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BOTSWANA ~ REVISITING THE PULA 'CARRY' TRADE

Performance Review

Through October 31, the trade we initially recommended last January has delivered impressive results:

★ Short-term nominal rates have remained high and are currently at 12.79%. This has made it possible to roll the 91-day position with a minimum give-up in yield, producing an unlevered holding-period return of 10.49% in local currency.

★ Meanwhile the resurgent *Pula* has continued to strengthen against the US$, appreciating by 16.92% over the period under review.

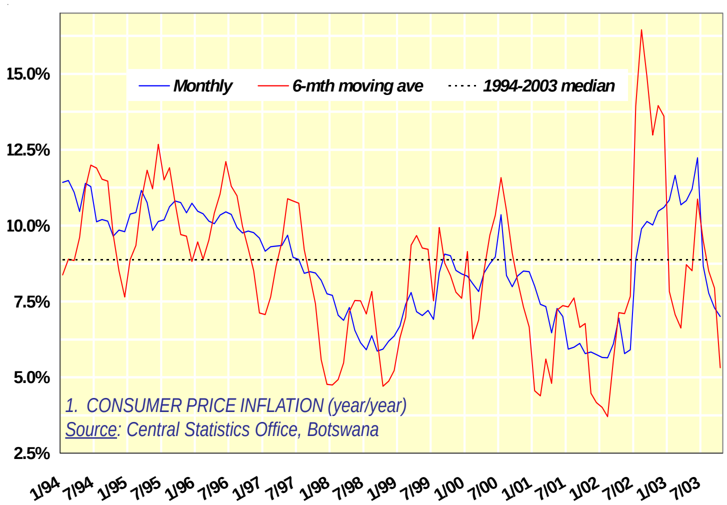
★ The combined effect of these two benign elements has been **a 9-month total return of 29.18% in US$, equivalent to an annualized return of 39.02%** - for a single-A credit (Moody's; S&P's).

Is the game over?

Emphatically not. Our assessment is that Botswana's economic fundamentals as well as the uncertain outlook for the US$ mean that this trade still has legs.

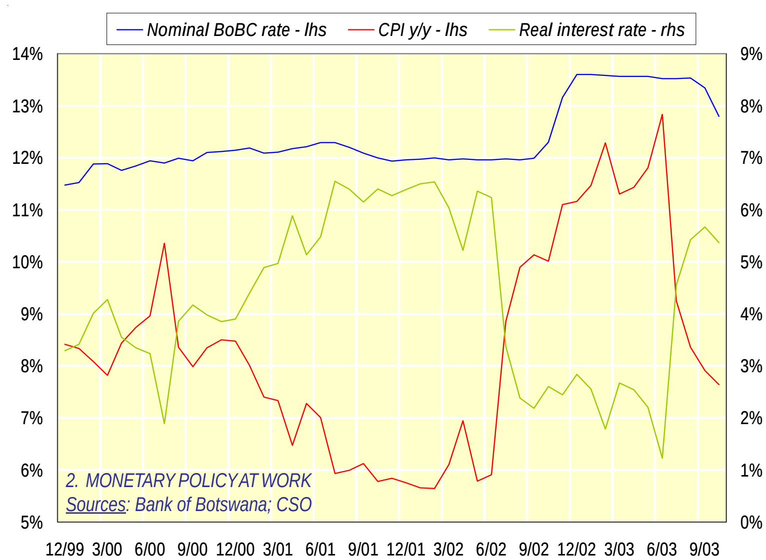
Economic Backdrop

● As we have consistently argued, the inflationary spike of 2002 has proved attributable to a trio of one-time events ~ primarily, the July 1 introduction of a V.A.T. Chart 1 illustrates the rapid deceleration in prices from the 9½ year peak of 12.23% hit in May 2003 to October's reading of 7.0%.



1. CONSUMER PRICE INFLATION (year/year)
Source: Central Statistics Office, Botswana

● While nominal interest rates have come off their peak, the decline has been very modest. Our view is that the Bank of Botswana will be far less aggressive[1] about cutting rates than the Reserve Bank of South Africa. As can be seen from Chart 2, the BoB has a naturally restrictive bias. This is understandable given the currency peg arrangement by which the *Pula* is managed.



2. MONETARY POLICY AT WORK
Sources: Bank of Botswana; CSO

● We feel that this natural inclination will be reinforced by the fiscal slippage experienced last year, when the budget registered a deficit equal to 3.8% of GDP[2]. While the budget performance during the first quarter of the current fiscal year showed a significant improvement[3], we believe that the monetary stance will remain tight and do not see nominal rates falling below 12% even in the medium term - a view supported by the evidence of past practice, as illustrated.

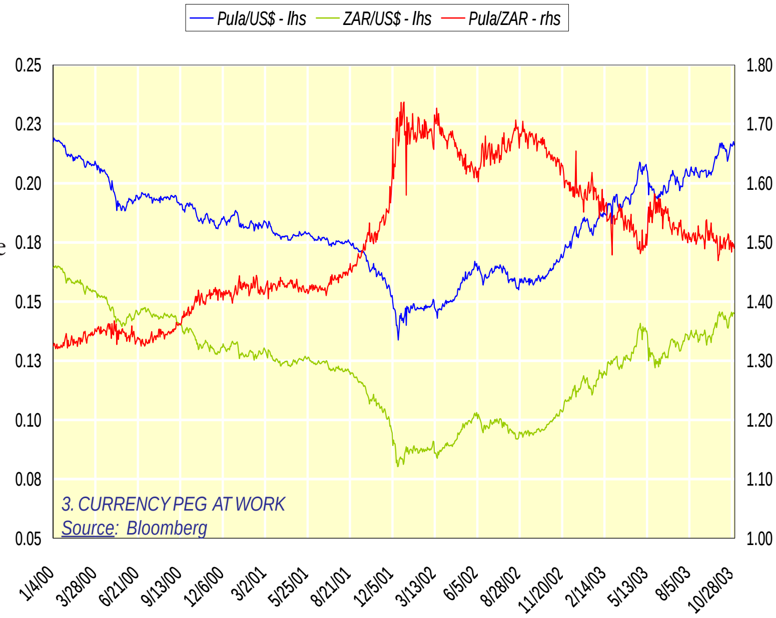
[1] The Bank has only cut overnight rates once this cycle, to 14.75%.

[2] This was only the third time in 21 years that the government had posted a deficit.

[3] i.e. a 41% reduction in the deficit, compared to the same April-June period last year.

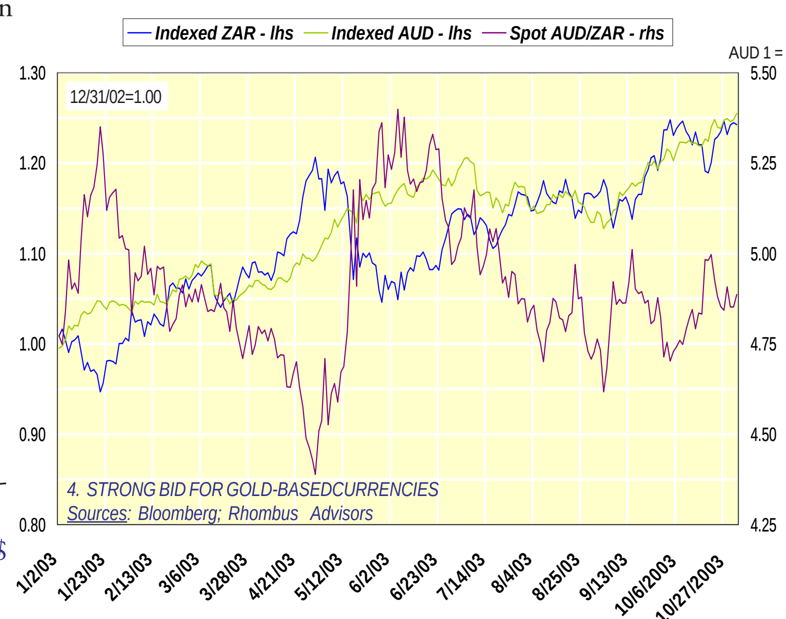
Currency Outlook

As will be recalled, the *Pula* is managed against a currency basket that is dominated by the *Rand*. Botswana's net international investment position[4] and foreign reserve levels[5] mean that there can be no question about the credibility of its currency peg. In fact, the only real source of uncertainty is the *Rand*, on whose near-term prospects we remain positive.



- Chart 3 indicates that the South African currency has completely recovered from the sell-off experienced in late 2001. For this reason, some observers have argued since mid-April[6] that the *Rand* and, by extension, the *Pula*, are well into 'overshoot' territory. We are not convinced.

- In the first place, we feel that there has been something of a virtuous cycle at work in the South African economy, with the appreciating *Rand* producing a rapid decline in inflation, thereby enabling policy-makers to cut rates aggressively, which is attracting additional investment inflows.



- There is also a powerful exogenous factor to consider. The near-explicit abandon by U.S. policy-makers of the *'strong dollar'* policy has improved the bid for precious metals. This, in turn, has driven up the value of gold-based currencies like the *Rand* and the Australian dollar, as illustrated in Chart 4. It is no coincidence that, over the period January-October, these two currencies' spot rates against the US$ exhibit a correlation of 0.80.

- As at the 11/14/03 close, the *Pula/Rand* cross-rate stood at 1.4729, i.e. 1.54 standard deviations **below** the average rate (and median value) of BWP=R1.60 observed over the last 24 months[7]. This will provide a powerful shock-absorber in the event of a significant pull-back by the *Rand*, as was observed during the speculative assault against the South African currency in 2001-Q4[8].

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[4] i.e. in excess of 100% of GDP.

[5] i.e. equivalent to approximately 26 months of import cover.

[6] When the Rand first tested the US$1=R7 mark.

[7] The current level is only 0.05σ above the minimum value (i.e.1.4694) observed during the 24-month period in question.

[8] During this period, which saw the *Rand* lose almost one third of its value, BoB allowed the cross-rate to strengthen from 1.50 to 1.71 - with the result that the *Pula* depreciated by only about 15% against the dollar (see Chart 3, above). There is also reason to believe that BoB has since reduced the *Rand*'s weight in the currency basket.