Brown, growth in ex-OPEC production is more than offset by the rise in global population and the rapidly growing wealth of Asian markets. Oil consumption forecasts involving predictions for stable Chinese consumption are patently absurd; with 7-10% economic growth, energy consumption can be expected to increase by at least as much. Though not growing as fast, India is also seeing a sharp increase in energy use. Russia is uniquely well situated to feed these fast growing markets.

Russian growth - The Bears Shall Have Honey!

From the macroeconomic standpoint, we believe that the two most important trends which will continue to drive Russian GDP growth at levels well in excess of 5% for the rest of the decade are rapidly growing domestic consumer expenditures and the increasing leverage throughout the Russian economy.

-As jarring as it may sound to Western ears, Russia has a fast-growing (lower) middle-class. The proportion of income spent on food and other necessities is falling steadily, while that spent on communications, transport, entertainment and housing is increasing. Although official statistics for consumption (and GDP growth) are worse than useless, reports by Russia’s premier consumer survey and marketing firm, IRG, based upon a host of surrogate indicators, are far more enlightening. IRG reports a veritable explosion in small business revenues driven by fast-growing consumption of services and consumer non-durables. This growth is being seen not only in Moscow, but most strikingly, in even the most far-flung regions.

While most of the growth in consumer non-durables and services is being met by local producers, in the absence of FDI or joint ventures,

the consumer durables sector still seems fairly hopeless.

- The death of Russia's manufacturing sector has been greatly exaggerated. While the automobile sector is being maintained solely by import tariffs, the manufacture of capital goods, machinery and weapons is showing great dynamism. Russia is becoming an important source for power generation and transmission machinery, drilling rigs, pipes, chemicals, turbines, etc. for the developing countries. Russian machinery tends to be cheap, technologically simple but relatively robust, and especially, easy to repair.

- Although agricultural outputs will be down this year due to bad weather (as Europe swelters, Russia freezes!), the turn-around in Russian agriculture, from basket-case to net exporter, seems little short of miraculous. As the oligarchic groups diversify into food production, the trend should continue.

- As repeatedly pointed out by Al Breach, in the aftermath of the 1998 crash, the Russian economy remains totally underleveraged. Until present, virtually all growth has been financed with cash from retained earnings. Similarly, consumer expenditures are almost entirely paid for on a cash basis (literally cash, i.e. large piles of US banknotes!) Total indebtedness of Russian households is a miniscule \$31 per capita. As both bank and securitized credit gradually become more readily available, consumer and corporate balance sheets will begin to be leveraged up, leading to a sharp increase in demand.

In short, with the usual caveats, T&B remains boringly bullish.

Russian Markets

So, now make me some money...

EQUITIES – QUIET DAYS IN MOSCIE

(Note: we will here confine ourselves to the mainstream assets: Sovlink Equities trading picks for the second and third tiers can be obtained from your Sovlink salesman)

Reviewing our predictions issued for the first half of 2003 ("T&B The Immaculate Misconception" January 20, 2003, available for download from the Sovlink Website, www.sovlink.ru, by clicking on "Strategy," followed by the title) T&B feels relatively pleased. Being somewhat lazy, especially under the tropical sun, we see little reason to radically shift our views. Most of the same factors operant in the first half should remain so in the second. We remain buyers of Prefs, Telecoms, and metals and manufacturing.

Oils – We were perhaps the only house to rate Tatneft a buy. We recommended taking profits about 6 weeks ago, with the stock up almost 50%. We would not rush back in just now. Yukos and Sibneft have pretty much lived up to our high expectations, albeit with rather more volatility than we had imagined! Those two baying hounds, Lukoil and Surgut have, quite predictably, continued to disappoint. Transneft, having had a great start, is currently looking a bit pale. We continue to suspect that management is massaging it down in order to buy more; their most recent earnings report was excellent, and we continue to rate it a buy. For lovers of the speculative, Bashneft, the beneficiary of a local pump-and-dump operation some time back, may eventually come in for a second lease on life, as the political struggle for Bashkiria hots up. Finally, although our institution does not offer a Gazprom structure, we think Gazprom locals a vital part of any liquid core portfolio.

Telecoms/Energy -The energos, and particularly the Prefs, have been absolute stars. After a 100% run (before dividends!) we would remain exposed to UES Prefs, but would now cut our exposure by half. On the other hand, we suspect that most of the remaining energos are coming to the end of their runs. Lenenergo may be relatively cheap, and since the Ords have uncharacteristically outperformed the Prefs (amidst FSC allegations of

price manipulation by one local brokerage), we might even venture a relative-value trade.

The land-line phones, on the other hand, are only half-way through their rise. We reiterate our advice to take profits in Rostel, but would up our exposure to the preferred shares of Uralsvyaz, Southern, Siberia and Volga. Early in the year, we added MGTS Prefs. We would now increase our exposure.

In the remaining sectors, both Norilsk and Severstal fall into the “only wish I had bought more!” category. They are benefiting from improved corporate governance, reasonably sustained global commodity markets, and investor diversification. Aeroflot was a weak call; it has not moved and we would move our money elsewhere. The shipping companies, Prisco and FESCO, still have great promise. We are becoming increasingly interested in the manufacturing (if you are interested in pipes – you are better off in Vyksa than in Chelyabinsk) and metals sectors; Sovlink analyst Rob Van Genderen (robg@sovlink.ru) will be initiating coverage of a number of smaller companies in these fast-growing sectors.

BONDS – BUYING THE PLUNGES!

As our first boss in finance, the late QA put it, if the customer liked it at 90, he should love it at 75! Having first recommended Rf28s in the mid-twenties (September 1998) we finally put out a sell at 174, some 6 weeks ago. When they dropped

below 160, we thought they were getting cheap again, and suggested buying back in. We fired too soon - they are now trading around 148. At this level, we would buy more. While perhaps 80% of the sell-off was directly attributable to plummeting US treasuries, spreads have also widened out more than 100 bp due to general market factors – not to any change in perceived Russian risk. We think that at 350 bp, investors are more than compensated; a treasury hedge would be appropriate for those preferring not to take a near-term view on US rates.

The same recommendation applies to Gazprom 13 and Sistema 08s. The Sistema bond is back almost to its issue price. With less than 5 years' duration and the Moscow City government as the ultimate backer, we would fill our boots for the carry trade. Gazprom 13s look like free money! At current prices, we would buy every bond we could find, sell the corresponding size of 10-year treasuries, and wax fat and happy on the differential.

Elsewhere in the Emerging markets, we would be fairly cautious. All of Latam is currently a highly leveraged bet on the success of Brazilian reform, with the overall emerging debt market jumpy and disoriented, evenly split between greed and fear. We would probably favor shorter-duration assets of non-core markets, e.g. Colombia. For yield hogs, Ecuador is looking very attractive, and, with spreads to treasury in the 4 figures, bears commensurately little Treasury risk. Brazil will probably present better entry points.

APPENDIX

THE POLITICS OF FEAR

The United States has once again changed colors... of terror alerts, that is. The quiet citizenry can now again remove the masking tape from the windows, the water buckets from their bathrooms, and return to their usual activities with only their normal degree of fear.

Since September 11 (2001), there has been a never ending sequence of official alerts warning of imminent attack – be it by terrorists armed with garden-variety explosives, or from more exotic radiation bombs, chemical and biological weaponry. In keeping with this climate of fear, fundamental liberties taken for granted by generations of Americans have been seriously eroded. Privacy, due process of the law, freedom from arbitrary arrest and confinement, and from State terrorism, all of these luxuries are gradually being sacrificed on the alter of (an understandable) desire for safety.

Manipulation of the media in the run-up to the Iraq war was egregious (though admittedly, the US press has belatedly begun to challenge some of the more outrageous lies they once readily swallowed). The Bush administration successfully distorted the issue, presenting a war fought to advance political goals as a “war on terrorism.” Domestically, the most extreme measures put forth, e.g. the TAP (Total Awareness Program) which involves opening access to everything from credit cards to dental records, from health data to library cards, for inclusion in a vast data base controlled by the security services, would be the envy of any dictatorship. Most strikingly, during this time the United States has not suffered a single domestic terrorist outrage.

It could, of course, be argued that this relative safety is the result of the stringent measures taken – but there is good reason to doubt it. If, after September 11, the US had been still teeming with would-be suicide bombers, it seems most likely that they would have already precipitated themselves into their expected share of paradise (taking with them as many innocent lives as logistically possible), rather than patiently waiting for the police noose to tighten about their necks...

The issue is not entirely trivial. If there is a serious terrorist threat, it is reasonable that extraordinary measures be taken – provided that these are kept to a the minimum necessary, and that they can be objectively shown to reduce the threat of further outrage, any society would accept them. If, on the other hand, this threat is fictitious, manufactured for political gain, then such measures constitute a criminal attack on fundamental rights.

We claim no expertise in counter-terrorism, however, given the manipulation witnessed in the run-up to the Iraqi war, we remain deeply suspicious. Mr. Bush never misses an opportunity to remind his audience that he is fighting terror. Opinion polls show increasing disquiet with the state of the economy (in particular, with the burgeoning budget deficit); the aftermath to the second Iraqi War confirms our oft-stated belief that the war was fought with only the vaguest of exit strategies; but on the issue of terrorism, Bush stands unchallenged. Indeed, it could be argued that, without a terrorist threat, Bush has little hope of reelection; any potential challenger must pray that there are no further provocations.

FEAR seems to be the primary axis of modern thought – although the Western man is undoubtedly safer than at any time in the past, he certainly does not feel that way. The SARS epidemic killed fewer people than die on a bad weekend on the French highways, yet it succeeded in bringing some fraction of the global economy to a grinding halt for several months. In the West, we live longer, healthier lives than at any time in history, safe as we are from the dangers of banditry and botulism, revolutions, uprisings and wars.

Most disconcertingly, this fear fails to transform itself into pressure for useful measures. Any school child could tell you that, left to fester, Palestine will continue to produce more history than can be consumed locally, yet the currently unsustainable situation is allowed to prevail. Population growth has destabilized both economies and the ecology throughout the developing world. Europe is currently broiling in an unprecedented heat-wave, yet action on global warming has still not found consensus.

Given the diabolical combination of basic health measures which decrease mortality and the absence of a commensurate reduction in fertility, large segments of the third-world (especially the Moslem countries) are becoming essentially ungovernable (anyone doubting this assertion is invited to visit Jordan or Indonesia...). Given the growing ease of transportation and modern communications, the consequences will not likely be kept localized. Most recently, a war fought to advance narrow political goals has served only to sharply widen the cleavage between the Moslem world and the West. From nuclear proliferation to increasing fundamentalism of all stripes, little good can be expected of it. Perhaps we should simply fear the right things!

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