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Commentary
Third Quarter 2011

Gloire

Glory is, perhaps, the trait with which the French people most identify. It abounds at Versailles, for example, which immortalizes not so much Louis XIV, as it does his glory. Americans have our battle cry of freedom, and proclaim liberty or death, but for the French, it is *le jour de gloire*, not *liberté, est arrivé.*[1]

Just west of the palace of the Sun King at Versailles is the École Spéciale Militaire de Saint-Cyr, the prestigious military academy established by Napoléon in 1803. For more than two centuries, the elite of France have sent their sons (and more recently, a few of their daughters) to prepare as officers in the French Army and as future leaders of the Republic.

Few exemplify this glorious tradition better than Raoul Albin Louis Salan, class of 1918. Born at the turn of the century to a prominent family, Salan fought briefly, but gallantly, in the First World War, earning the *Croix de Guerre* for bravery. He headed French intelligence in Asia between wars, and fought closely with his mentor, Charles de Gaulle (class of 1912), in the French Resistance during World War Two. He was to win the *Légion d'honneur*, the highest decoration France can bestow.

Following the war, France was eager to restore the glory of its far-flung empire and, against American wishes, resumed control of Southeast Asia that had been lost to the

Japanese in 1940. Shortly after the French return to Indochina, a group led by Ho Chi Minh petitioned for independence. The French rejected this, the Americans dithered and Ho took up arms. Salan was appointed head of the French Army in Tonkin (North Vietnam), and in 1948, was named head of the army in all of Indochina. Four years later, Salan became chief of all French forces—air, sea and ground—in East Asia.

Through 1951, the French won every campaign, inflicting serious casualties on Viet Minh forces. But in early 1952, the year Salan was named commander-in-chief, General Vo Nguyen Giap won a series of battles, forcing a French retreat and cutting off their supply lines. Salan knew he needed a new strategy to maintain military control of Indochina. The plan he devised would lead to

[1] *La Marseillaise, the French national anthem: the day of glory has arrived?*

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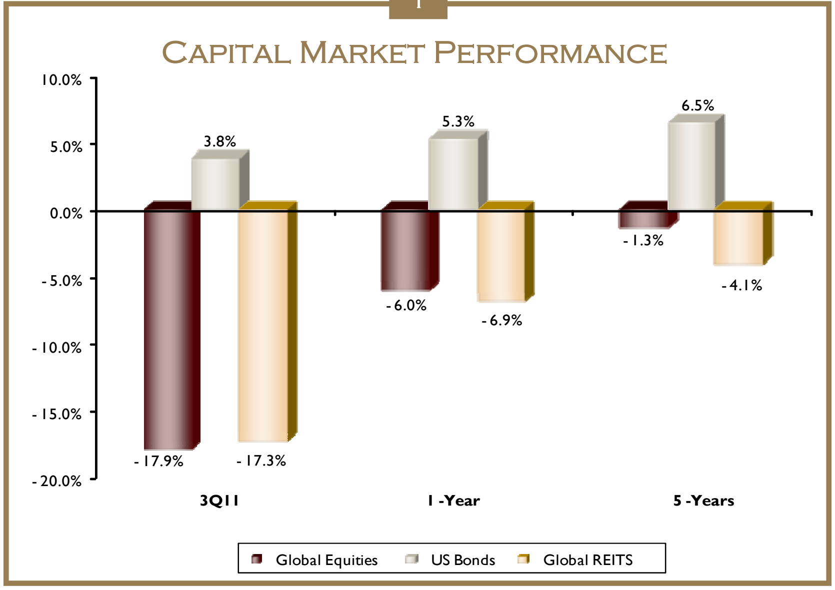
France's greatest military victory since Austerlitz.[2] A little more than a year later, however, it was this very strategy that would lead to France's worst military disaster since Waterloo.[3] And therein lie the lessons for us today.

"The third quarter came to a close (thankfully)... "

The third quarter came to a close (thankfully) with world equity markets off 18%, marking the worst three-month period since the global meltdown at the end of 2008. The US market performed slightly better, losing 14% of its value, while Europe, Asia and Latin America all fell more than 20%. Every equity market in the world dropped in the quarter, with the biggest damage found in Europe: Austria, Poland and Italy all lost about one-third of their value, while Greece and Hungary each fell nearly in half. In three months. It was a very bad quarter. If it feels like even Mother Nature is in a foul mood, she is (see Chart 2).

1



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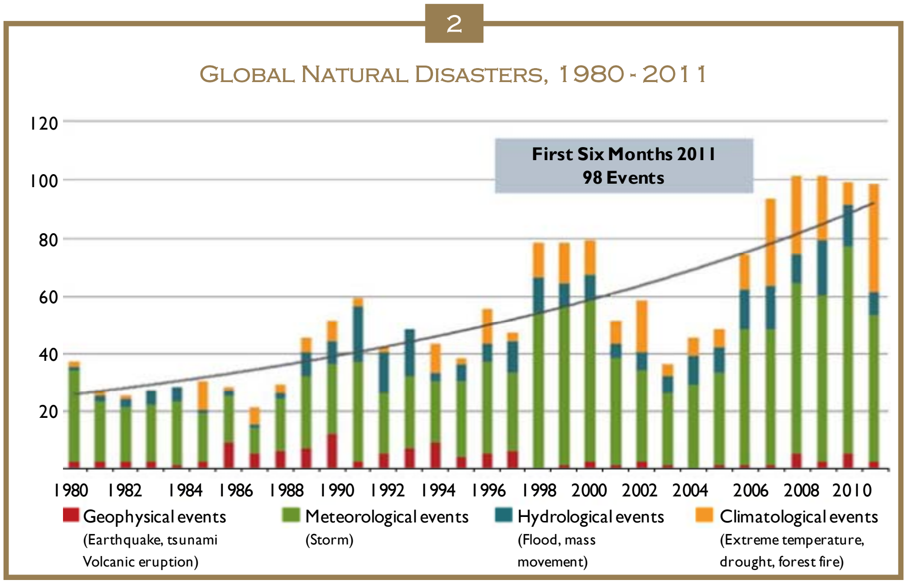
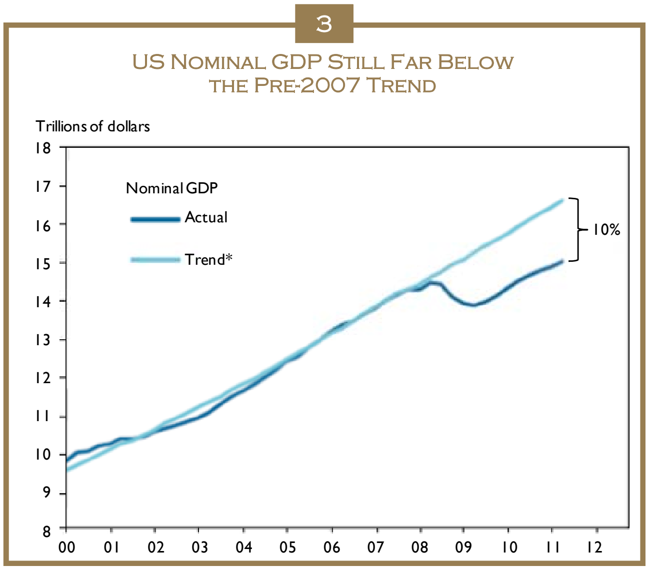


Source: Munich Re

[2] Perhaps Napoleon's greatest victory, against the Austro-Hungarians in 1805.

[3] Napoleon's demise in 1815.



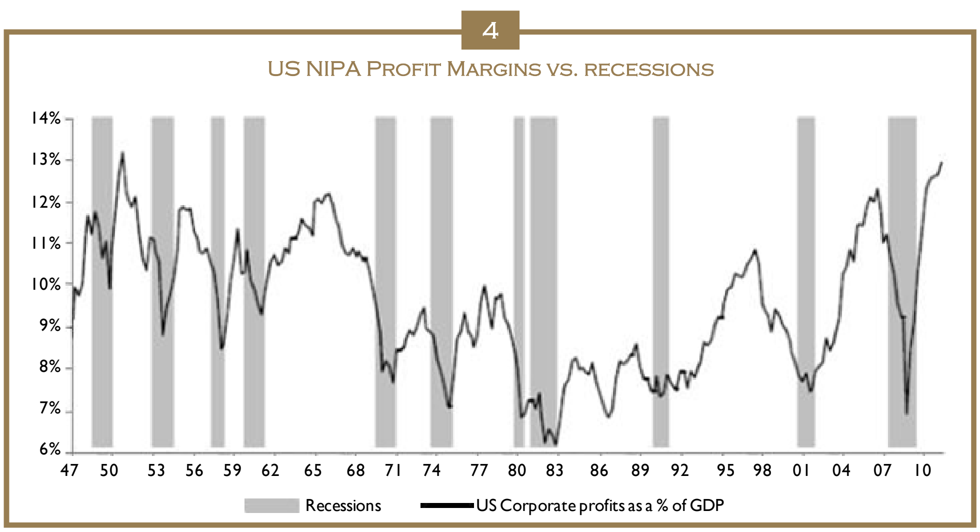
** Estimated as level of nom GDP in 2007Q4 extrapolated backward at historical trend rate of 5.3% and extrapolated forward at assumed 4.5%.*
Source: Department of Commerce, GS Global ECS Research.

Before we sink into the abyss of gloom and doom (we'll get there in good time), there has been some positive news. Real GDP grew at a 2.5% rate in the quarter, with final sales (which exclude inventory adjustments and so are a truer indicator of underlying demand) rising a respectable 3.6%. The US annual economic output is now $13.35 trillion, finally surpassing the previous high of $13.33 trillion established at the end of 2007. We have fully recovered the losses from 2008, but the economy is still well behind its previous ten-year trend (see Chart 3).

If there is a driver of the economic rebound, it is business spending on capital equipment and software. This was very strong last quarter, up more than 17%. The category represents only 7% of total spending in the economy, but since the recovery began in 2009, business spending has accounted for fully one-third of the growth of GDP. No wonder, as profit margins are near record highs (see Chart 4), and companies are flush with the highest cash balances in nearly 60 years.

The dismal state of the housing market is well known, as we've covered it extensively in previous letters, but the silver lining is that housing is now as affordable as it has been in over a generation, with a mortgage payment on an average house claiming just 10.8% of average income, half of what it was four years ago (and a quarter of the level of the early 1980s—see Chart 5, page 4).

"...the silver lining is that housing is now as affordable as it has been in over a generation..."



Source: BEA, NBER *Courtesy: JP Morgan*

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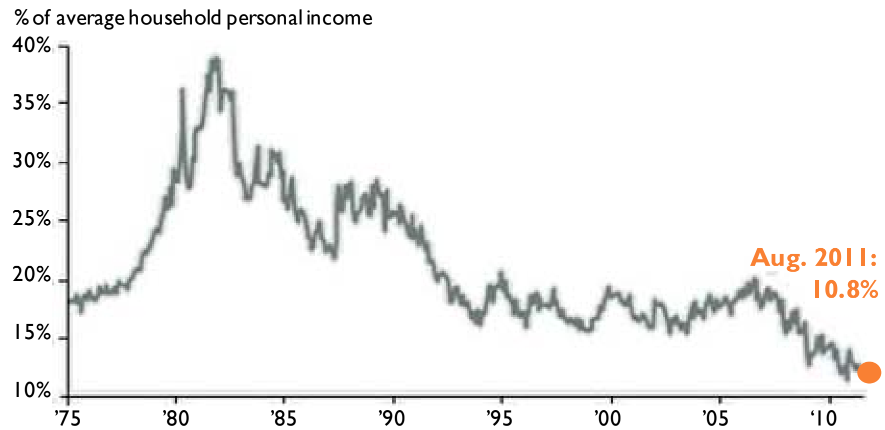
AFFORDABILITY: MORTGAGE PAYMENT ON AVERAGE NEW HOME

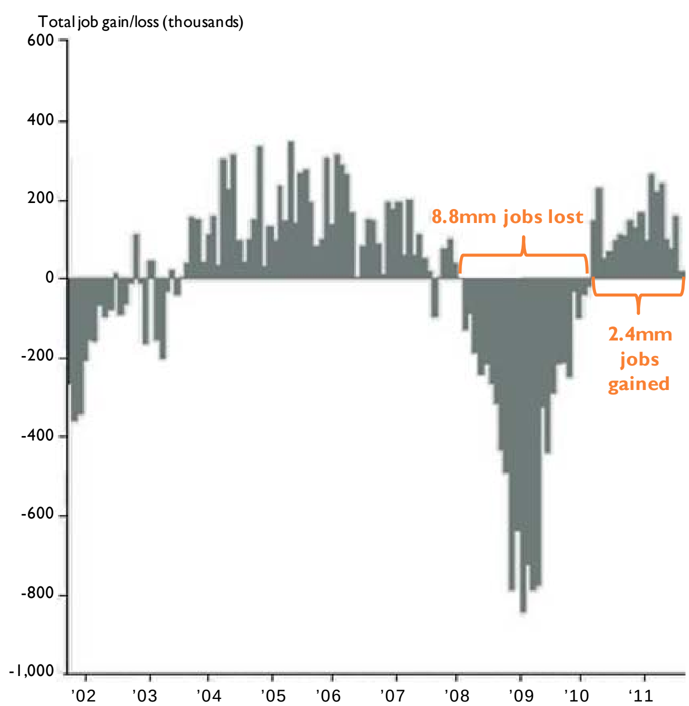


Census Bureau, FRB, BEA, J.P. Morgan Asset Management. Calculation assumes a 20% down payment, a 30-year fixed-rate mortgage, excludes property tax and homeowners' insurance and is expressed as a % of pre-tax income. Data reflect most recently available as of 9/30/11.

"...little of business' cash hoard is finding its way to labor."

6

EMPLOYMENT - TOTAL PRIVATE PAYROLL



Source: BLS, FactSet, J.P. Morgan Asset Management

Businesses may be spending furiously on equipment, but little of this cash hoard is finding its way to labor. The economy lost 8.8 million jobs through the end of 2009, and has recovered about 2.4 million, so we are 6.4 million jobs behind the previous peak (see Chart 6). In the past 60 years, it has taken, on average, two years to make-up all the jobs lost in recessions. We are now at the two-year anniversary of job recovery, but we are a long, long way from that goal. Recently, the economy has been adding about 100,000 new jobs per month. At this pace of job creation (which is not guaranteed), we will have recovered all the lost jobs sometime in 2017, but given the natural growth of the workforce, the unemployment rate will likely rise, not fall.

There are numerous factors that contribute to the complex dynamics of the employment market. Certainly, the impact of globalization has been enormous, providing companies with access to hundreds of millions of low-cost workers and other cheaper resources. But the fact that job growth has been very modest, particularly compared with previous periods (see

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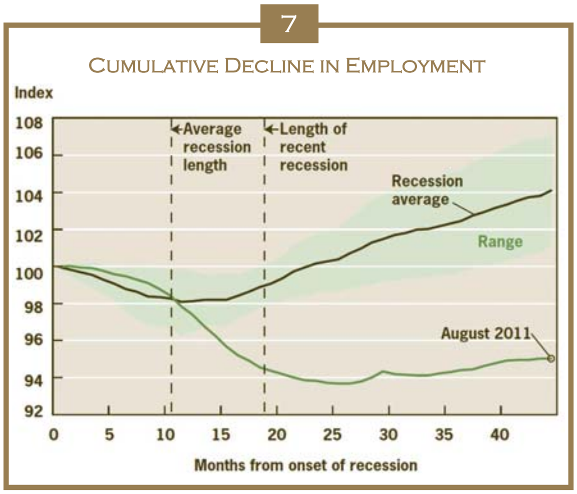

Note: The level of payroll employment is normalized to 100 at the start of the recession. The recession average line represents the average progression of the employment index for all recessions after 1950. The shaded area shows plus and minus one standard deviation from the average.

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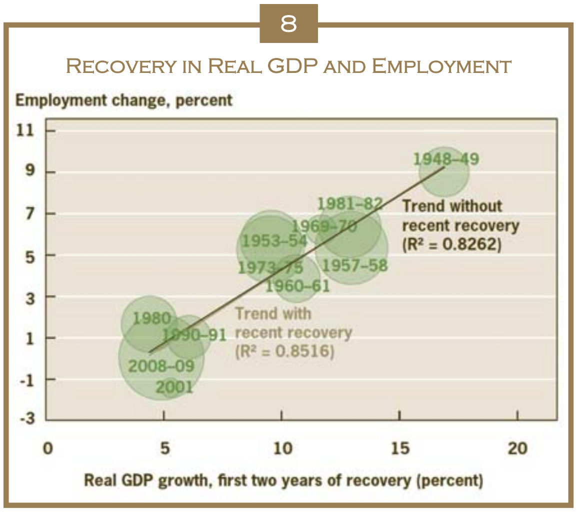

Note: Size of the bubble represents the size of the GDP decline during the recession, GDP data are quarterly.
Source: Bureau of Economic Analysis; Bureau of Labor Statistics.

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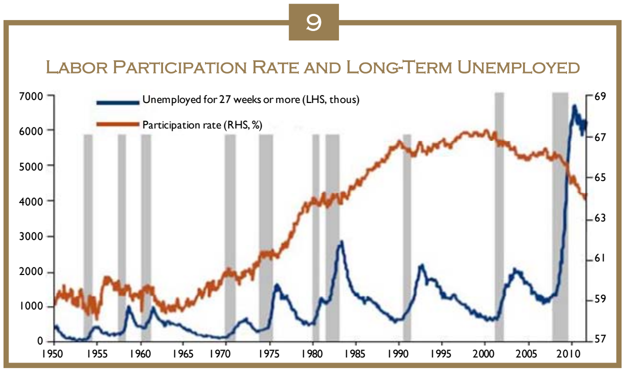


Source: BLS, BofA Merrill Lynch Global Research

Chart 7), may be (at least partly) explained by the very sluggish growth rate of the economy. Adjusting for GDP growth, job creation has actually been in-line with the past (see Chart 8).

Nonetheless, the distinguishing characteristic of the employment picture is not the elevated unemployment rate of 9%, but the significant decline in the overall labor pool, and the persistence of long-term unemployment. Adding to the official unemployed those working part-time and those who have simply given up, 16.5% of the workforce, one in six people, is un- or underemployed, and more than six million have been out of work for over six months (see Chart 9). These data are frightening.

"Money may or may not be the root of all evil..."

Money may or may not be the root of all evil,[4] but money, or more accurately, monetarism, is a helpful lens through which to view economies and capital markets. In late 2010 and early 2011, when global growth and the capital markets were strong, many governments tightened policies. There were rate hikes by central banks in Europe, Brazil, India, China, and others. The second round of quantitative easing by the Fed came to an end in June, and additional austerity measures, from credit controls in Brazil and China to budget cuts in Europe and the US, were put in place. Predictably, economic growth slowed, equities sold-off, and those markets especially dependent on foreign capital flows (India and Turkey, for example) saw the largest declines. In response, central banks are now easing, with Brazil cutting rates aggressively, the Bank of England beginning its own QE2 round of easing, the ECB cutting rates outright, and the Fed targeting

[4] The passage is actually, "the *love* of money is a root of all kinds of evil," (1 Timothy 6:10), which has a very different connotation than "money is the root of all evil."

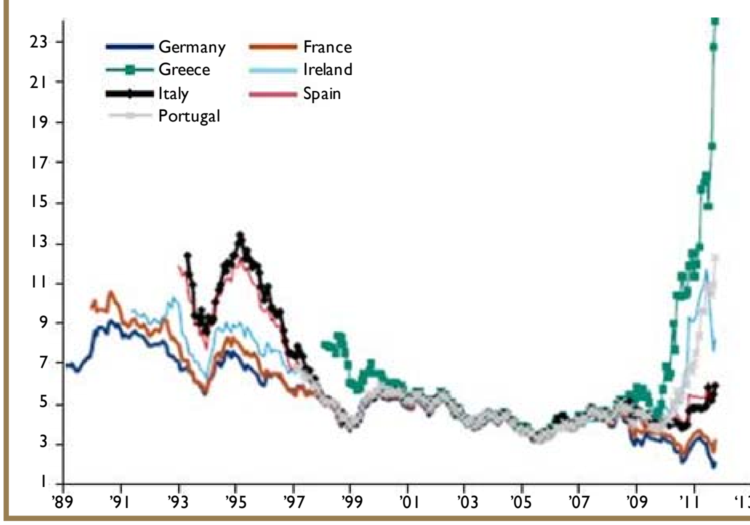
lower long-term interest rates through "Operation Twist."

These actions (or rather, reactions) by politicians and central bankers follow the pattern of a classic deleveraging environment. Deleveraging occurs when debt reaches an unsustainable scale relative to "true" (i.e., non-levered) asset values and income levels. This process of debt reduction, deleveraging, is typically long and painful. Private credit is absent, because borrowers, and therefore lenders, are insolvent, and governments fill the credit gap. Currently, 90% of all non-financial borrowing is by governments (versus 25% normally), and half of this borrowing has been financed through money creation by the central banks. This is a nearly identical pattern seen in the 1930s when government borrowing also accounted for nearly all credit formation.

"This is a nearly identical pattern seen in the 1930s..."

10

European 10-year yields



Source: BofA Merrill Lynch Global Equity Strategy, Bloomberg

This process is playing out across the developed world, but it is in Europe where the challenges have become urgent because the very construct of Europe's monetary union is structurally flawed. The economic (not to mention social) diversity of the region means there will inevitably be differences in growth rates, productivity, wages and prices. Indeed, these differences have always existed. A single currency proscribes shifts in exchange rates to help balance these differing economic conditions. As currency devaluation is no longer available as a tool to adjust current account imbalances, governments are required to adopt appropriate tax and spending policies. This did not happen.

Over the past decade, budget and trade deficits were covered with borrowing, masking the necessity for fiscal discipline. As a consequence, every country (even Germany) violated the (Maastricht) agreement to keep budget deficits below 3% of GDP, and public debt levels soared, willingly financed by investors who believed they would be repaid (or, in the case of European banks, were told by their regulators that Greek debt was as money good as German bunds). In the aftermath of the 2008 financial implosion, it became clear that certain countries—Greece, Ireland, Portugal, to begin with—faced very high likelihoods of not being able to repay their debts, with the predictable consequence of a soaring cost of borrowing (see Chart 10). Greece stands out in this chart, but squint and you will see that Italy and Spain are borrowing at 6%, well above their nominal growth rates. For these two large economies, even this cost of funds is not sustainable.

The United States is also, of course, a monetary union, meaning that California cannot devalue its state currency in order to help restore competitiveness (no doubt it would if it could). But unlike Europe, the United States is also a fiscal union, and in difficult times, more taxes are collected from areas that are relatively well-off and spending is directed to areas that are struggling (through unemployment insurance, food aid, welfare benefits, et al.). There is no such transfer mechanism in Europe. Perhaps a fiscal union would be helpful in Europe, but the political obstacles are enormous, and even a sufficiently massive transfer of wealth doesn't address the underlying economic imbalances across the region.

A more immediate impediment to addressing the debt crisis is that the European Central Bank, by its charter, is prohibited from being a lender of last resort. This constraint was imposed on the ECB by Germany as a condition for German participation in the euro. But the unlimited access to a lender of last resort defines sovereign risk and, absent this access, sovereign risk is effectively converted into credit risk, which explains why spreads for sovereign bonds in peripheral Europe have widened at the same time yields for US and UK debt have fallen. It is not the fiscal unions in the US and UK that lower their cost of debt, it is the Federal Reserve and the Bank of England, as the unlimited lenders in their currencies, that afford the dollar and the pound safe-haven status.

Perhaps politicians like emergency summits: they meet with other important politicians and issue proclamations that aver they have saved the world from disaster. The latest iteration modified the previously modified European Financial Stability Facility (EFSF) by providing guarantees on new Italian and Spanish debt, a recapitalization of banks, and imposing a "voluntary" 50% haircut on Greek debt held by private banks (but not on debt held by the IMF, ECB or other government entities—they expect to be paid in full).

At the core of these policies, indeed of every government action in the developed world since the financial crisis in 2008, is the belief that the subsequent economic retrenchment was a cyclical downturn, albeit a severe one, whose antidotes are large doses of fiscal spending and monetary stimulus. Policymakers have drawn the lesson from Japan that the absence of aggressive fiscal and monetary policies is the root of that country's stagnation over the past two decades.

This is a dangerous misreading of the economic environment and a misunderstanding of Japan's recent history. Japan has run huge fiscal deficits, borrowing on such a scale that it has the highest debt-to-GDP ratio in the developed world. The Bank of Japan has held interest rates near zero for over a decade. Rather than an example of insufficient fiscal and monetary stimuli, Japan is an exemplar of aggressive government intervention. Yet it remains mired in the morass of economic stagnation.

"This is a dangerous misreading of the economic environment …"

Japan experienced huge asset bubbles, in equities and in property, in the late 1980s, fueled by leverage. What stands out in the subsequent period is not the lack of government action, but the collapse in productivity growth in the economy. In the 1980s, productivity in Japan grew at a 2.4% annual rate, but in the 1990s there was virtually no progress, with productivity gains averaging just 0.2%.

Japan ran into three problems at once: a declining demographic pool, rigidities in the rules regulating business and especially labor practices, and state financial support for inefficient banks and companies. To this last point, rather than allowing markets to clear, banks and businesses were subsidized by the government lest their demise lead to large losses of jobs. A principal explanation, then, for Japan's two decades of stagnation is the inefficiencies of preventing necessary economic adjustments from occurring.

Rather than learning the lessons from Japan's stagnation, we have followed the same policies. From General Motors to Dexia, and now to Greece, liquidations of insolvent companies and countries have been thwarted. Policymakers have chosen Japan's path, and the risk of long-term stagnation, rather than face the immediate and painful consequences of economic adjustment.

Na San is a small valley with a short airstrip surrounded by 24 hills in northern Vietnam. Salan's hope was to establish a forward base, well-defended by artillery and reinforced by paratroopers, that could disrupt the Viet Minh supply lines and draw their troops into battle rather than withstand the continued and disruptive guerrilla tactics Giap had perfected. Salan hoped that the presence of French artillery at Na San would tempt Giap out of hiding.

"Salan was a national hero…"

Salan established 30 armed positions in the mountains around Na San. In late November 1952, the Viet Minh, with overwhelming numerical superiority in troops, began their attacks. Each time they were repelled by one or more of the French outposts. On 30 November, two outposts were lost in a 9-hour assault, but French paratroopers brought in additional troops and supplies, and at the end of the next day, the outposts were recaptured by the French. That evening, Giap ordered a final offensive. In some places, the French were outnumbered 15:1. French air support dropped flares all night to illuminate the battlefield, the artillery fired continuously into waves of Viet Minh forces till morning, and then it was over. Giap retreated, leaving behind 7,000 casualties. It was a glorious victory for the French, and Salan's brilliant strategy of establishing a forward base defended by heavy artillery and air support that would draw the enemy into battle was quickly adopted throughout Indochina. Salan was a national hero, and brought home to France.

Salan's replacement, Henri Navarre, expanded Salan's strategy of strongly defended outposts to ever larger forward bases, including one in the northern mountains near a village named Dien Bien Phu. In November 1953, 11,000 French troops with 24 tanks and other heavy artillery were dropped into Dien Bien Phu. Giap fell for the trap, and began a build-up of Viet Minh forces for an assault on the French stronghold. 50,000 Viet Minh dragged cannon, anti-aircraft guns and other heavy equipment through the impassable mountains around this remote base.

Giap began his full attack on 13 March 1954 and quickly overran one of the forward outposts. A counter-attack failed, and two days later Giap took another well-defended position. The coming weeks saw heavy fighting and casualties and additional French troops and supplies air-dropped in. Giap shifted strategy from all-out assault to isolating each of the French outposts, and began to capture one at a time. With each victory, Giap moved his heavy guns in and maintained a barrage against the airstrip, as he learned from Na San that he needed to disrupt French air support. Furious fighting ensued for weeks, until the end of the day on 7 May when the French surrendered after suffering 7,500 casualties with 11,000 troops captured. A few months later, the French agreed to a partition of the country, ceding the north to Ho and Giap.

Of course, we all know what happened: the Americans, not willing to allow a communist Vietnam, stepped in. For the next twenty years, 2.6 million American troops would serve, with 300,000 wounded and 58,000 killed. On the last day of April 1975, Saigon fell to Giap's troops.

In an interesting twist, after Indochina Salan was sent to Algeria to suppress a brewing revolution against French occupation. In May 1958, Salan led a rebellion of officers calling for a return of De Gaulle to power. De Gaulle did return in 1959 and appointed Salan inspector general of the army. A year later, De Gaulle forced Salan into early retirement, and Salan went back to Algeria in 1961, this time to lead a coup against the French government there. He was convicted of treason and sentenced to death, which was commuted to life imprisonment. He was granted amnesty in 1968, and a 1982 law reinstated him into the Army. Salan died in 1984, his heroism intact.

Salan's success at Na San was the result of a bold and imaginative strategy that exploited the French advantage of air dominance with the topography of the jungle mountains to negate the Viet Minh's strengths in guerrilla warfare. But success at Na San did not translate to Dien Bien Phu because as Giap adjusted his tactics, the French did not modify theirs. What worked so gloriously at Na San, failed tragically at Dien Bien Phu.

Today, many believe we averted catastrophe through massive government spending and unprecedented money creation by central banks. Perhaps we did. But that is no guarantee that more of the same policies will revitalize our economies and restore our prosperity. A lesson the French learned ingloriously, at Dien Bien Phu.

Founded in 2001, Angeles Investment Advisors LLC provides investment advice to select institutions and high net worth families and individuals.

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