

Truth and Beauty...

(and Russian Finance)

Bullet Proof?

Reflections on a Cold Summer

<u>RUSSIAN NEWS AND VIEWS</u>	2	<u>GLOBAL MARKETS</u>	5
The Yukos Follies	2	The US Recovery	5
<i>Apocalypse postponed</i>		<i>Skating on thin ice</i>	
Oil prices	2	Trading Recommendations	6
<i>Errare Humanum est (perservere diabolicum)</i>			
Mani Puliti	3		
<i>Russian Style</i>			
Acquired Immunity	3		
<i>Russian crooks / Western heroes</i>			
<u>RUSSIAN MARKETS</u>	4	<u>APPENDIX</u>	7
Equities	4	The First Casualty	7
<i>Our predictions for September</i>			
Russian Fixed-Income	3	History Repeats Itself	8
<i>The Return of the Native</i>			
Acquired Immunity	3	A Coalition of One	8
<i>Russian crooks / Western heroes</i>			
		"Smart Bombs" – Dumb Politicians	9

T&B has reluctantly descended from the highland rice-fields of Central Bali where we were blissfully cut off from the Internet, e-mail, mobile telephone and other scourges of modern man, and once again is connected to the Global Mind. With bated breath have we plunged into an assessment of what our friends and colleagues have been thinking and writing, and have scanned the relevant press (greatly facilitated by the exceedingly useful Ben Aris Russia Business List).

By and large, we are comforted in our general opinion: “they’ll never learn!” Yet, with some difficulty, we shall resist the temptation to leave it at that and head back into the paddies, instead assessing what the summer months have (or should have...) taught us, and venturing some predictions for the New Year (being French, T&B counts the year as beginning in September – i.e. following the blissful August frolic - rather than with the brutal Winter solstice).

Russian News and views

THE YUKOS FOLLIES – APOCALYPSE POSTPONED

Scanning the news in late August, a forgetful strategist could be forgiven for imaging that the Yukos affaire had never occurred. Although Menatep’s Lebedev still languishes in Lefortovo prison, Khodorkovsky has turned strikingly quiet; and, in sharp contrast to the predictions of several local brokerages, the sky has very distinctly failed to fall; both the RTS and the hard currency debt markets (in spread terms) are back close to their peaks.

As T&B warned two months ago, this entire *scandale* has provided a splendid opportunity for savvy local players to relieve gullible foreigners of their valuable Russian assets – at bargain basement prices. *Caveat Vendor!* Those with the courage to buy during the sell-off have, of course, been amply rewarded. What led certain local institutions to engage in so much gloomy speculation about the likely implications of the Lebedev arrest is not entirely clear, but, at least in some cases, the hope of future IB mandates from the oil giant were perhaps not alien to their thought processes...

Given that the Yukos affair signally failed to provoke the dire consequences foreseen, several houses have consoled themselves by pointing out that it has encouraged a rat-pack of politicians to jump on the anti-privatization bandwagon, demanding a thorough review of the privatization of whatever company they happen to want to put the squeeze on. Needless to say, this is pure political grandstanding; it has been tried before (e.g. Lenenergo) and failed, and even the

opportunistic political hacks in question know that it won’t work, except perhaps to get their names in the papers.

Reiterating our oft-stated view, as an oil company, Yukos remains on track to become a global major. While any thought of a Eurobond has been temporarily shelved, given the sharp back up in global yields, this would not have been the best time to issue in any event. Instead, Yukos has succeeded in raising 3- and 5-year money on the syndicated loan market at the lowest spreads ever for a Russian borrower: L+1.5% - 2%. This is probably a better option than could have been hoped for in the Eurobond market, even without the *scandale*. The Sibneft merger is going ahead as planned, and although we currently see better upside elsewhere, if T&B had to buy Russian equities with a 5-year lock-up period, Yukos would be one of our three top picks.

OIL PRICES – ERRARE HUMANUM EST (PERSERVERE DIABOLICUM!)

We are bewildered by the propensity of global oil analysts to continue to project oil prices falling to absurdly low levels... although one house has belatedly acknowledged that oil prices are going to remain a great deal stronger than their longstanding forecast, their revision is a long way from being consensus: another one continues to confidently base its macroeconomic model on an average 2005 Brent price of... \$20. We throw up our hands in despair!

T&B shall spare our gentle readers yet another reiteration of why the old consensus view on oil prices is totally, irretrievably misguided (recent issues of T&B, most recently “The Asian Strategy,” discuss it *in extenso*). As we have reiterated in virtually every report issued over the past 4 years,

we are confident that oil prices will remain very substantially above the consensus forecast.

Vitaly, this widespread misapprehension creates serious mispricings – cagy investors will not fail to exploit them. LUKoil (certainly not our favorite company, but which we currently rate a buy) has an expected 2003 P/E ratio of approximately **4.3**. Absurd, n'est-ce pas? Such valuations are justifiable only if one expects oil prices to collapse in 2004, then to remain low for the rest of the decade! Any analyst projecting cashflows for Russian oil majors on the basis of manifestly misguided price predictions is doing the bargain hunters a huge favour!

MANI PULITI, RUSSIAN STYLE?

T&B has been fairly caustic with the doomsayers who saw the arrest of Lebedev and the raid on Yukos as the beginning of a new dictatorial phase in Russia, arguing instead that it was simply a dust-up between the President and a single oligarch whose arrogance had vastly outgrown his appointed station. While we think that our viewpoint has been amply vindicated, the Yukos *affaire* may yet turn out to have formed part of – or at least coincided with – a new and very welcome trend: the first, tentative moves towards the imposition of a more rules-based society in Russia.

This summer has been marked by a series of arrests of notoriously corrupt functionaries, as well as the break-up of several police extortion rings; bureaucrats can no longer be assured of total impunity. This is election season, and the Russian populace exhibits a deep – and thoroughly justified – contempt for its corrupt police force and dysfunctional judicial system. There is a widespread sentiment that people are being robbed on a daily basis, with at least the passive collusion of their government, and that diligence and industry will get you nowhere... it is connections and cash that count.

Let it not be underestimated how damaging this is, giving rise to a truly spectacular degree of nihilism, moral cynicism and opportunism. One of the abiding strengths of the United States is the widely-shared "Horatio Alger" myth: the poor young man who sets out to build his fortune based on nothing but his natural virtue, thrift and hard work. In American folklore he grows rich and respected – in Europe the tax man makes a

pauper of him, while in Russia, corrupt politicians and the local mafia squeeze him to death.

Russia has 700 years of history to contend with, and a civil society to build; these are generational issues, and one should not expect miracles. In any event, a crackdown on corruption and bad governance would clearly be a vote-winner. While we hope to see future prosecutions target recent rather than historic misdeeds, an end to oligarch immunity would be a very welcome change.

ACQUIRED IMMUNITY – RUSSIAN CROOKS/WESTERN HEROES

We have just learned of the arrest of Vladimir Gusinsky, currently being held by the Greek authorities in execution of a Russian arrest warrant. His very professional PR machine is no doubt revving up as we speak, and no doubt we will soon be hearing the anguished cries of "persecution" by those naïve or corrupt enough to cast Mr. Gusinsky – alongside the equally notorious Boris Berezovsky – as would-be saviors of Russian democracy. Of course, the Media-Most story was characteristic of the worst oligarchic practices of the late Yeltsin years; anyone who bothers to review the details of how – and with whose money – Gusinsky built his media empire, and why it collapsed like a house of cards, may wish to see him charitably afforded the opportunity of clearing his good name in a public criminal trial. Certainly, we would not begrudge him that boon...

In one of those interesting double standards so characteristic of Western attitudes towards Russia, while we have long heard an indignant clamor that certain wealthy criminals be brought to justice, every time an errant oligarch comes to grief, he is suddenly lionized as an innocent victim of political repression! While decrying the danger of the "Russian Mafia," several European countries have proved unwilling to extradite Russian citizens wanted for crimes in their home country – be they Chechen terrorists or simple fraudsters. Perhaps Russia should remind the Western powers that extradition agreements and Interpol cooperation are a two-way street by offering asylum to a few of their Western counterparts – rumour has it that the gentlemen from Enron have signed up for intensive Russian language tuition...

Russian Markets

When will they ever learn? The lessons of summer...

EQUITIES

Our predictions for September: Temperatures will fall, leaves change color...

One of the enduring bits of idiocy in capital markets is the notion that markets follow predictable seasonal patterns... if they did, even the most dim-witted trader would quickly find a way to arbitrage it out, buying at the bottom and booking an easy profit. In spring, we were warned that the Russian market always gets crushed in summer... instead, it has risen to within spitting distance of its historic peak... yet once again, we are hearing warning of the dreaded "September effect".

T&B is characteristically wary of issuing short-term market calls. On this fifth anniversary of the August crash (yes, time does fly...) our fundamental view is largely unchanged – the Russian market remains generally undervalued, indeed, over the long term it is something of a one-way bet. Fortunately for us brokers, it will not be anything like a straight line up; market timing is thus the real challenge. This is readily understandable, given the need of strategists to say something in the absence of many reliable indices upon which to base short-term predictions. In particular, we invite any readers in need of light entertainment to check the back issues of the research dailies from those local houses which helpfully furnish technical analysis, contrasting the predictions made with what actually occurred – frankly, my Labrador could have done at least as well! Although T&B will not contest the utility of technical analysis in large, liquid markets with a high degree of transparency and a large number of independent participants, in the Russian market we find it about as useful as tits on a bull!

Yet, with the usual caveats, if we were forced to place a bet, it would be that the RTS continues to rally nicely in September. Global markets are firm¹, oil and commodities are strong, while domestic

¹ Every one of the 64 major world equity indices is up YTD; Russia is tied for 2nd place with Poland, while everyone has been trounced by that Latin dragon, mighty Venezuela – up 82% on the year!

liquidity remains what it was – the crux of the issue; macro numbers continue to come in excellent, with Russian debt once again trading at investment-grade spreads.

The oligarchs are still picking the last bits from the carcass of UES, the controversy surrounding Yukos and Sibneft is largely dormant, and it is rumoured that one financial institution, having failed signally in its attempt to buy up 25%+1 of Mosenergo on behalf of a Russian major, may have to come back for more. With an increasing proportion of the market in the hands of strategic investors, those for which there remains decent free float – notably both Lukoil and Gazprom – are very much back in fashion. For investors able and willing to look beyond the blue-chips, there is a welter of compelling stories: from the (fairly obvious) preferred shares, in particular the wire-line telecoms, to the 2nd tier metals, a couple of energos, the pipe-rollers, a few second-tier oils and an assortment of refining, transportation and infrastructure assets. Best returns will be found here. Time, as Borges noted, is not infinite but ultimately circular: MGTS – an old favorite from pre-crash days, is back in favor, and we are delighted to be receiving client requests for information about Kazan Helicopter. Enjoy the ride! (but watch out for the whirling blades).

RUSSIAN FIXED-INCOME – THE RETURN OF THE NATIVE

In our last issue, we predicted that US bond yields would probably stabilize, and – as Russian spreads were going to head south – strongly recommended the entire range of Russian hard currency debt, especially the high-yielding corporates.

Despite the relatively strong headline US economic releases, the treasury market has indeed stabilized, with the long-end tightening somewhat relative to the middle of the curve; the 10Y treasury has improved by about 10 bp, with the 30-year coming in by 25 bp. EMBI debt has largely decorrelated from the treasury market, with Russia outperforming nicely: the hugely oversold Rf28 surged some 8 points, while the entire range of corporates has tightened to both the sovereign and the treasury curves. Although this move probably has a ways to run, we note that the long sovereigns are once again trading inside of investment-grade Mexico (250 bp for the Rf 28).

Priced at around 91, the Rf30 will gradually move towards par, but in the current interest rate climate, it should meet resistance there (note that while its coupon steps up to 7.5% in 2007, it also begins to amortize, thus providing a certain degree of "pull to par" which limits both upside and downside).

While we expect the sovereigns to continue to perform nicely, we would shift our focus towards the highest-yielding corporates (except for anything with the word "bank" in it²). We reiterate our buy recommendations on Sistema 08 and Sibneft 09, and will take an initial look at Alrosa 08s, now trading well below par. For an excellent arbitrage play, buy Gazprom 13s against the Rf10, taking the 320 bp spread differential on what is essentially a sovereign credit! For what it's worth, we are becoming less bullish on treasuries; we continue to recommend the long dated Russian sovereigns, but with a full treasury hedge.

Global Markets

THE US RECOVERY. SKATING ON THIN ICE.

Global Markets are continuing to make a monkey of T&B, and yet T&B can only reach for more bananas! Although over the past several weeks the dollar has further strengthened against the Euro, global equity markets have risen on the back of a strong tail-wind from America and G7 bonds have remained under pressure, we believe that the

² Memories are short, but not that short. ALL of the non-ruble corporate and regional Eurobonds were eventually paid off after the '98 crash – all the banks save one were a disaster. The exception, of course, was Alfa, which we would now feel comfortable in owning; it was the only bank to pay off its Eurobonds in full after the crisis, offers a respectable credit history and has (very) rich parents. The Zenit and UralSib issues are currently under water – finally, like the apocalypse, while there are persistent reports that a NIKoil Eurobond is in the works, it never seems to quite happen... too bad, it would make a truly great short!

market is setting itself up for a major disappointment.

Although we will not dispute the fact that recent economic releases are encouraging, we continue to believe that the putative recovery is built upon a fundamental flaw: excessive debt at all levels of the economy, increasing dissavings, and gaping global macroeconomic imbalances. You simply

Cognitive dissonance

While virtually everyone has paid at least lip-service to the fundamental economic problems, there seems to be a widespread psychological resistance to actually contemplating their likely repercussions: by way of example, in a recent, strongly bullish report on US economic growth prospects, one major house correctly noted that the US current account deficit would continue to burgeon, while the Federal budget deficit could easily hit \$1 trillion – driving up yields very significantly and further enhancing consumption at the expense of investment. Perhaps with the active encouragement of senior management, they then proceeded to ignore the obvious conclusions, ending their report instead with a bland statement that "technology" would save the day.

cannot borrow your way to wealth! Considerations of space (and of our reader's patience) preclude a thorough discussion of the macros, however we note that, while recent US economic releases have not been supportive of our bear case, many of these are misleading or flawed. Several points to consider:

-Under Greenspan the quaint notion of hedonic pricing was introduced to the calculation of both GDP and inflation (thus affecting estimated capex, productivity, etc); this shift goes a long way towards explaining the "productivity miracle." In

brief, "hedonic pricing" somewhat arbitrarily introduces a correction factor compensating for the qualitative improvement in products by increasing their assessed value. The correction is particularly noteworthy for computer equipment, where the price of computing power has plunged – as a result, that \$2000 computer you just bought may have gone into the national statistics as representing \$20,000 in capex. Whether or not this correction is justifiable we will leave to the academics; certainly, it greatly flatters US productivity and GDP numbers (as well as distorting the comparison between US and European output growth in favor of the former, by some 0.6% of GDP).

-As expected, mortgage refinancings have collapsed by 80% (from a peak of 10,000 for the Refi index, to only 2000). Vivaly, the refinancing trade cannot resume in earnest until 10-year rates fall back to or below their recent trough of 3.12%, as most American fixed-rate mortgages are now at interests rates below those currently on offer. While this collapse has not yet fed through into a

drop in consumer spending and housing, it is simply a matter of time – probably 3-6 months – before it does so.

- Although non-defense durable goods were up sharply over the past month, we note that, in absolute terms, they are only back to their levels of 1998 – about \$55bn, vs. the \$65-70 bn of recent years. As Chris Wood noted in a recent report, the incipient recovery cannot become sustainable without a new investment cycle – thus far, there is no evidence that one has gotten underway.

- We never cease to be amazed at the ability of the market to ignore elephants in elevators, e.g. the huge twin deficits: the US budget deficit is now aiming for the ½ trillion mark while the c.a. deficit is currently running at \$2bn a day; according to Morgan Stanley, it may well hit \$3bn – i.e. 6.5-7% of GDP – by 4Q2004. The classical effect of this would be a currency crisis with a major back-up in real interest rates; the latter is, in fact, already underway...

- At 3.1%, 2nd quarter GDP growth was substantially better than expected; this growth was primarily due to military build-up and replacement of weapons expended in bringing American-style democracy to the unfortunate Iraqis... since this is being financed by deficit spending, it does not seem to be sustainable over the longer term.

-Most importantly the recovery remains jobless. Productivity is the name of the game, as companies are run for cash. Three million jobs have been lost since 2000; the recent Philadelphia Fed showed a further deterioration in the employment indices, as did the otherwise extraordinarily strong ISM, showing a further deterioration in the employment conditions index to 45.9, this despite a rise in the overall index to 54.7. Consumer confidence polls show that a large and increasing majority of respondents describe jobs as being “hard to find.” This does not bode well for spending by over-leveraged consumers, at least once the current tax cut has been spent.

Big, scary and yellow (or, be careful of what you want... you might get it!).

Given domestic political imperatives, US Treasury Secretary Snow is currently ratcheting up the pressure on the Chinese to let the renminbi float. The Bush administration is known for its fondness of prayer; Snow probably prays the Chinese will publicly agree, then simply ignore him! While a renminbi float would be economically rational, it would also relieve the Chinese of the obligation to buy all those US treasury bonds with their huge trade surplus. Indeed, with a revaluing currency, their \$350 bn dollar forex reserves would appear to be grossly in excess of any conceivable need. The effects on the US bond markets could be fairly dire...

TRADING RECOMMENDATIONS

-Equities. Although at present we would probably trade global equities markets from the long end, we would tend to await what we think will be a truly historic occasion to short them, especially finance and technology. Don't get in too early, but don't miss it once it starts!

-US treasury rates. We must moderate our previous mildly bullish stance on bonds – given the uncontrolled deficit, we expect a further rise in US yields, as foreign investors demand more payment for assuming the increased risk. With the budget deficit out of control, we would adopt a neutral stance.

-In EMBI debt we would remain aggressively long, but either cut our duration or hedge out treasury risk.

-We remain dollar bears. Previous periods of dollar weakness have been characterized by 8-10% countertrend rallies, like the one we are now seeing.

Finally, whether or not we are right in our calls regarding the general trend of the US economy (indeed, especially if we are not) we are increasingly convinced that, just as the past two decades favored G7 equities (and bonds), the coming one will favor commodities – along with

selected emerging markets, especially those of Asia. We would recommend investors able to own diversified baskets of energy, base metals and gold futures do so; those unable to play commodity markets outright should favor those equities which will benefit from strong commodity prices, especially companies exporting to Asia. We remain aggressively bullish on oil.

Similarly, we would recommend increasing exposure to selected emerging market equities, either directly or via funds. Needless to say, if these later predictions prove correct, the Russian economy, and financial markets, should thrive.

Appendix

Operation Frequent Manhood: Coming to grief.

Disclaimer

T&B enjoys the extreme luxury of writing freely on a wide range of topics, suffering no censorship. A few of our readers have recently expressed irritation at some of our political views, inter alia, our criticism of the US invasion of Iraq, and our general take on the policies of the Bush administration. Even as the occupying armies in Iraq become increasingly bogged down, and with the mainstream press outspoken in its assessment of the lack of candour with which the case for war was presented, their irritation has not diminished.

In the pursuit of his profession, T&B reads a wide variety of views; by necessity, a good proportion of these are sharply – often diametrically – opposed to our own. We are in no way impoverished by this experience – indeed, we prefer to read authors whose opinions differ from ours; when we find them compelling, we are ready to change our views; when we do not, it at least allows us to better hone our own arguments. Given that, until recently, some of our readers have been exposed to little or no critical assessment of the basic policies of the current US administration, we think it no bad thing to remind them that – rightly or wrongly – there is an alternative view.

Nevertheless, to avoid causing unnecessary turbulence, we have recently taken to isolating some of our more politically contentious views in appendices – similar to the human appendix, the patient can live quite well without it, and when inflamed (or inflammatory) it can be safely removed. Therefore, those readers who prefer not to be subjected to our hostility to the Bush regime, enthusiastic support for the BBC, or our general premise that neo-imperialist policies have unforeseeable and sometimes deadly consequences (“Blowback”, is the term assigned by Chalmers Johnson in the eponymous book) may chose to simply skip the appendices.

Readers are reminded that they are welcome to forward T&B to any interested party. Anyone wishing to forward the present appendix can download it from our website.

Please note that it reflects the opinions of its author only, and not necessarily those of his institution or the employees thereof.

THE FIRST CASUALTY

In any war, Truth is the first casualty

T&B continues to receive a steady trickle of notes from readers – indeed, including some who had initially been quite critical of our stance – acknowledging that the US-led invasion of Iraq has indeed proved a tragic error. Frankly, we are slightly bewildered as to why so many thoughtful, intelligent people were so readily misled (although even T&B must admit to being awed by the degree of idiocy of the military “planning” – apparently, there was literally no exit strategy – save for some vague fantasizing about a grateful Iraqi people rising up as one man to welcome the liberating Americans. Anyone, of course, who has spent so much as a weekend in the Middle East, knows that this is about as likely as Ariel Sharon joining the next Hadj pilgrimage to the Mecca! Once again, the great danger of propaganda is a “blow-back,” when governments start to believe their own lies...)

The key to this mystery was perhaps elucidated by the remarks of a couple of our English correspondents – they sadly noted that they had initially found it impossible to believe that their own government could deceive them so egregiously; recently published opinion polls show that fully 2/3 of British respondents now realize that it did precisely that. We suspect that our American readers were equally disinclined to believe this of their own government, indeed, probably far more so. Again, the painful truth is slowly sinking in.

Perhaps T&B here has some slight advantage: in the course of the years, we have lived under the governments of a fair number of countries, rich and poor, turbulent or settled, democratic or otherwise; yet all of them have at least one point in common: they all lie!

Some can get away with egregious fabrications, others must contend with an educated and cynical populace. Some lie as a matter of course, others only out of necessity; some lie to promote the interests of a corrupt few, others to impose a course of policy that the elite, in its infinite wisdom, had decided was best for the common good... but all lie.

Therein lies the value of a free press. If it is to serve any purpose, the press must be deeply skeptical, especially in life-or-death issues such as foreign wars. Even the most apparently justifiable wars must be assessed critically... if it is just, the resolve to wage it can tolerate critical examination; if otherwise, it had best not be waged at all. The whoring shills of Fox network and their ilk are thus as guilty of the current slaughter as the Neanderthals in the Pentagon – indeed rather more so, since the military man is not expected to think critically. While we are gratified that much of the periodical press has belatedly revised its early uncritical acceptance of the Bush line, the honor of the press corps has certainly been salvaged by the tough, plucky journalists of the BBC, who have afforded the Blair government a sterling opportunity to demonstrate its own shallow hypocrisy, manipulation, and cynicism.

HISTORY REPEATS ITSELF

As the US sinks into the Iraqi quagmire, we are increasingly reminded of the Vietnam debacle. Certainly, there are perhaps more differences than similarities; both are instructive. Among the differences, a clear and credible motive was given for the US involvement in S.E. Asia: the Cold War. To a great extent, the stated reason – a battle against Communism – had, at least, the virtue of being the true motive, however useless and barbarous the conduct of the ensuing war may have been.

The true motivation for the Iraqi adventure, on the other hand, remains subject to some doubt. Certainly, the reasons officially put forth – the war against terrorism and freeing the Iraqi people from the hateful regime of Saddam Hussein – were transparently false. To the extent that it was something other than a show of pure political arrogance and military machismo (as well as affording Cheney's Halliburton an opportunity to reap hundreds of millions from the reconstruction), it was about extending control over an economically-vital region – bringing Pax Americana to the Persian Gulf.

This purpose, of course, has collided with a rising tide of Arab nationalism and long-smoldering Islamic resentment of the West. Rightfully or wrongfully, the Arab "Street" sees this war as a resumption of the Crusades. The governments of moderate, non-fundamentalist Islamic states such as Malaysia find it particularly hateful, since it is fueling a dangerous trend toward religious radicalization at home. The sorcerer's apprentices scurrying about the Washington corridors of power have shown little compunction about unleashing some particularly savage genies whom others shall have to contend with.

Like the Vietnamese, the Iraqi resistance will most likely prevail. However cruel and odious the regime overthrown by the US, the invaders will be hated every bit as much. The US is currently spending perhaps \$5 bn a month in trying to hold the ground, yet the generals already complain of understaffing; the \$80 billion allocated by the US congress has melted like snow, and at least as much will now have to be requested. While there is nothing like the level of bloodshed of Vietnam, the Anglo-American armies are losing a couple of men a day. Troop moral is miserable, promises of a quick withdrawal seem ludicrous, the domestic press is becoming harder and harder to control, while the war grows increasingly unpopular at home. Most vitally, the Iraqis do not have the option of backing off – it is their country, they've nowhere else to go. The Iraqi resistance can thus be victorious without winning a single battle... they have simply to outlast the invaders.

A COALITION OF ONE

Having scorned the UN and condemned it to "irrelevance" in their arrogant push for war, the Bush administration now finds itself praying that the erstwhile irrelevant organization will help to pull its chestnuts out of the fire. There seems little hope of that happening. The French, Russians and Chinese repeatedly warned that the war was folly... it is rather a lot to now ask them to waste lives and money trying to help save Mr. Bush's face. After the appalling devastation of the United Nations humanitarian mission in Baghdad, it is

tragically obvious that any Westerner in Iraq is *ipso facto* a combatant, and thus very much in harm's way. Although a mixed force of some 9000 men, entirely funded by the US, has been introduced, this is more for purposes of PR than for holding the ground; the "coalition of the willing" is apparently not the coalition of the able.

The cost of rebuilding Iraq is estimated in the tens, perhaps hundreds of billions; yet no funds had been allocated for this purpose. Apparently, the deep strategic thinkers in the administration had fantasies of first devastating the country with high-tech ordinance, then letting their friends in the infrastructure business (Halliburton, Bechtel, etc.) rebuilt it all, funded with proceeds from the sale of Iraqi oil. Things, of course, did not quite work out that way; thus, with a breathtaking display of *chutzpah*, the Bush administration is now pushing for a "donor's conference" to find other countries willing to fund the consequences of an illegal war which virtually all of them condemned – our working assumption is that the US will find little enthusiasm.

"SMART BOMBS" – DUMB POLITICIANS

It was all so unnecessary. In the run-up to the war, the US very effectively ratcheted up the pressure on the Hussein regime, which was reduced to accepting inspections under the most humiliating of conditions, while all the while its territory was undergoing daily aerial bombardments by US aircraft. The threat of WMD, always vastly exaggerated (chemical and biological weapons have proved a total failure under battlefield conditions, and Iraq was nowhere near to having a credible nuclear program) could have been readily eliminated – and Hussein's political influence badly weakened – without the tens of thousands of dead, the widows and the orphans and the cripples, the devastated infrastructure and the ravaged tissue of international relations.

As foreign policy, it has been an unmitigated disaster. Lest it escape anyone in the administration, the days of outright colonialism are over. The people of the third-world are more politically aware, better armed and organized, and have themselves built international networks of support. Islamic nationalism is an increasingly potent force. Predictably, the planned follow-on (though perhaps it was conceived primarily as a fig leaf for Tony Blair) – the "road map" for settlement of the Israeli-Palestinian conflict – is a shambles; the imperatives of American domestic politics prevent the US from acting as a credible fair-broker. Similarly, rather than frightening other potential opponents into submission, the stalemates in Iraq and Afghanistan will radicalize them – encouraging them to seek nuclear weapons as a form of insurance – while paradoxically freeing them from any credible fear of US military intervention; it seems most unlikely that, already mired in Iraq and Afghanistan, the US intends to open a third front, be it in Syria, Iran or North Korea.

14 months remain before the next US Presidential election. For Bush to pull out of Iraq now would certainly guarantee his electoral demise. Much like the latter phases of the Vietnam war – when Nixon insisted that the war must be fought in order to "save face" – overtly or otherwise, Bush is faced with much the same imperative. How many deaths, how much destruction, how much money will be squandered on an ultimately futile war remains to be seen... we currently see little grounds for optimism.

As had been repeatedly warned by European Arabists, the ethnic fighting has already broken out. Turkmen against Arab, Arab against Kurd, Sunni against Shia. Dreadful as the Saddam regime was, at least, like the communist regime in Yugoslavia, it was able to keep a lid on intra-ethnic tensions. A focus of Arab/Moslem nationalism, the war will inevitably be internationalized. It is unwinnable. Sooner or later there will be no choice but for the US to march back out of Iraq, leaving behind a deadly shambles...at best, a sort of post-revolution Iran, at worst, another Afghanistan. Thus are the consequences of the "hanging chads!"

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