

# Not as bad as it looks

## Recommending Iraqi Debt

We have moved Iraqi debt to Overweight from Underweight in our model portfolio for three reasons. First, it has substantially underperformed the ML IGOV index over the past four months (Chart 1). Second, oil production and exports have hit post-war highs (Chart 2). Third, we believe that pessimism has peaked in relation to the prospects for a unified Iraq.

## Recent underperformance leaves upside potential

Iraq has significantly underperformed Merrill Lynch's IGOV index since 11 May, generating a negative return of nearly 6%, compared with a 3.9% gain in the IGOV. The underperformance mainly reflects pessimism about the future of the country and concerns that the Israeli-Lebanon war would degenerate into a regional conflict.

## Iraq boosting oil output, despite violence

Despite a lack of investment and sabotage by insurgents, the country's oil production and exports have been growing steadily over the last few months. As of early September, oil production has risen to a post-war high of 2.4mbpd, while the exports have reached 1.8mbpd. Iraq, which has the third-largest proven crude oil reserves in the world, is planning to raise its oil output to 3.0mbpd before year-end and 4.3mbpd by 2010. The government has allocated some US\$4bn, or 12% of the country's entire budget, to develop the oil infrastructure. We think the government's production targets are plausible. Parliament is expected to approve the draft hydrocarbon bill in early 2007, allowing the government to kick-start negotiations with major oil companies to develop Iraq's oilfields. In addition, oil prices, while below this summer's record highs, are still well above the US\$46/bbl needed for favorable debt dynamics.

## A unified Iraq? The more likely outcome long term

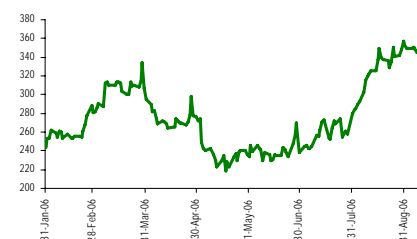
The surge in sectarian violence in recent months has created a sense of pessimism about the future of Iraq, with many in Baghdad and Washington talking openly of the country's partition along ethnic and religious lines. Needless to say, such an outcome would be very negative for the country's credit, but we think the current pessimistic assessment of Iraq's prospects suggests that there is limited downside in terms of political news flow. More importantly, we continue to believe that Iraq has a future as a unified state, simply because the US is highly likely to maintain a significant presence in the country for the foreseeable future. We believe that a decentralised Iraq, giving Shi'ites, Sunnis and Kurds a high degree of autonomy, is a more likely outcome in the long run. While the task of resolving the process of federalism is likely to prove difficult, it would be credit positive, as it would imply a central entity that would service the debt.



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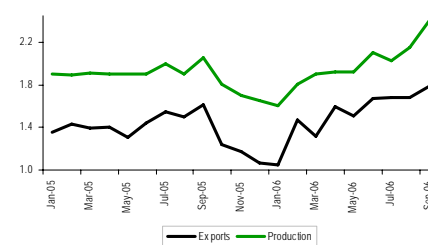
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Chart 1: Iraq's risk premium over IGOV Index (Spread Differential)



Source: Merrill Lynch

Chart 2: Oil Output & Exports (mbpd)



Source: OPEC, Iraq Weekly Status Report

Chart 3: Iraq: foreign currency reserves (US\$bn)



Source: Central Bank of Iraq

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