THE GLOOM, BOOM & DOOM REPORT

ISSN 1017-1371 | A PUBLICATION OF MARC FABER LIMITED | FEBRUARY 28, 2002

Following the Post Bubble Script

> A "sound" banker, alas! Is not one who foresees danger and avoids it, but one who, when he is ruined, is ruined in a conventional and orthodox way along with his fellows, so that no one can really blame him.
>
> *John Maynard Keynes* (1883–1946)

CONSEQUENCES OF THE ENRON SCANDAL

Recently I spent a few days in New York, where Osama bin Laden's limelight has been stolen by the bankruptcy of Enron. The TV news channels had only one story to report: how the United States' seventh-largest company could go bankrupt so rapidly while the securities regulators, Enron's auditors, and its board of directors were all sleeping the slumber of confidence, complacency, and ignorance. Of course, every commentator had some kind of explanation for the financial disaster, but no one observed that Enron itself isn't really the problem; rather, it is a symptom of the rot, excesses, and financial irregularities that occurred in the US bubble economy of the late 1990s and which remain characteristic of the entire US capital market today. Enron is far from being a unique case of accounting irregularities, false reporting, and over-leverage; in fact, it is just one of a large number of companies who, in recent years, have artificially boosted their earnings with a view to manipulating their share prices higher.

The demise of Enron will have far-reaching implications not only for its dubious management, and for those companies and politicians who had a business relationship with it, but also for the entire stock and corporate bond market. The price of a stock or a market depends on fundamentals, but even more importantly, it depends on the confidence of the investing public. When investors feel confident, they are willing to pay a far higher price for a stock or an entire market than when they lack confidence. Thus, when investors feel good about the economy and the outlook for corporate profits, they may pay 25 times earnings for the stock market. Conversely, when their confidence level is low, they may pay only 10 times earnings or less, as was the case during most of the 1970s. At the same time, if investors can no longer rely on the financial information that the corporate sector provides, they will demand a higher risk premium on corporate bonds. This simply means that corporate bond spreads, especially in the case of lower-quality bonds, will either stay very high or widen further (see Figure 1). Wider corporate bond spreads combined with lower equity valuations will, in turn, increase the cost of capital and contain an earnings recovery. Therefore, I feel that the Enron debacle, together with the recent collapse in the share prices of Tyco, Worldcom, Elan (which have all broken down below their September 2001 lows), IBM (see Figure 2), as well as other companies that may have had questionable accounting

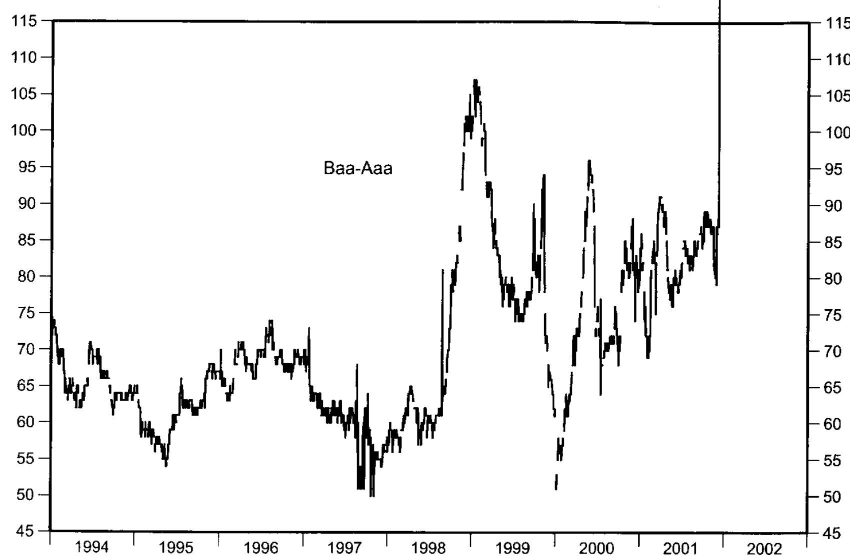


Figure 1 **Corporate Bond Spreads (basis points), 1994–2002**

Source: yardeni.com

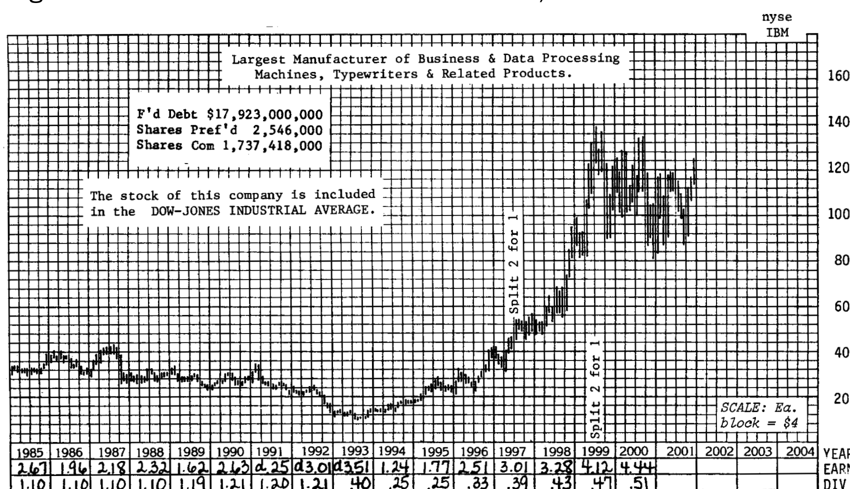
practices, will lead to a lower valuation for US equities in future, as well as to higher financing costs. Thus, I maintain that it is quite probable that we have already seen this year's high for the US market in early January when the S&P 500 briefly exceeded 1180 (see Figure 3).

More than the lies most Enron executives and directors were dishing out at the congressional hearings, what caught my attention was the fact that the entire investment community — including the analysts who had continued to recommend the stock right up to its demise — was taken by surprise by what is the largest bankruptcy in American financial history. After all, swindles and other transactions that overstep the confines of law and morality have been inseparable from earlier financial booms and bubbles and usually only come to light after the boom has come to an end. It is in this "bust phase" of the bubble cycle that credit standards become tighter, investors grow more critical, and the rules of the investment game tend to change permanently.

The late Charles Kindleberger, in his book *Manias, Panics, and Crashes* (John Wiley & Sons, 1978), devoted an entire chapter to "The Emergence of Swindles", where he writes: "The propensities to swindle and be swindled run parallel to the propensity to speculate during the boom." According to Kindleberger, swindling is demand-determined, because "in a boom, fortunes are made, individuals wax greedy, and swindlers come forward to exploit that greed". Moreover, he argues, "it increases further in financial distress from a taut credit system and prices that stop rising and begin to decline". Among other dubious and illegal activities, Kindleberger cites the systematic embezzlement from the Royal African Company, the East India Company, and the Union Pacific by insiders who skimmed off profits due to stockholders through contracts with companies they themselves controlled, and cites contemporaries who referred to the 1920s as "the greatest era of crooked high finance the world has ever known". According to Kindleberger, the revelation of the swindle, fraud, or defalcation "makes known to the world that things have not been as they should have been, that it is time to stop and see how they truly are. The making known of malfeasance, whether by the arrest or surrender of the miscreant, or by one of those other forms of confession, flight or suicide, is important as a signal that the euphoria has been overdone. The stage of overtrading may well come to an end. The curtain rises on revulsion, and perhaps discredit."

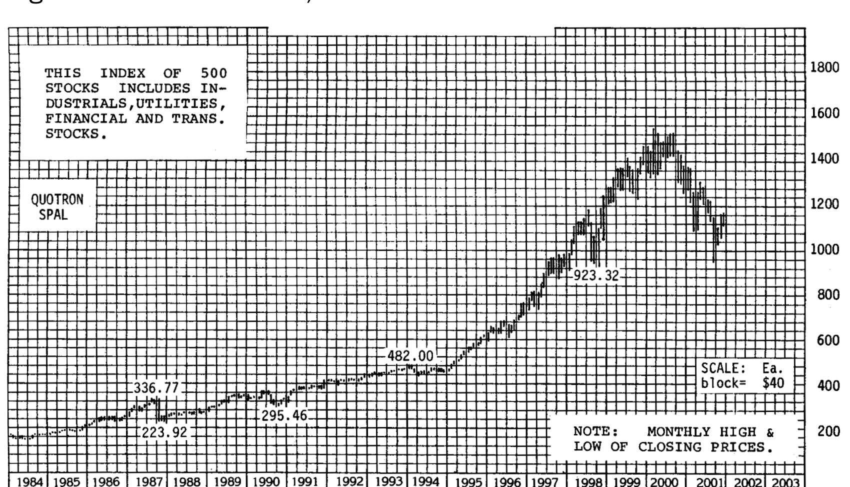
The reason the Enron bankruptcy is significant for the future direction of the US stock market is that, until now, the optimistic Wall Street market observers have gone out of their way to argue that there was never really any US stock market bubble, with the exception of the bubble we had in the Internet and telecommunications sector. In other words, the weakness in the stock market over the last two years was dismissed as a correction brought about by speculative excesses that had occurred only in the high-tech sector; the broad market, it was argued, was fundamentally on solid ground and hadn't shown any signs of speculative excesses. But now, with Enron, we don't have the failure of a "new economy" start-up, run by some 25-year-old wizard with no business experience whatsoever, but an "old

Figure 2 **International Business Machines, 1985–2001**



Source: The Stock Picture

Figure 3 **The S&P 500, 1984–2002**



Source: The Stock Picture

economy" company run by respected and politically well-connected businessmen, going out of business as a result of some highly questionable business practices and in the process opening up a totally new Pandora's box for the entire investment community.

Investors will have to wake up to the fact that the relentless rise in stock prices in the late 1990s in the Western world led not only to a colossal bubble for some speculative Nasdaq-type stocks, but also to an unprecedented mania in most large market capitalisation companies, and — even more troubling — in the entire financial system. **In other words, the last few years produced a mania not just in one sector of the market — the Nasdaq — but in the entire financial system.** As long as one could argue — not very convincingly, however — that the financial mania was concentrated in just a relatively small number of speculative stocks, hopes of a new high in the market averages could be entertained on the basis of a shift in leadership. The optimists simply argued that a sharp rebound in the depressed (???) Nasdaq, combined with new highs in "old economy" shares, which even at the height of the mania were never perceived to be "overvalued", would shortly lead to new highs for the major market averages. However, if indeed the entire financial system was in a gigantic bubble phase, then the possibility of a new high in the market averages could no longer be entertained, because the historical evidence shows that once a major mania comes to an end, it usually takes from ten to 20 years, or even longer, to make new highs. (Recall that it took US stocks 25 years to exceed their 1929 peak. How much longer will it take Japanese equities (top in 1989) and gold (top in 1980) to reach new highs?)

Moreover, a rather more troubling thought is the following. Since, with the exception of my friend James Chanos and a handful of other analysts, the entire investment community was duped by Enron and its highly dubious executives, is it conceivable that the investment community at large is also overlooking the fact that the entire US capital market, with its high leverage and gigantic derivatives market, is just one huge Enron-like disaster waiting to happen? Only time will tell, but I do think it is important to ask the question. Since the dubious practices Enron executives engaged in were so large in scale, it is doubtful that they could have been carried out without the help of a large number of "highly respected" consultants, lawyers, investment bankers, senior government officials, and politicians. (The issue here is that Enron executives were assisted by people who either didn't know what they were doing, in which case they were simply irresponsible, or who knew perfectly well that they were assisting a major corporation in carrying out highly dubious schemes, in which case they were plainly dishonest.) Thus, the possibility that the Enron rot goes far deeper than is generally acknowledged cannot be dismissed lightly and should make investors — particularly in financial stocks — rather nervous.

If the regulators failed to spot the irregularities that occurred at Enron (after having failed to contain the leverage of LTCM), it is more than likely that they have little insight into the banks' and other financial institutions' off balance sheets and derivatives positions. I am aware that it is neither a fund manager's nor an analyst's job to question the health of the capital market, since, as Keynes pointed out, financiers are not people who foresee dangers and avoid them, but, rather, people who, when they are ruined, are ruined in a conventional and orthodox way along with their fellows, so that no one can really blame them. But herein lies precisely the problem. The entire investment community is so obsessed with outperforming benchmarks and reaping huge profits from all kinds of hyper-complicated and speculative financial transactions that no one is really questioning how durable and sustainable the current situation can be, where the size of the capital market — specifically, the debt market — and the profits derived by its intermediaries continue to expand at a far higher clip than nominal GDP. (For a more detailed discussion of the monetisation of the American economy, see GBD report of September 29, 2001, entitled "Who Shall Decide When Doctors Disagree?".)

At a recent investment seminar, Douglas Cligott, the thoughtful and currently bearish strategist of J.P. Morgan Chase, produced a figure showing how the financial sector's share of market capitalisation and earnings had increased since the 1970s (see Figure 4). As can be seen,

Figure 4 **Financial Sector's Share of Market Capitalisation and Earnings, 1973–2001**

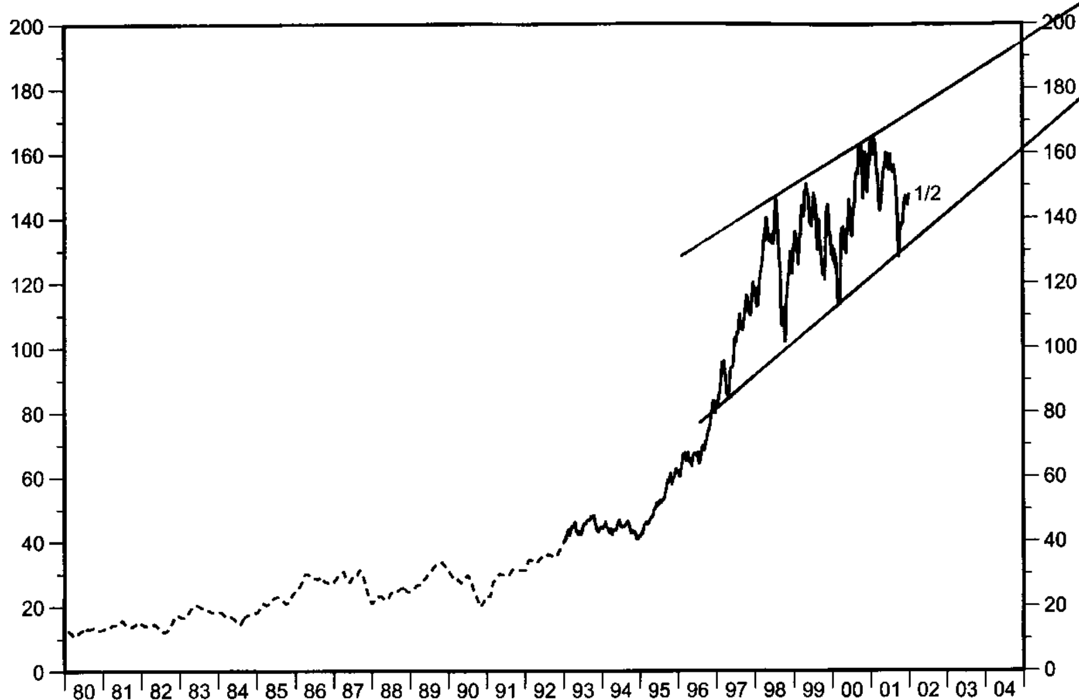
Source: Datastream and J.P. Morgan

financial sector earnings have grown from just 5% of S&P 500 earnings to almost 30%. If other financial activities of corporate America, such as investment income, venture capital gains, earnings from consumer and other vendor financing subsidiaries, and net pension fund gains, were included, the percentage of profits corporate America derives from financial activities would have been closer to 40% of S&P 500 earnings at the market's peak in 2000. (By comparison, the technology sector accounts for less than 10% of S&P 500 earnings.) In the meantime, the market capitalisation of the financial sector has risen to around 20%, from 5% in the 1970s; but again, if companies like GE and Ford, which derive a substantial portion of their earnings from financial subsidiaries, were included, the percentage would be far higher. (Tech stocks account presently for about 17% of S&P 500 market capitalisation — down from 35% at their peak in 2000, while the energy sector has shrunk to just 5% of market capitalisation, from 27% in 1980.)

The above trend line growth of the financial sector's market capitalisation and earnings is obviously not sustainable ad infinitum, and in the wake of the Enron scandal and other financial skeletons now coming out of the cupboard, **I maintain a very negative stance towards financial stocks, including money centres** and investment banks, consumer finance companies, sub-prime lenders, and mortgage finance companies (see also GBD report of September 29, 2001, referred to above). My negative bias towards financial stocks is also based on the fact that they have out-performed the S&P 500 by a wide margin since the end of 2000 and now account, as mentioned above, for more than 20% of the S&P 500 market capitalisation if we include financial subsidiaries of industrial companies (see also Figure 4). I might add that, in addition to the negative fundamentals I expect for the financial sector, the technical position of financial stocks is also unfavourable. As can be seen from Figure 5, the S&P 500 financial sector has formed a huge wedge since 1996, which, from a technician's point of view, is an extremely bearish formation, because as prices advance, each new up-wave is feebler than the last, as a gradual petering out of investment interest takes place. Therefore, once prices break out of the wedge on the downside, they waste no time before declining in earnest.

There is one more point to consider. In the United States, very few investors question how sustainable it is for the US to import foreign capital to the tune of over US$450 billion per annum in order to finance its excessive consumption (current account deficit). At some point, the appetite of foreigners for US assets will diminish and lead to a weaker dollar, but that aside, foreign investors should also worry that, indeed, the US capital market has grown into something like a giant Enron monster. If that were indeed the case, then in the same way that Enron's executives made it impossible for the company's employees to sell their Enron shares, which they held in their 401(k) accounts, the US government could

Figure 5 **S&P 500 Financial Sector (1970=10), 1980–2002**



Source: yardeni.com

one day impose capital controls and make it difficult — or, in an extreme case, altogether impossible — for foreigners to liquidate their US dollar assets and transfer them overseas or convert them into gold. "That's impossible," you might think, but we have seen so many instances where foreign investors were screwed by local authorities (the last instance being Argentina) and their assets frozen, that, at some time in the future, such a course of action cannot be ruled out entirely even by the US government. I certainly don't wish to alarm our readers unnecessarily, and I don't consider that any kinds of capital controls in the US are an immediate threat. However, our readers should be alerted to such a possibility occurring at some point in the future and may, at the very least, wish to take some precautions. One of the precautions I continue to urge our readers to take against an Enron-style systematic risk in the financial system is the accumulation of gold shares and physical gold and other commodities. (See further below, and "The Risk of a Systematic Failure" and "Gold Refulgent" in GBD report of June 22, 2001, entitled "When Something Doesn't Add Up".)

CHANGE IN LEADERSHIP

Simply and broadly put, an investor could have done very well over the last 30 years with just a handful of investment decisions. In 1970, a long-term investor should have bought gold, silver, and oil (commodities); in 1980, he should have sold his gold and oil, and bought Japanese stocks; then, in 1989, he should have switched out of Japanese stocks into the S&P 500 or, ideally, into the Nasdaq, which he should have sold at the beginning of 2000. We can see from this that, from time to time, the investment environment changes entirely. At such milestones in financial history, the rules of the investment game are altered; but alas, the vast majority of investors continue to play by the old rules and therefore either lose money or miss out on the substantial capital gains which the new opportunity or leadership brings about. In the field of investment, the words of the American author Josh Billings are most appropriate. He wrote: "I suppose that one reason the road to ruin is broad, is to accommodate the great amount of travel in that direction." In particular, major changes in the investment environment are inevitable when they are preceded by a major investment mania or bubble. In the late 1960s and early 1970s, the US stock market reached manic proportions as the growth stock cult led to very high valuations; in the late 1970s, a worldwide gold mania took place; in the late 1980s, Japanese shares rose parabolically and became extremely overvalued (as we now know); and finally, in 2000, we undoubtedly experienced a colossal bubble in the Nasdaq and, by the look of recent events, which I have described above, also in the S&P 500. (Other symptoms of a major bubble having occurred, aside from the recent revelation of dubious practices, would include record trading volumes, a large number of new issues, insider selling at a record pace, a high number of stock splits, feverish M&A activity, active participation by the public, record foreign purchases, and an intensive coverage of market events by the media.)

The key to successful investing is to understand that, with nearly 100% certainty, the bursting of a bubble leads to a permanent change in the leadership. (By "permanent", I mean a change of leadership lasting for one or two decades or more.) Thus, it is important to try and determine whether, in 2000, a mania only in Nasdaq stocks (high-tech and telecommunications shares) came to an end, or whether a bubble encompassing the entire stock market burst at that time. If we had a bubble only in Nasdaq stocks, then the leadership might only change from this sector of the US market to another sector (for instance, into energy shares or basic stocks). But if there was a complete stock market bubble, as had been the case in 1929 and in Japan in 1989, then obviously a new leadership in an asset class other than the US stock market should be expected. I want to make this point very clear. **If we can be sure that in 2000 a major US stock market mania reached a climactic peak, then it is futile for the average investor even to try to play bear market rallies.** I concede, however, that smart and nimble traders, and active managers who are not required to follow a benchmark, may continue to find long opportunities, as they did in Japan post-1989, but the chances of achieving substantial capital gains are limited, because the overall trend will remain at best sideward and more likely down. In other words, if I am right in my assumption that the period from 1998 to 2000 marked a milestone in financial history in the sense that the long-term bull market in US stocks, which began in 1982, ended in a colossal bubble and (to my knowledge) an unprecedented investment mania, then we should assume that within the next ten years the major US stock market averages such as the Dow Jones Industrial, the S&P 500, and the Nasdaq won't make new highs and will probably be lower than they are today, since it is common for the declines that follow major bubbles to approach a level 70% to 90% lower than at the peak or at least to give back five to ten years of previous capital gains (an S&P 500 of between 150 and 500). Don't forget that the Japanese market, as well as the other Asian stock markets post-1997, fell to around their 1984 to 1986 levels (in the case of Japan, giving back six years of capital gains prior to the peak in 1989, and in the case of the other Asian markets giving back between five and eight years of capital gains prior to their peak between 1990 and 1994). Thus, if the US stock market just fell to its 1995 level and therefore gave back only five years of capital gains prior to its high in 2000, we would be looking at an S&P 500 of around 500. This target price level for the S&P 500 isn't totally unrealistic given the fact that S&P 500 earnings declined in the second half of 2001 to around the level they were at in 1995!

Although the financial press is full of articles about how powerful the V-shaped economic recovery (which they perceive as already having

begun) will be, which is supposed to catapult corporate profits back to near their highs reached in 2000, it is far from certain that this widely advertised recovery will really take place and lead to improved corporate profits. (Alan Blinder, a former vice chairman of the Fed, calls the US economy a crouching tiger, which will leap up a lot faster than most people think.) But even with the US economy and corporate profits improving, the stock market may not approach its previous high reached in 2000, as investors may assign a lower valuation to corporate earnings than during the euphoria in the spring of 2000, for the reasons we outlined at the beginning of this report. Therefore, I believe that, with or without an economic and corporate profit recovery, a shift in leadership away from US equities is almost a certainty. What is far less certain is which asset class will perform over the next ten years as well as Japanese stocks did in the 1980s and US stocks in the 1990s.

In other words, we are interested in finding a major asset class that has the potential to increase several-fold in price over the next ten years or so. I looked at several possibilities and eliminated those assets that clearly don't have such a potential. Highest on the list of poorly performing assets in the next few years were Japanese government bonds, whose yields will most likely not decline any further and could rise to around 5% to 6%. I also eliminated US and European bonds, on the basis that any deflation in the Western world, which could boost bond prices further, would be rather brief as central banks would switch on the money printing presses like never before. I then looked at emerging economies. Our readers will recall that in the last GBD report, entitled "Staying Overweight Asia and Underweight the US" (see GBD report of January 29, 2002), I made a strong case for investing money in markets such as Indonesia, Thailand, and the Philippines, rather than in the US. And while I haven't changed my views at all since publishing this and earlier reports which made a case for purchasing Asian stocks (see also GBD report of May 16, 2001, entitled "Emerging Markets: An Unpopular but Depressed Asset Class"), I have to admit that I would be very surprised if the Asian markets rose by five to six times over the next few years. As I outlined in last month's report, I think that a large number of Asian stocks are inexpensive and will rebound. Moreover, I believe that, on balance, the Enron scandal is very positive for Asian equities. Why? Simply because over the last few years, foreign investors have avoided Asian equities on the basis that Asian companies have little transparency, and corporate governance in Asia is poor. But now it should be evident that transparency is hardly much better in the Western world than in Asia. Moreover, while in the West less money is dished out under the table to government officials in a Webster's Dictionary-sized envelope, large sums of money do change hands in the form of political contributions, or are paid out to consultants and directors who have family or other close ties to senior government officials and politicians. Therefore, the argument for not investing in Asia because of poor transparency, poor corporate governance, and corruption will, over time, become less relevant and lead to an increase in foreign money flows to Asia.

Still, I see little in terms of political and economic reforms that would warrant a substantial re-rating of Asian stock markets, aside from an earnings recovery from a very depressed level. I therefore feel that while the stock markets of countries such as Indonesia and Thailand could double over the next two to three years, I equally doubt that they would provide the kind of secular leadership Japan provided in the 1980s and the US in the 1990s.

What about China, the current favourite among economists and strategists? The problem with China, from an investor's point of view, is that its stocks are already quite pricey and an endless supply of new issues will keep prices from rising sharply from the present level. In fact, having just read through a 145-page bullish report on China by a US investment bank, which two years ago published similar lengthy reports about Internet stocks, the more appropriate strategy might be to *sell* Chinese shares. (Figure 6 shows that Shanghai A shares appear to have topped out and could be vulnerable to a further sharp break.) I have little doubt that China will continue to grow at a rapid pace, but I am far less certain about Chinese corporations' future profit growth. (However, as explained in earlier reports, I continue to like real estate in Chinese cities such as Shanghai and Beijing.)

So, if Asia is unlikely to provide a longer-term market leadership, could Europe be the stock market leader over the next ten years? Possibly so, if badly needed economic and social reforms are carried out and if Eastern Europe is successfully integrated into Western Europe. However, I assign this extremely optimistic scenario a very low probability. Moreover, the European markets are very closely correlated to the S&P 500 and the Nasdaq, and therefore, if the US market performs poorly, it is not very likely that Europe would totally decouple and provide the kind of long-term leadership I am looking for. The same concerns I expressed about Asia and Europe would also apply, to a large extent, to Latin America. **Within the major financial asset classes, that leaves only two markets — Japan and Russia — that could provide a sustainable leadership over the next few years.**

In the case of Japan, I am fully aware of all the macroeconomic problems the country is suffering from, including the deteriorating financial position of the government, a bankrupt banking system, a rapidly aging population, and increasing competition from China. Therefore, it is difficult to envision how Japanese stocks could provide leadership in the future. However, there are two reasons why Japanese shares could at some point in 2002 perform rather well. In the 30 years I have been following the Japanese market, I don't recall a time when everyone in the investment community was as negative about Japan's economic prospects as at present. For a contrarian, this unanimous bearish sentiment is something to take notice of. Also, while the macro picture appears to be

Figure 6 **Shanghai A Share Index, 1995–2002**

Source: Bloomberg

almost hopeless, on the corporate level the shift of production outside Japan, especially to China, and a weaker Yen could lead to a sharp improvement in corporate profitability. Lastly, in Japan, stocks and bonds have tended to correlate inversely. So, whereas stocks have been declining since 1990, bonds have rallied, with JGB yields declining from 8% in 1990 to 1.5% currently (see Figure 7). However, over the last three years, the Japanese bond market rally has been stalling and Japanese bonds seem to have traced out what I would consider to be a massive top formation. In other words, by the look of it, Japanese government bond yields are poised to rise from here, possibly very strongly, which would signal either the end of Japan's deflation or an economic recovery, or a combination of the two. I concede that a third possibility would be that Japanese government bonds will collapse because of fears that the government will go bankrupt, which goes to show that, under almost any scenario, Japanese government bond yields will rise and thus **Japanese bonds could well be the short of the century** (see Figure 7). However, in a poor environment for bonds, and amidst great uncertainty, a move from cash and funds allocated presently to bonds might flow into equities and lead to a sharp rally. Still, a sharp rebound rally aside, I doubt that Japanese equities will ever again provide the kind of leadership they provided in the 1980s.

In the case of Russia, the situation is more encouraging. Following the Russian default in 1998, we wrote on a number of occasions about the possibility of a re-rating of Russian equities based on Mr Putin becoming something like a Russian Lee Kuan Yew, someone who could bring some law and order into the system and put Russia back on the map. (In the long run, however, he may prove to be an unpleasant leader for the Western world.) The economic recovery and structural improvements which have taken place since 1998 have not gone unnoticed by equity investors and have led to a very powerful

Figure 7 **Japan: Long-term Government Bond Yield, 1990–2002**

Source: yardeni.com

performance of Russian shares (see Figure 8). Still, I believe that Russia could very well continue to exceed investors' expectations and may become, over the next ten years or so, a society resembling a Western European state (see Enclosure 1). **Thus, a further significant re-rating of Russian equities is a distinct possibility.** In addition to an improved social structure, I also like Russia because it is the country that would benefit the most from rising commodity prices (see also below). In any event, our friends Ian Hague and Harvey Sawikin of the Firebird Fund (hsawikin@fbird.com), who have written for this report in the past and made a strong case for investing in Russia at the beginning of last year (Russia was up more than 60% in 2002), are far more qualified to express an educated view of Russia, and have kindly contributed a piece to this report.

The leadership change could also come about as a result of a reallocation of funds from financial assets to hard assets, including real estate and commodities. In particular, **I believe that the Enron scandal is very positive for gold and silver,** as investors may increasingly question the soundness of our financial system. Moreover, if Enron proved to be just the tip of the iceberg, gold, whose integrity as money cannot be tampered with by central bankers, could provide the kind of leadership it had in the 1970s when it rose from US$35 to US$850. In recent times, many of our readers have written that they cannot understand why gold would appreciate in the present environment, which is highly deflationary. In last month's report, I explained that the most important factor for determining the price of any commodity isn't whether we are in an inflationary or deflationary environment, but, rather, good old demand and supply for that particular commodity. Thus, in a deflationary environment which might lead to many more bankruptcies of leveraged companies, including some large banks, and to more sovereign defaults, investors may increasingly look to park some of their money in an asset of "last resort". Incidentally, this seems to be happening now in Japan, where people are increasingly turning to gold because of concerns about the health of the banking system. Still, the Japanese buying of gold is tiny when compared to the country's GDP per capita. Japan imports at present only about 100 tons of gold annually for a population of 120 million with a GDP per capita of more than US$35,000. Compare this to India, which imports close to 900 tons of gold for a population of one billion but with a GDP per capita of only around US$300! Compared to India's purchases with a far lower purchasing power, Japan's buying of gold has so far been very small, but it could rise significantly in the future and become a price-driving factor in the gold market. In fact, if global investors and bank deposit holders were to put only 1% of their financial assets (more than US$1,000 billion) in physical gold and mining stocks, an enormous bull market would follow, since all the above-the-ground gold in existence is worth only slightly more than US$1,100 billion (about 30% is held by central banks), while all the gold mining stocks around the world are worth as little as US$50 billion.

The gold bears will, of course, say that central bank selling will continue to depress prices and that, therefore, gold won't perform. However, I should like to point out that despite central bank sales, gold has been the world's strongest currency over the last two years, since it appreciated against the US dollar. Moreover, when gold prices increase further, whenever that may be, there will be a public outcry against central bankers who sold their gold reserves in the neighbourhood of gold's lowest prices in two decades. So, I can envision a time when central bankers will suddenly refrain from further gold sales in order not to lose any more credibility than they have already lost. *The Observer* in England noted on February 10 of this year that, "according to the Bank of England records and a recent House of Commons Public Accounts Committee report, the Treasury received just £2.25 billion in 16 auctions between July 1999 and last month. The total Treasury 'loss'

Figure 8 **Russia RSI General – Price Index, 1994–2001**

Source: Datastream

compared with the situation if the Treasury had kept the gold would be around £350 million at current levels." (Central bankers' gold sales over the last two years at very depressed prices are an inducement for them to try to keep the gold price from rising, since far higher gold prices right now would make them look rather stupid.)

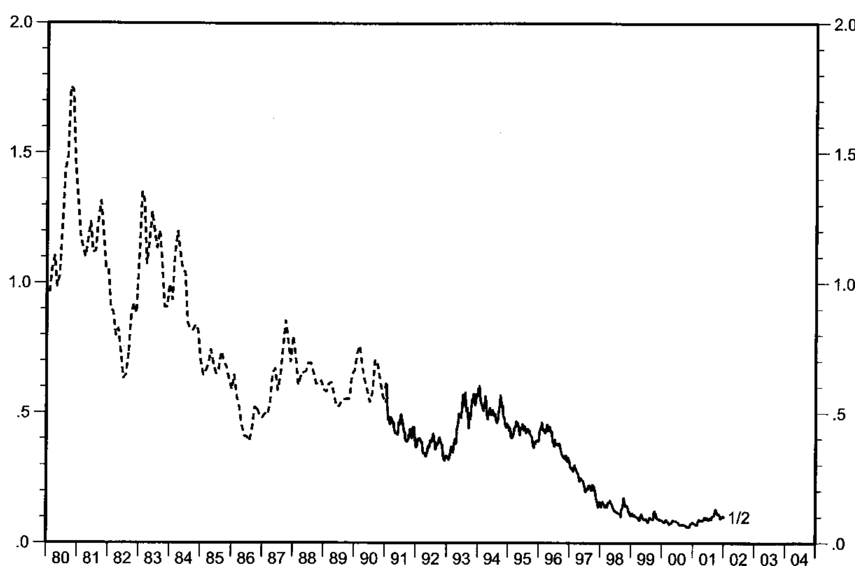
There is one more point to consider, which my friend Peter Cook (cccorp@att.net), who works for Rochester Partners, highlighted to me. According to him,

> This decade will probably look like the 1970s, in which real assets will do well and financial assets will do poorly, especially on an inflation-adjusted basis. The markets are beginning to sense this. For example, emerging market assets have outperformed G-7 equities for a year or so, even with Argentina looming. The US Treasury market has broken down technically, the yield curve is steepening. US cyclical stocks are rallying consistently, and gold stocks have finished their basing periods and have broken out technically. And all of this has happened without the dollar falling, which is what you would normally expect to see. I am still waiting for commodity-based currencies to rally and for Japan to break out to confirm my inflation scenario. As a result, you could go long NEM, ABX, FCX, AU, ASA, and several other smaller cap gold stocks, which will probably do well. They tend to trade like an S&P short, so if you want shorts, these would suffice.

Personally, I would prefer Harmony Gold and Apex Silver Mines to Barrick Gold (ABX), because American Barrick is heavily hedged, but this is not the point. What intrigued me was Peter's idea about going long gold shares as a short on the S&P, because if you think of it, this strategy incorporates little risk. (Figure 9 shows that gold shares have begun to outperform the S&P 500 index after having formed a saucer bottom.) In a deflationary environment, it isn't likely that the S&P would go up much, since corporate earnings would continue to disappoint. However, because of credit problems in the system, gold would have a fair chance of rallying, as it did in the 1930s. In an inflationary scenario as outlined by Peter, however, interest rates would rise and probably contain a strong S&P advance. In such a scenario, gold could rally due to rising inflationary expectations. Therefore, under almost any scenario, gold seems to make sense at the present time — as a hedge against a systematic failure, and against weakness in the S&P 500 because of either inflation or deflation.

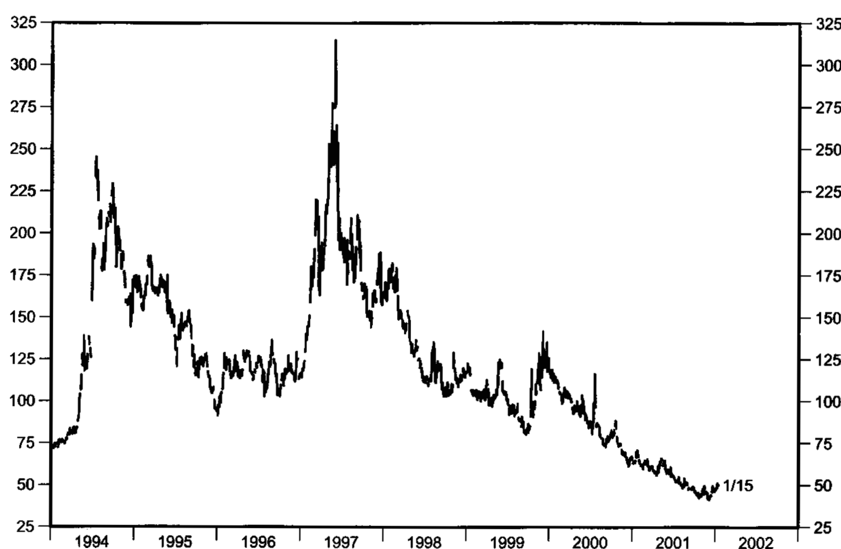
Aside from gold, other commodities may from time to time provide even better investment opportunities due to their extremely depressed prices. Commodities such as the grains, coffee (see Figure 10), cotton, rubber, tin, etc, are all at multi-year lows and could rebound at some point very sharply, particularly in an economic recovery scenario.

Figure 9 **S&P Gold and Precious Metals Mining Index Relative to S&P 500, 1980–2002**



Source: yardeni.com

Figure 10 **CRB Futures: Coffee (cents per pound), 1994–2002**



Source: yardeni.com

CONCLUSIONS

The Enron scandal is negative for US equities because investors' confidence has been shaken further. Moreover, this scandal may prove to be just the tip of the iceberg. The valuation of equities depends to a large extent on investors' psychology, and we believe that, in future, investors will pay less for corporate profits and demand higher yields for corporate bonds. As Charles Kindleberger pointed out, the revelation of so many swindles, frauds, and dubious practices "makes known to the world that things have not been as they should have been, that it is time to stop and see how they truly are. The making known of malfeasance, whether by the arrest or surrender of the miscreant, or by one of those other forms of confession, flight or suicide, is important as a signal that the euphoria has been overdone."

Thus, even if corporate profits were to recover strongly, such a recovery would be unlikely to lead to a new high for the US stock market. The revelation of fraud and dubious practices is one of the clearest symptoms that, prior to the downturn, a dangerous and irrational investment mania took place. Since many dubious practices occurred in the late 1990s in "old economy" companies, it is now more and more obvious that in the United States there was not just a bubble in Nasdaq stocks, but that the entire capital market went through a colossal bubble phase.

If, indeed, the mania encompassed the entire stock market and not just the Nasdaq, then the bursting of the bubble, which began in the spring of 2000 and is still in process, will in due course lead to a total change in leadership away from US equities. **Therefore, for the next few years, investors should position themselves in assets other than US equities.**

As potential new capital gain leaders which would provide long-term superior performances, such as occurred for gold and oil in the 1970s, Japanese shares in the 1980s, and US stocks in the 1990s, **Russian equities and gold, along with other commodities, seem to be the most likely candidates.**

ACKNOWLEDGMENT

We have made extensive use of Ed Yardeni's excellent figures in this report. We highly recommend to all our readers his outstanding financial website: www.yardeni.com. Ed Yardeni also publishes excellent daily comments on all US economic statistics.

Putin's Russia: Finally Moving Forward

Ian Hague and Harvey Sawikin, Firebird Management LLC
1325 Avenue of the Americas, New York, NY 10019, USA
Tel: 1-212-698-9260; Fax: 1-212-698-9266; E-mail: durban@fbird.com
Harvey Sawikin and Ian Hague are Principals of Firebird Management LLC and manage several funds active in Russia and the former Soviet Union.

In a recent *Barron's* Roundtable, Dr Faber rated the Russian stock market a buy — presumably a trade, not a long-term investment, in light of his expressed opinion of Vladimir Putin as a dangerous "Napoleon". We of course agree that Russian stocks are attractive in the short term, but unlike Dr Faber we believe that Putin is actually close to the perfect man for the job at hand, and is putting in place a foundation for stability and growth that will last for years to come. In this context, and taking Dr Faber's statement at face value, the question we start with is: What's wrong with Napoleon?

Napoleon did much for France that was of lasting benefit to its economy (notwithstanding his love of trade embargoes) — for example, putting its monetary house in order by backing the currency with gold, lowering tax rates, and formalising the system of revenue collection. He was also a brilliant institution-builder who reworked and modernised the French Commercial Code, created the world's first modern secondary educational system, and transformed the bureaucracy and army into relatively meritocratic organisations that genuinely served the interests of the state and people. For Napoleon's time, these were tremendous achievements, ones that contributed to France's prosperity throughout the turbulent century that followed.

Like his French counterpart, Vladimir Putin rose to the top of a post-revolutionary state-system that was defective as a result of lawlessness, ideological disarray, and institutional underdevelopment. Indeed, it was precisely because of these defects that he had to achieve his present position in a more Machiavellian — but still recognisably democratic — way than we are used to in the West. Furthermore, since he has come to power, he has successfully crafted an image as a pragmatic alternative to the feeble, mostly rhetorical democracy of Boris Yeltsin. This image has struck a chord among average Russians: in a recent poll by VTSIOM, an independent polling agency, 87% voiced opinions on Putin that were "neutral" to "positive". To an electorate as cynical and disappointed as Russia's, that is about as good as any leader can hope to achieve.

THE OTHER SIDE OF THE STORY

The Western press has tended to focus on the Putin government's actions against corrupted and oligarch-controlled electronic media — first, forcing NTV into receivership; and second, cancelling the broadcasting licence of Boris Berezovskii's TV6. This criticism is fine, and it is what the Western press is supposed to do. Russia has almost

no tradition of a free, private-sector press, and this is one of the institutions that it will have to develop by trial and error. Here, finger-wagging by Western opinion makers and governments is helpful.

What the press has missed by focusing on this one issue, however, is Putin's success over the last two years in building a state with the *political capacity* to implement economic reform. This was done in a number of ways. First, Putin and his political team altered the system of power sharing between the federal and regional governments decisively in favour of the federal government. Next, he co-opted the two most popular segments of opinion in the legitimate political establishment — the liberals and the moderate nationalists — to create a working majority in the lower house of parliament (Duma). Finally, making use of his KGB background, he achieved decisive political victories over internal elite opposition by threatening to prosecute key oligarchic groups that had been instrumental in creating the system of "crony capitalism" that flourished under Boris Yeltsin.

Whereas people who only occasionally look in on Russia tend to dismiss these steps as insignificant, to us portfolio investors in the public companies over which these parasitical groups once exercised unchecked control, the change has been rapid and unmistakable. Some of the oligarchs, such as Anatolii Chubais (UES), Vladimir Potanin (Norilsk Nickel), Oleg Deripaska (Siberian Aluminum), Mikhail Khodorkovskii (Yukos), and Roman Abramovich (Russian Aluminum), have taken the high road by refashioning themselves as legitimate businessmen. They are creating financial transparency at their companies by switching to US GAAP accounting, paying dividends to investors and taxes to the government, and seeking foreign stock exchange listings instead of draining cash flows through transfer-pricing schemes.

Others, who really never had the ability or desire to make the transition from economic parasites to value-adding businessmen, waged war against the Kremlin and lost. Such was the fate of the Vyakhirevs *pere et fils* and their crew at Gazprom, who have been legally removed from management, as well as Berezovskii, who has been forced into exile but reportedly retains a passive interest in several firms (e.g., Sibneft), and Vladimir Gusinskii, who has both been exiled and had his assets taken through the bankruptcy process.

WHERE THE RUBBER MEETS THE ROAD: ECONOMIC REFORM

Putin's consolidation of political authority has made it possible for him and his team of free-market economists to begin to execute a long-delayed agenda of structural reform that is thoroughly transforming the growth prospects for Russia later in this decade. The president's strong majority in the legislature and his popularity have created a political window for a number of crucial but potentially unpopular steps to be taken in the next two years. Based on what has been done so far and the level of seriousness being shown by the key policy-makers, we are confident that much of this agenda will be achieved.

Contrary to what many had expected after Yeltsin left power, Russia has not slid back into some sort of nostalgic, politically easy, "third-way" economy with the state at the centre. As should be clear from Table 1 on page 13, the strategy that Putin and his team in the Ministry of the Economy and Development devised embraces the guiding principles of a free-market economy: private ownership of land, labour, and capital. What makes it specifically Russian in its preoccupations is the attention paid to the development of institutions that protect the rights of owners of these factors of production from the predations of other owners and from the state itself.

Thus, the new Russian government has learned the main lesson of the 1998 disaster: no economy can function without laws. This was no more than theoretical to Russian policy-makers in 1998, and no amount of IMF aid or World Bank-funded, Big-Five consultancy advice was going to make it any easier to learn. This is why, while a number of the reform steps currently being implemented are based on Western best-practices, the Russians have had to invent their own program, suited to the Russian reality and in their own long-term best interests.

A CATALYST FOR REFORM: BETTER RELATIONS WITH THE WEST

If Putin's approach to domestic reforms has been Napoleonic, what of his foreign policy? Is he really the potential menace to his neighbours feared by minds even as clear as Dr Faber's?

All we have to go on is what has transpired so far. Obviously, the key has been Putin's status as the first world leader to offer assistance to the US post-9/11; in his case, by not objecting when the US accessed bases in Uzbekistan and Tajikistan to conduct its air war on the Taliban. At the time, this move seemed bold (something Napoleon or Talleyrand would have thought up?) — indeed, shocking — to many in the West whose view of the Kremlin, formed by the stereotypes of the Yeltsin era, excluded the possibility of creative foreign policy initiatives.

The move also surprised Putin's generals. He made further unilateral steps towards Washington when he announced that Russia intended to close its bases in Vietnam and Cuba, generating a dyspeptic response from his general staff. It is a sign of his mastery over the chessboard of civil–military relations that once he overruled his defence ministry on this issue, not a further peep emanated from the brass hats. It is possible, of course, that challenges to Putin's new foreign policy orientation will surface — especially now that military reform is on the agenda — and in particular on the issues of NATO expansion to the Baltics and the

United States' continuing commitment to live out its fantasy of missile defence.

In this connection, it is critical that America and its allies reciprocate tangibly over the next several months, if Putin is to maintain domestic political support for his opening to the West. Unilaterally scrapping the ABM treaty was a very stupid way of doing that, but we have hope that with a genuine Russophile (Ms Condoleeza Rice) at the head of the Security Council, some other policy concession can be given that Putin can use as evidence that his policy shift is generating benefits. Japan, for its part, has floated the idea of a US$30 billion investment in the Russian Far East in exchange for the handover of the Kurile Islands after a long transition period. A deal of that kind could, incidentally, help boost the fortunes of a Japanese leadership that seems to have lost much of its credibility.

WTO ACCESSION?

Although no explicit quid pro quo has been announced, it is likely that one of the concessions the US has in mind to reward Russia's support for the "War on Terror" is accelerated consideration of its application to join the World Trade Organization (WTO). Russia would indeed like to join, but on better terms than those currently offered — including a phase-in before opening its own markets in the financial sector, agriculture, aerospace, and several manufacturing industries. At the same time, Russia wants the US and the EU to drop their anti-dumping rules on steel and most agricultural commodities.

Since it will probably take years to work out specific deals in all of these areas — the US still does not have durable agreements on these questions with its own trading partners — the likely outcome is some halfway house arrangement of the kind China won after years of bargaining. The first steps in reaching such a deal are now being taken by the US Congress, as it considers a bill to repeal the Jackson–Vanik Amendment that ought to be passed by the time of the next Putin–Bush summit. A further step would be any new Commerce Department ruling that finds Russia to be a "market economy" — by which is apparently meant any country with a steel sector as uncompetitive as America's.

THE RUSSIAN ECONOMY NOW

When will Russia's reforms begin to have a visible effect on its macroeconomy? Although the evidence is not all in, there is reason to believe that these policies and the political authority that backs them have already begun to impact GDP growth and fiscal, monetary, and foreign trade balances. At a recent meeting with Russia's Deputy Finance Minister, we were told that the new, flat 13% income tax had already increased the revenue take of the government in this area by 40%. The revival of the bank lending market over the last 12 months is further good news, and it seems that we can finally say with some conviction that capital flight has reversed. Russia's largest source of direct investment in the last two years was Cyprus, a recognised waystation for capital flowing from (and now back to) Russia.

Improvements in the domestic components of GDP will be welcome, as oil export revenues are guaranteed to be far lower in 2002 than in the previous two years. Overall, the likely effect of the oil price drop this year will be to shave a further 2% off Russian growth, to about 3.5%. The indirect effect of declining export margins should be slightly slower growth in investment, and in household income and demand. Any decline in external demand, however, may be compensated by growth in domestic demand stimulated by the repatriation of flight capital and by Central Bank reserves, which currently stand at a healthy US$38 billion. Moreover, the government's 2002 budget evidences its realism about the sustainability of oil-driven export growth, building in a range of scenarios that achieve balance for any oil price above US$14.

CURRENT MARKET PROSPECTS

As the Russian RTS Index has vaulted by 75% since the beginning of the 4Q 2001, potential new investors will undoubtedly wonder whether there is any upside left. In this regard, we note that the RTS now stands around 300, half the level it reached in 1997; the entire market's capitalisation is still only US$75 billion, or one-third of Brazil's (and Argentina's!); and the market P/E is a relatively undemanding 6x. Russia's continuing cheapness is more understandable when one considers that it has only been four months since most American and European investors have been willing to look seriously for pockets of growth and stability in the world, no longer deterred by fear of collateral damage from falling G-7 markets.

In this regard, key leading indicators, such as commodity prices and Asian stocks, are forecasting a US economic recovery later in 2002. Emerging markets have historically outperformed in the early stages of a post-recession recovery and — at least in the view of the professionals who trade them — none offers a better risk/reward than Russia's. The market's continuing gains have been especially impressive in light of the consensus bearish forecasts for oil. The coming battle for market share between Russia and Saudi Arabia — which Firebird portfolio manager Jamie Richard first identified last year in the influential Gulf 2000 newsgroup, and which he writes about more fully in the current issue of *Foreign Affairs* — has now been picked up by the mass media and is priced into the market. As a result, oil traders, anticipating a price break when the Russian export cuts expire in 2Q 2002, have taken their largest short position in history.

As noted above, we agree that the lower oil price scenario is the likely

Table 1 **Russian Reform Successes in 2001, 2002**

Policy Area	Legislative Change Adopted	Effective Date of Implementation	Notes
Land reform (urban land ownership)	Land Code Part I	October 25, 2001	Urban real estate can now be privately owned
Legal reform	Law on Status of Judges	December 31, 2001	Makes judges more independent from local authorities
Tax reform	Profit Tax Law	January 1, 2002	Implementation of 13% flat tax from January 1, 2001
Financial reform	Law on Investment Funds	December 3, 2001	Legal basis for closed-end funds and more freedom for investment activities
	Law on Combating Money Laundering	February 10, 2002	Creation of Financial Intelligence Unit to handle money laundering issues
	Law on Bank Insolvency	June 23, 2002	Creditor's rights in bank defaults protected
Reform of bureaucracy	Law on Licensing	February 10, 2002	Number of business activities subject to licensing reduced from 1,000 to 100; easier company registration
Pension reform	Law on Investment Component	January 1, 2002	Allocates up to 6% of pension funds for savings, including investments in securities
Corporate governance reform	Joint-Stock Company Law Amendments	January 1, 2002	Protects minority shareholder rights by limiting ability to dilute minorities and strip assets
Labour reform	Labor Code	January 1, 2002	Preserves workers' rights, weakens Soviet-style trade unions, required salaries to be paid on time and in cash

Table 2 **Reforms We Are Looking for in 2002**

Policy Area	Legislation/Policy Step Proposed	Implementation Date	Notes
Agricultural land reform	Law on Purchase and Sale of Agricultural Land	To be voted on June–July of this year	Farmland (for the first time in history!) to be approved by Duma
Reform of bureaucracy	Civil service reform		To be carried out by government itself: goal is to reduce the number of ministries and department offices, as well as to increase salaries
Further tax reform	VAT reduction	Consideration by Duma in the third quarter	Large reduction in VAT on the table. This is now made possible by higher compliance with declared tax on profit
Further legal reform	Code of Criminal Procedure Amendments Code of Civil Procedure	Spring 2002	
Reform of the military		Sometime this year	15% reduction in overall troop numbers, major reduction in the number of generals, further progress towards a professional army
Banking reform	Most steps to be taken by government and Central Bank regulatory changes	September–October 2002	Reducing limits on foreign ownership of banks, sale of state-owned Vneshtorgbank, privatisation of other state-owned banks

Table 3 **Russia's Macroeconomy Improvement under Putin**

	1997	1998	1999	2000	2001	2002	2003
GDP, US$bn	446	274	187	251	308	360	380
GDP, yoy	0.7%	–4.9%	5.9%	8.3%	5.3%	3.5%	3.8%
Industrial production y-o-y	2.0%	–5.2%	8.1%	11.9%	5.2%	3.0%	3.5%
Trade balance US$bn	17.0	17.9	34.2	60.8	51.0	43.0	40.0
Inflation CPI	11.0	84.4	36.7	20.0	18.6	15.0	11.5
Exchange rate, US$/RR	6.0	10.4	27.0	28.2	29.3	32.0	35.0
Forex reserves, US$bn	16.5	11.6	12.5	27.9	36.6	36.0	35.0
Urals average, US$p/bbl	18.3	111.9	17.53	26.6	22.5	18.0	18.0
Foreign debt, US$bn	143	159	157	152	145	137	132

one: the Russian economy is not yet growing enough to absorb all the new production, meaning full exports will have to resume. In any case, Russian policy has been consistently to reclaim the market share it had in 1989, before the collapse of the Soviet Union. Moreover, Russia feels it is in a better position to withstand a price war than OPEC; as we have said, even assuming average US$18 Brent this year, the macro picture is solid, including a primary balanced budget. The bond market confirms this view, continually pushing Russia's Eurobonds to new highs. As for the stocks, even assuming US$16 oil, the Russian majors trade at discounts of 10–30% to their emerging market peers and 50–75% to the Western majors.

Moreover, Russian oil companies such as Lukoil and Surgutneftegas could rally even in a weak price environment simply by improving governance, which will further reduce the risk premium applied to their share prices. This is what happened with Yukos last year, and in fact Surgut and Lukoil are promising to clean house, with the former's long-awaited GAAP accounts coming soon and the latter having added Templeton's Mark Mobius to its board of directors. Of course, the key will not be symbolic actions, but actual improvements. (Lukoil, in particular, has disappointed investors time and again, and actually Firebird is engaged in a public governance battle with the company over their management of the Neftochim refinery in Bulgaria, of which our funds own 1.5%.)

Beyond the oil majors, there are dozens of Russian mid- and smaller-cap stocks that continue to trade 75–90% below where they traded in 1997. Not all of these will regain their old valuations, but there are many that we believe will, and the growth of these, by themselves, could boost the RTS Index towards its old peaks.

Finally, although weaker oil prices are our base case, it is also possible that some surprise, such as a Middle Eastern conflict that affects one of the major producers, or a more robust than expected global recovery, could send prices higher. In light of the current short position, the price rise would likely overshoot, which would in turn spark a short-term rally in the Russian oils. Overall, we prefer oil in the US$18–22 range. Lower prices dampen Russian inflation, while keeping pressure on the government to continue the structural reforms with which we began this piece, and which could result in Putin taking his — not altogether unhappy — place in history as the Russian Napoleon.

Erratum: In last month's GBD report we misspelled the email address of Claire Barnes of the Apollo Fund. Here is the correct email address: cbarnes@apolloinvestment.com. We apologise for any inconvenience caused.

THE GLOOM, BOOM & DOOM REPORT

© Marc Faber, 2002

Author & Publisher
DR MARC FABER

Research Editor & Subscription
LUCIE WANG

Copyeditor
ROBYN FLEMMING
E-mail: rflemming@albury.net.au

Subscriptions and enquiries
MARC FABER LTD
Suite 3308–3310, The Center
99 Queen's Road Central
Hong Kong
Tel: (852) 2801 5410 / 2801 5411
Fax: (852) 2845 9192
E-mail: contrary@pacific.net.hk
Website: www.gloomboomdoom.com

Design/Layout/Production
POLLY YU PRODUCTION LTD
Tel: (852) 2526 0206
Fax: (852) 2526 0378
E-mail: pollyu@netvigator.com

This publication is printed on recycled paper

Barons on their best behaviour

As their international stature grows, Russia's oil magnates are starting to play by the rules, says **Andrew Jack**

They spent the past decade dividing Russia's oil wealth among themselves. Now the same small group has set its sights on influencing the wider world.

Amid the global economic downturn, the power of Russia's five private-sector "oil barons" has become apparent. Their decision on export cuts proposed by Opec, the oil producers' cartel, will play a key role in determining global oil prices. Those prices in turn will influence the chances of economic recovery far beyond Russia's borders.

The barons, some surprisingly youthful, and their even younger companies – Lukoil, Yukos, Surgut, TNK and Sibneft – may not yet be household names in the west. But judging by their current size and future expansion plans, their influence will soon be felt and their fame will grow.

"Within 10 years, they will be the richest people in the world, just like the Arab oil sheikhs," says Bill Browder, head of Hermitage, a Russian equity fund that has clashed with several of the groups in the past to defend its investments. "Now [that] they own their companies and are becoming wealthy, they want to be accepted."

Collectively, the barons control the bulk of Russian oil, giving them substantial clout in a country where their sales generate more than a quarter of both export earnings and government revenues. With Russia the world's third largest producer and second largest exporter, the oil also gives them an international voice.

Some Russian "oligarchs" – notably Boris Berezovsky and Vladimir Gusinsky – rose to prominence during the 1990s by thoroughly mixing business with politics and at times directly confronting the state. With the rules of the game fundamentally changed under President Vladimir Putin, both men have fled into self-imposed exile.

By contrast, the oil magnates have a lower public profile and have adapted to the new rules in order to retain their power. used the country's weak legal system to consolidate their ownership and emerge as majority shareholders. In doing so, they came under fire from minority shareholders, whose investments were diluted and who complained of poor transparency, low dividends and cash being removed from the businesses.

Despite the recent fall, higher average oil prices in recent years have allowed the barons to change. They have paid off outstanding debts and compensated minority investors. They have hired expatriates, appointed independent board members and adopted International Accounting Standards.

Under Mr Putin, they have agreed to pay more taxes and to consolidate their businesses onshore. They have also started to invest more in oil production, refining and downstream operations such as petrol stations. A willingness actively to manage their companies has swelled stock market capitalisations, raising their own personal wealth in the process.

"Russian business has radically changed," says Anatoly Chubais, the former top Kremlin administrator who now runs UES, the state-controlled electricity group. "Oligarchs understand that clean business earns them money." He singles out Mr Khodorkovsky, who in two years has turned from the scourge to the darling of foreign investors.

With many Russian oil fields past their peak, the barons are also looking abroad. They began with acquisitions in eastern Europe and have been exploring possibilities in the Middle East.

Lukoil, which Mr Alekperov once boasted would join the "Seven Sisters" of the multinational oil giants as a tardy eighth arrival, last year acquired the quoted Getty Petroleum in the US. Yukos last month purchased 22 per cent of the Norwegian Kvaerner group and has just secured the purchase of two of its London-based subsidiaries. Both companies are bidding in the Greek government's privatisation of Hellenic Petroleum.

All five rose to power by establishing control over Russia's oil companies during the insider-run privatisations of the 1990s. They 51-year-old Vagit Alekperov of Lukoil, or the 50-year-old Vladimir Bogdanov, who spends most of his time in Surgut's Siberian company town, are reclusive, rarely giving interviews or meeting their investors. Both are old-style oil men who learnt their trade in the Soviet period.

The remainder are younger entrepreneurs who dabbled in a range of businesses before concentrating on oil. Roman Abramovich, 36, the dominant shareholder in Sibneft and a former ally of Mr Berezovsky, sports a permanent four-day stubble and visibly flinches at the sight of reporters and television cameras.

Mikhail Khodorkovsky, 38, built the financial group Menatep before focusing on Yukos. Mikhail Fridman, 37, one of the main shareholders at TNK, remains active in other sectors through his Alfa Group conglomerate.

But oil is not their only focus. Mr Alekperov has been tipped as a future president of Azerbaijan, where he was raised, succeeding the ailing Heydar Aliyev. Lukoil has been using its minority stake as an excuse to push into liquidation TV6, a television network controlled by Mr Berezovsky, in a blow to free speech that may curry favour with the Kremlin.

Mr Abramovich has withdrawn from the day-to-day management of Sibneft and was last year elected the governor of Russia's far eastern Chukotka province. He recently angered minority shareholders by making himself a short-term loan through a share buy-back arrangement to finance acquisitions in Russian timber and aviation.

For the most part, though, Russia's oil barons have shown that they can perform well, at least when times are good. If oil prices resume their recent slide, harder times might put that image to the test.

Source: Financial Times, December 1, 2001