GRAVELINES

Elizabethan England was an era of plots and intrigue, chivalrous knights and swashbuckling pirates. The many domestic conspiracies and foreign wars of the 16th century were nominally about religion, but were, of course, really about power: the entrenched authority of the Roman Church and its empire against a rebellious realm on the fringe of the continent.

In the early 16th century, Henry VIII made the first break with Rome when Pope Clement VII refused to annul Henry's marriage to Catherine of Aragon so he could marry Ann Boleyn. Catherine's nephew was the most powerful man in Europe, and the pope's staunch supporter, the Holy Roman Emperor, Charles V. The schism between England and Rome continued under Henry's son, Edward VI, but when Edward died after six years on the throne his half-sister, Mary, a Catholic, reunited with Rome. Mary reigned for only five years, and was succeeded by her half-sister, Elizabeth, who reinstated her father's rupture with the Church. Re-establishing papal authority in England became then the principal obsession of the Catholic powers.

The limitless riches of the New World made 16th century Spain the most powerful nation on earth. To protect the Spanish crown's monopoly on the abundant treasure of the Americas, the lucrative trade routes and ports of call were restricted only to Spanish ships. Elizabeth was all too happy to look the other way when English "sea dogs" (otherwise known as pirates) preyed on Spanish shipping or forced their way through the trade blockade. Most famous among these pirates was her favorite, Francis Drake. In 1577, Elizabeth commissioned Drake to plunder Spanish ships and settlements along the Pacific coast, which he did with much success. Drake continued westward, becoming only the second to circumnavigate the globe, and upon his return to England two years later, was knighted for his efforts (as much as for attacking the Spanish as for sailing around the world). The Spanish called him *El Dragón*, and their king, Phillip II, offered a multi-million dollar (in today's terms) reward for his capture.

Meanwhile, Elizabeth's enemies wanted her dead, or at least replaced with her Catholic cousin, Mary, Queen of Scots. In 1570, a plot organized by a Florentine banker, Roberto Ridolfi, to instigate a rebellion of English Catholics, was uncovered. The co-conspirators were executed, and Parliament demanded the same for Mary, but Elizabeth hesitated to take the life of a fellow monarch for fear of the precedent it would set. In 1584, another plot, this one hatched in France by the English nobleman Sir Francis Throckmorton, to overthrow Elizabeth in favor of Mary was also thwarted. Throckmorton was hung and Mary imprisoned. A third plot two years later by the English Catholic Sir Anthony Babington to overthrow Elizabeth finally led to Mary's beheading in 1587.

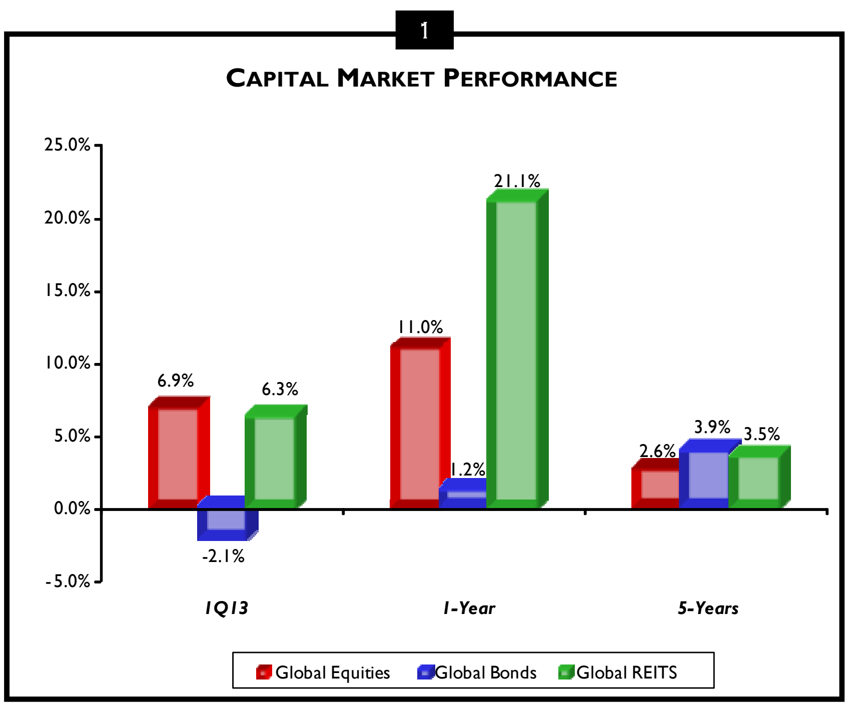
"...victory …won not on the seas, but in the planning..."

Spain, and the Church, supported all of these conspiracies, but Elizabeth had plots of her own. In 1585, she signed a treaty with the Dutch provinces then in revolt against Spain, promising to pay one-quarter of their military expenses and to supply 7,000 English troops for the fight against Madrid. Later that year, she gave (Sir) Francis Drake 33 ships and instructions to pillage Spanish ports. Drake sailed first to Galicia, sacked two Spanish cities, then turned to attack the Cape Verde Islands on his way to wreaking havoc in the Caribbean.

With attacks on his ships and cities, and outright support of the Dutch insurrection, Phillip II had had enough, and made plans to invade England with the most powerful armada the world had seen. Elizabeth knew that she needed more than Francis Drake and his band of pirates (um, sea dogs) to meet the invasion. She required not only more ships, but better ones, and more importantly, talented men to lead Her Majesty's Royal Navy.

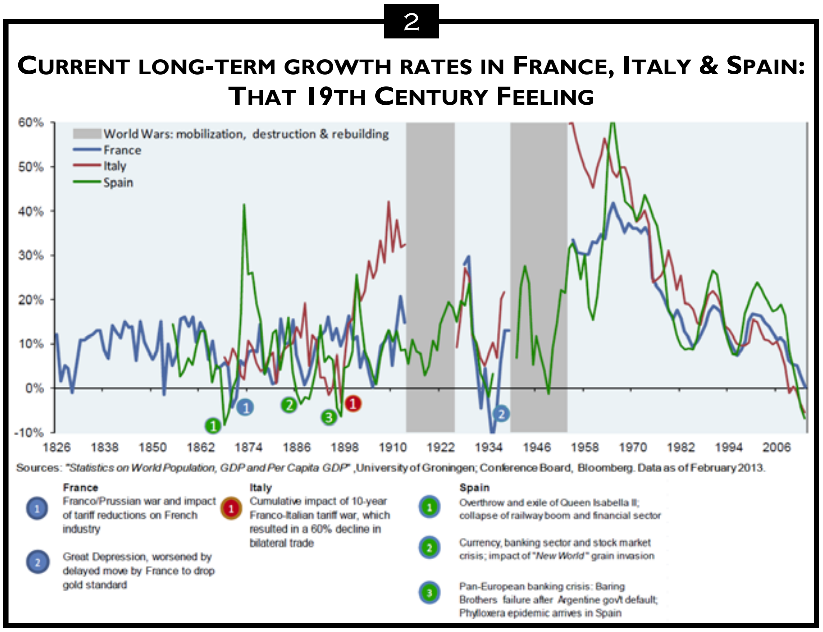
There are very few events that can be thought to have changed the course of history, but this battle was one. Hundreds, even thousands, of books have been written about the Spanish Armada, the critical errors made by Phillip and his captains, and their bad luck. It was seen then, and is widely viewed today, as a colossal Spanish defeat, and there is much evidence supporting this conclusion. But it was also an English victory, one that was won, not on the seas, but in the planning, years before, by another pirate in Drake's shadow, whose rise to influence and foresight saved England from certain conquest.

Anticipating better-than-expected economic data, equities generally posted strong gains in the first quarter of the year. The US and Japan were each up 11% in the quarter, while Europe, where economies are struggling, managed a 2% gain. Eastern Europe was especially weak, with the Czech Republic and Poland each down more than 10%, although Greece rose 14% as the last investor remaining marked up prices. It helped to be an Asian archipel-



ago, as the Philippines (+18%) and Indonesia (+13%) were among the leaders in the quarter. Best of all was Ghana, jumping 53%, bringing its twelve-month gain to 78%, best in the world, just ahead of Nigeria. West Africa is on a roll.

Natural gas spiked 20% in the quarter, and cotton nearly as much, but almost all other commodities fell. Sugar lost 10% and coffee 5%, although the declines haven't been passed through at Starbucks. Overall, the broad commodity indices were close to unchanged in the quarter.



Courtesy: J.P. Morgan

Bond prices took a rare tumble as the stronger economic news at the beginning of the year fueled fears that the extraordinary accommodative policies of central bankers might soon be reversed as economies recover.

Those fears are unfounded. Economic prospects vary across regions, but globally, the world economy is expected to grow at just over 3% this year, about the same as last year, and well below the 5% and 4% growth posted in 2010 and 2011, respectively. Growth rates remain split between developing economies, expanding at more than 5% p.a., and advanced countries, which hope to see output increase about 1%.

Among advanced economies there is a growing divergence in economic conditions, with the US posting growth of around 2% while Europe is contracting. New car sales in Europe, as one example, have fallen 18 straight months. The peripheral countries, such as Greece and Portugal, remain in steep decline, but the weakness has spread north.

The German economy has stalled (as has the UK's), but the next three largest economies in Europe—France, Italy and Spain—are all contracting, and are in the midst of a multi-year decline that is the worst since the 1930s, and back even into the 19th century (Chart 2).

Insolvent banks, over-indebted governments, 20%+ unemployment still characterize the peripheral economies. Weak economic conditions in Germany and its neighbors limit the effectiveness and level of assistance that can be provided. The urgent economic risk is that these factors combine to form an adverse feedback loop, exacerbating and amplifying the economic stagnation. Mario Draghi, head of the European Central Bank, has promised to provide as much liquidity as needed to avert a financial meltdown, but tax and fiscal policies are a mess with no consensus for action. Europe's politicians cannot agree which policies will spur economic recovery (hint: raising the marginal tax rate to 75% will not do the trick). Structural reform, such a liberalizing labor regulations, is urgently needed.

"Those fears are unfounded."

After three decades of growing at more than 10% p.a., China is also slowing. GDP growth fell to 7.7% in the first quarter, and some of the fundamental metrics, such as electricity use and freight volume, are stagnant (Chart 3). Total debt in China is up from 150% of GDP in 2005 to 225% today. Non-financial corporate debt, mostly at the giant state-owned enterprises, represents 130% of GDP, the highest in the world.

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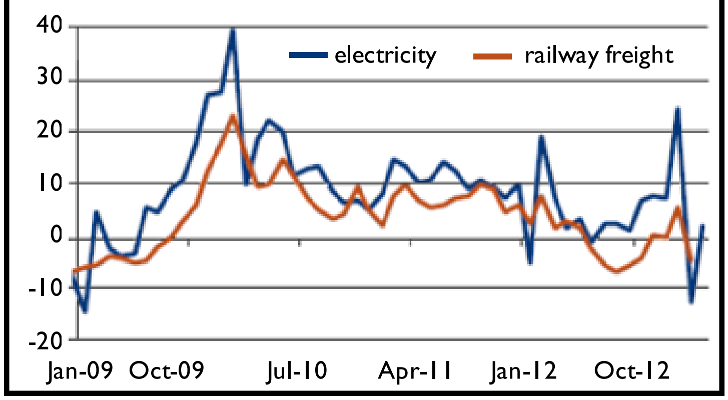

CHINA ELECTRICITY PRODUCTION & RAILWAY FREIGHT VOLUME (Y/Y)

Source: BofA Merrill Lynch Global Research

Growth is slowing, debt is rising, the population is aging: symptoms of the disease afflicting most of the developed world. But China has some strong cards to play. 92% of China's debt is denominated in RMB, and China's foreign reserves provide the highest coverage ratio to foreign debt in the world. Total debt as a percentage of GDP is rising but is half that of the UK and Japan, and well below the US, Germany and Korea (each +300%). Most countries can only dream of 7-8% GDP growth and $3 trillion of currency reserves. So yes, China faces some large challenges, but China's rise is not yet over.

"Growth is slowing, debt is rising, the population is aging..."

Economic challenges abound too in the US, but overall, conditions are improving, in contrast to most of the rest of the world. Almost all private sector industries are adding jobs, at the same or better pace than in the previous recovery a decade ago. The exception is the information industry, which includes publishing, telecommunications, et al., which had been shedding jobs even before the latest downturn. The unemployment rate is 7.6%, down from 8.2% twelve months ago. By comparison, over the past year the unemployment rate in Europe rose from 11% to 12%.

US manufacturing and services continue to expand (with ISM diffusion indices above 50), auto sales are running at a 15.7 million annual pace (1 million more than the long-term average), and corporate profits are at a record 10% of GDP. Housing starts are now more than one million annually, up 47% from a year ago, likely on their way to 1.5 million units. Household debt is falling (except for student loans—Chart 4), and debt service as

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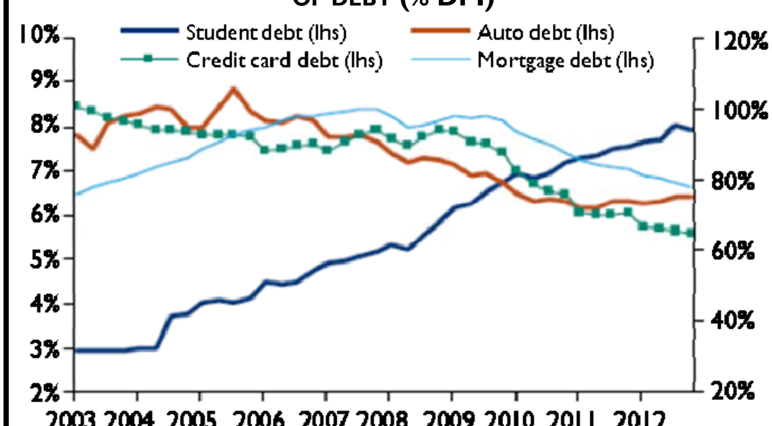

HOUSEHOLDS ARE DELEVERAGING FOR MOST TYPES OF DEBT (% DPI)

Source: Federal Reserve, BofA Merrill Lynch Global Research

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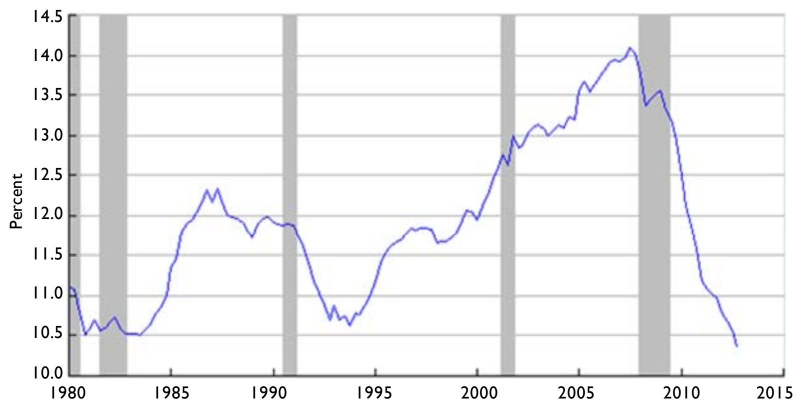
HOUSEHOLD DEBT SERVICE PAYMENTS AS A PERCENT OF DISPOSABLE PERSONAL INCOME (TDSP)



Note: Shaded areas indicate US recessions, 2013 research.stlouisfed.org
Source: Board of Governors of the Federal Reserve System

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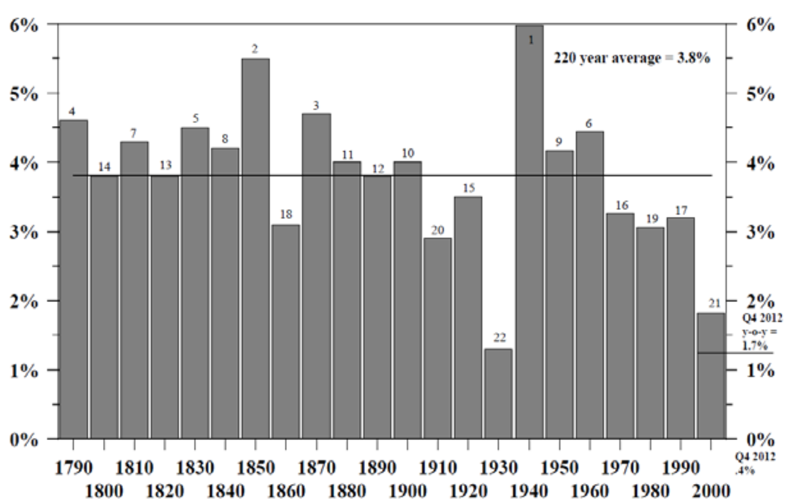
US REAL GDP 1790-2012
DECADE AVERAGE GROWTH



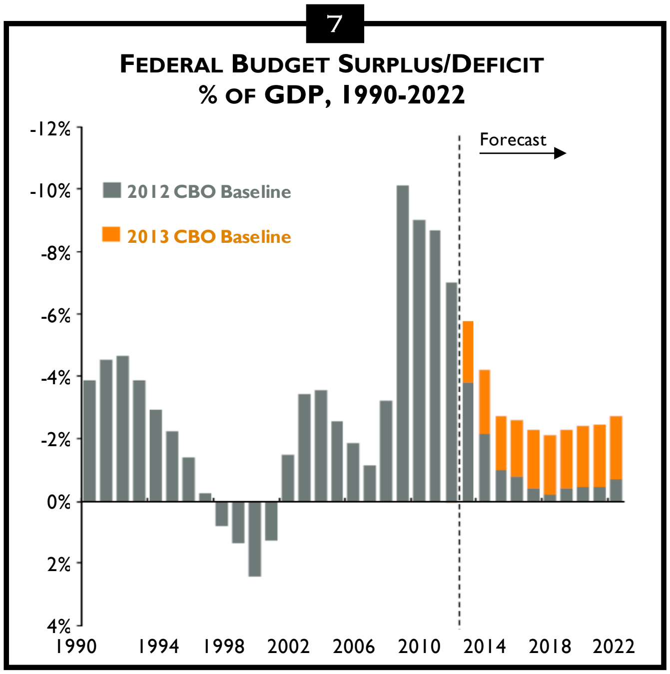
Sources: Bureau of Economic Analysis, Congressional Budget Office, Office of Management and Budget, N.S. Balke & R.J. Gordon, C.D. Romer. Through Q4 2012. Last decade includes growth through Q4 2012.
Courtesy: Hoisington Investment Management

a percentage of income is the lowest since records began in 1980 (Chart 5, page 5).

For all the extraordinary efforts of central banks, inflation is actually trending lower. In the US, CPI was up just 1.5% in the past year, and there are some powerful forces pushing it lower. Potential GDP, the estimate of output with high use of capital and labor, remains well above current GDP, $18.5 trillion versus $13.8 trillion. Large output gaps also exist in all major economies. Unemployment rates in advanced economies are also all well above long-term averages. Japan and many countries in Europe have lost competitiveness, requiring (significant) reductions in wages and prices. And commodity prices have been essentially flat for the past two years as supply and demand are in balance. All these facts suggest inflationary pressures are abating, not accelerating.

"...inflation is actually trending lower."

Still, it has been a disappointing economic performance in the recent past. 135 million people are currently employed in the US, up from 129 million three years ago, but below the 138 million peak of five years prior and fewer people employed than in 2006. The past 13 years has seen growth of just 1.8% p.a., less than half the average growth since the country's founding (Chart 6).



Source: U.S. Treasury, BEA, CBO, J.P. Morgan Asset Management

"...a simple accounting rule change..."

A year ago, federal budget deficits were forecast to disappear in a few years by the pipe-smoking savants of the Congressional Budget Office. Just a year later, they now see deficits climbing in the years to come (Chart 7).

In the advanced economies, rising government debt and deficits, combined with sluggish (in the US) to zero or negative growth (Europe and Japan) have left unresolved the debate on appropriate policy action. Some have pursued austerity, to bring spending and revenue more in-line, either by choice (David Cameron in the UK) or by necessity (Ireland, Greece, Portugal, et al.). Others call for an increase in government spending (and deficits) in order to stimulate economies. This view follows from the classic Keynesian diagnosis that the principal problem is insufficient demand, which the government should provide when the private sector does not. Some point to the $700 billion of TARP (Troubled Asset Relief Program) spending enacted in October 2008 and the $600 billion of quantitative easing announced by the Fed the following month as evidence of government intervention that saved the economy. But it may have been a simple accounting rule change, not the fiscal and monetary stimuli, that stopped the financial meltdown, as economist Brian Wesbury has argued.

The US stock market fell 38% from the day TARP was enacted to the eventual bottom on March 9, 2009. The financial sector was off 67% during that time, and the economy contracted sharply and unemployment soared. On March 9, 2009, the House Financial Services Committee announced it would hold a meeting with the SEC and FASB to suspend fair value accounting. The accounting rule was causing a death spiral for banks, as assets were marked to illiquid prices, driving values lower, destroying bank capital which required further selling, thus driving prices lower, ad infinitum. The day the markets saw that the accounting rule would be changed marked precisely the bottom of the market. In this narrative, it was a suspension of the accounting rules that restored liquidity to the markets, not fiscal spending or monetary policy, allowing prices, and eventually, the economy, to recover. As politicians and central bankers grapple with competing interests and one course of action or another, it may be that doing less will prove more effective at stimulating growth than another government project or round of quantitative easing.

Fiscal policies remain hotly debated, but in monetary policy, notwithstanding the previous paragraph, there is widespread agreement: loosen the spigots. The four principal central banks have all massively grown their balance sheets over the past four years (Chart 8, page 7).

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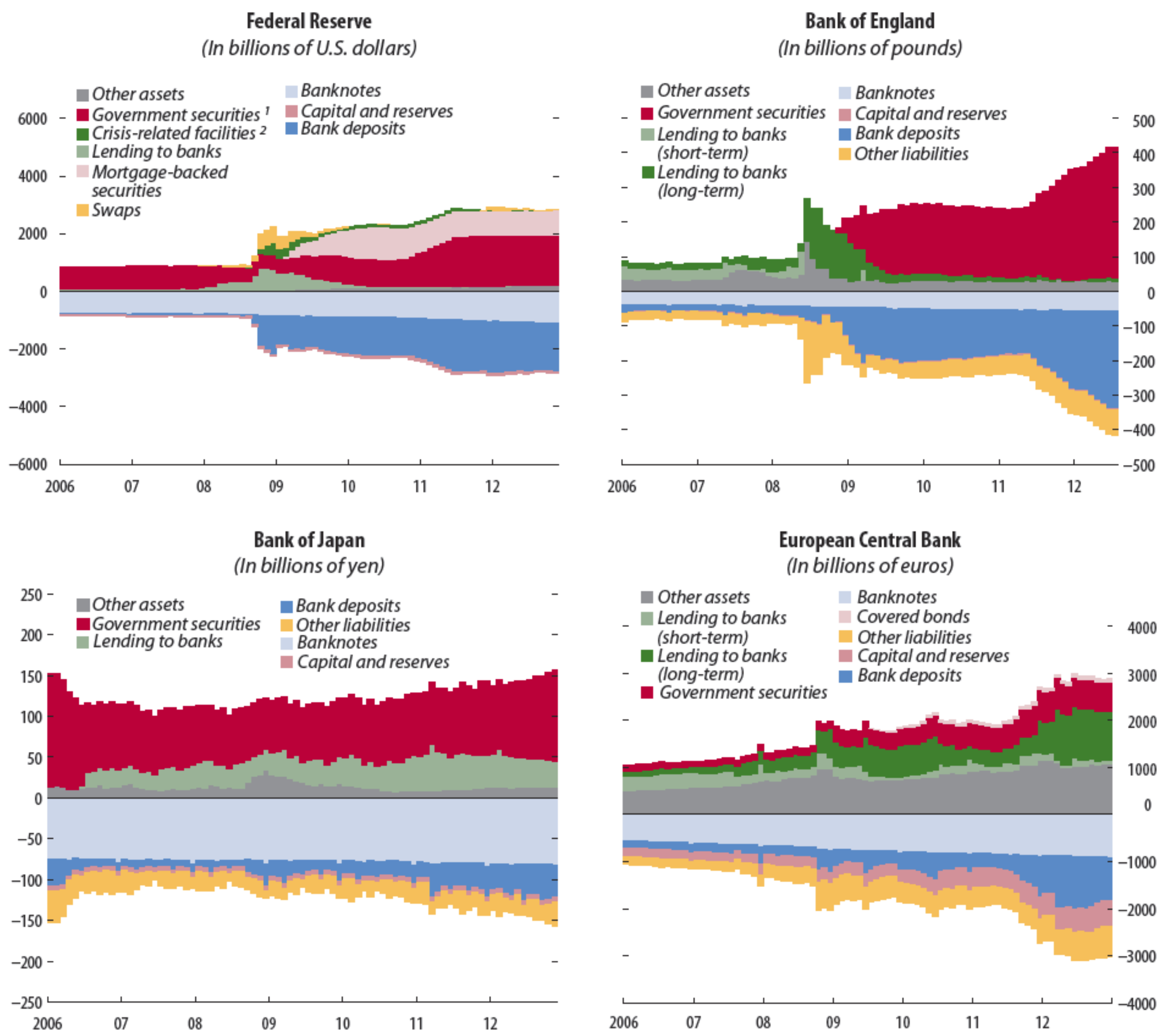
CHANGES IN CENTRAL BANK BALANCE SHEETS, 2006-12



Sources: Haver Analytics; national central banks; and IMF staff estimates.
Note: Government bonds purchased under the Bank of England's quantitative easing (QE) program are held by a separate subsidiary, which is financed by loans from the Bank of England (under "other assets"). Reported here are the amounts purchased under the asset purchase facility (the corresponding loan amount is subtracted from "other assets").
1 Including agency securities.
2 Special-purpose vehicles, commercial paper, and money-market-related assets.

"Can You Top This?"

Look closely, and we see some differences in policies. The ECB expanded its balance sheet sharply in 2011, but has not followed through, and is actually allowing it to shrink (one of the reasons its equity markets trail the rest of the world). The Fed, by contrast, is steadily increasing its balance sheet by buying $85 billion *per month* of Treasury and agency bonds. Its balance sheet has quadrupled in the past four years, and will surpass $4 trillion before Chairman Bernanke's term expires in June next year. But this year's winner of the *Can-You-Top-This?* contest is the Bank of Japan, which recently announced

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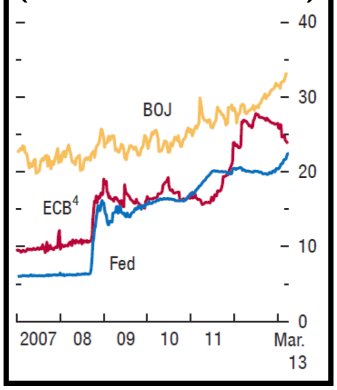
Central Bank Total Assets (percent of 2008 GDP)



Source: IMF

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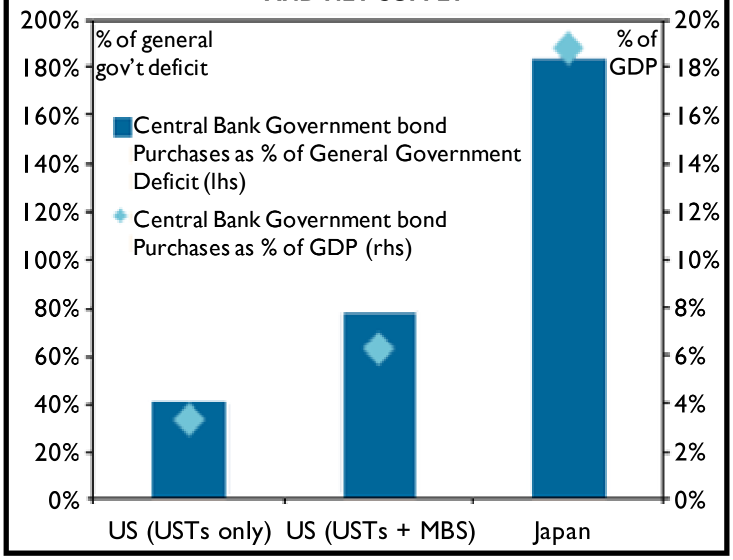
....and exceed Fed purchases relative to GDP and net supply



Source: Haver Analytics, GS Global ECS Research

"...more like a hope than a plan."

its intention of purchasing $600 billion of securities in each of the next two years, taking its balance sheet to $2.9 trillion, 60% of GDP (Chart 9). This dwarfs the Fed's own expansion plans (Chart 10).

In so many ways, Japan is unlike other countries, and this commitment to massive monetary expansion occurs in a very different economic background than the rest of the world, particularly among households. In Japan, household debt represents only 60% of GDP, the lowest in the developed world (the level is 80% in the US), and 80% of household assets is held in cash (versus 25% in the US). Nominal spending is at 1997 levels. Japanese consumers are not spending, not borrowing, and any consumption growth will have to come from wages, which are not growing. But business spending is 35% below its 1990 peak, and any spending is financed with internal cash, not borrowing. Japan's share of world exports has fallen in half since 1985 (from 15% to 7.5%). Prime Minister Shinzo Abe hopes that quantitative easing will weaken the yen, thus improving competitiveness and encourage investment in Japan, which will lead to more jobs and higher wages and consumer spending. But changing the spending patterns of a generation by expanding the balance sheet of the Bank of Japan sounds more like a hope than a plan.

This enormous expansion of central bank balance sheets has precedence in the 1930s and 1940s (Chart 11, page 9). Then, the Fed was directed by the Treasury to buy bonds to suppress yields in order to assist the war effort. Following the war, the policy remained in place, as Treasury officials were happy with the low rates. By 1951, the Fed expressed its displeasure with the policy, but were told by the Assistant Secretary of the Treasury that the administration was concerned about the possibility of an attack on the US, presumably from Soviet bombers, and the demands that would place on the Treasury. In the negotiations that followed, the Assistant Secretary agreed to release the Fed from its directive to maintain low rates in exchange for the Fed's help in converting outstanding Treasury debt to a nonmarketable 29-year, 2 ¾% coupon bond. The Fed got its independence back while the Treasury got cheap, long-term debt. Coincidentally, eleven days after that agreement was reached, the Assistant Secretary of the

Treasury was named Chairman of the Fed. William McChesney Martin would serve in that role for the next 20 years.

The consensus view is that central bank actions averted deflation and depression, bolstered the banking system and contributed to financial stability. But there is also a growing view that the benevolent effects of these measures may have run their course, and that if these policies persist, the seeds are being sown for other crises in the future.

The credit market is one such area of vulnerability. Financial repression (i.e., the government policy to hold interest rates exceptionally low for an extended period) has enabled companies to lower their costs of borrowing and extend maturities, making debt service more comfortable. But we are seeing an above-average level of new issuance, often intended for non-productive purposes, such as equity buybacks, and lending restrictions have relaxed (ominously) to 2007 standards (Chart 12).

Financial repression hurts savers, many of whom have responded to ultra-low yields by increasing their investment risk in order to earn even a modest return. This reach for yield with ever greater risk is found across individuals, insurance companies and pension funds. This is especially evident among the worst funded plans, which have persistently raised their risk profile as their funded status deteriorated (Chart 13,).

Interest rates are low, defaults are low, corporate liquidity is high: nothing wrong, yet. And just because seeds are being sown for future risks, does not mean they will sprout. But they might, and investors should look a little further into the future to understand where the risks lie.

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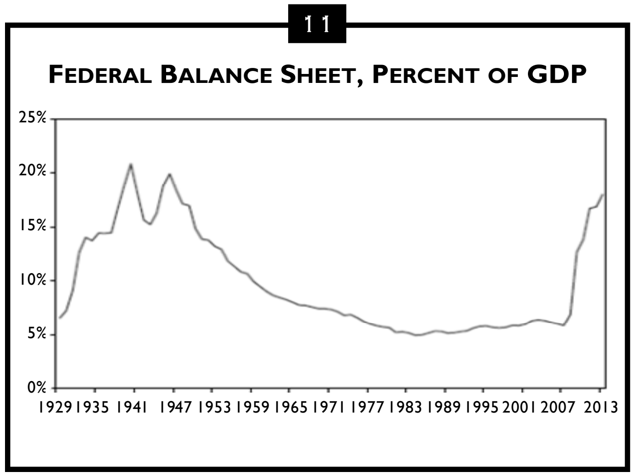

Source: Federal Reserve, Bureau of Economic Analysis Courtesy: Morgan Stanley

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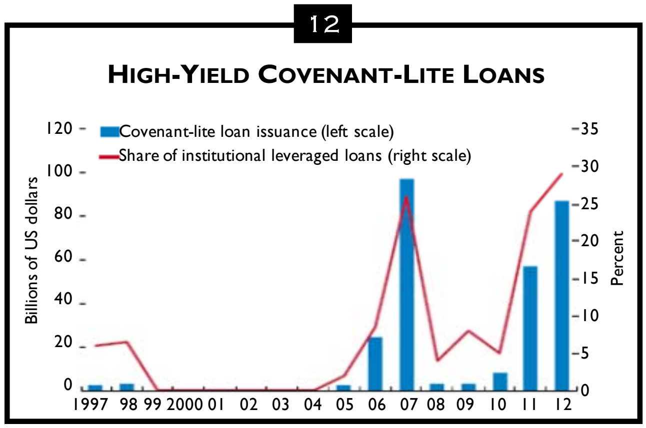

Source: IMF

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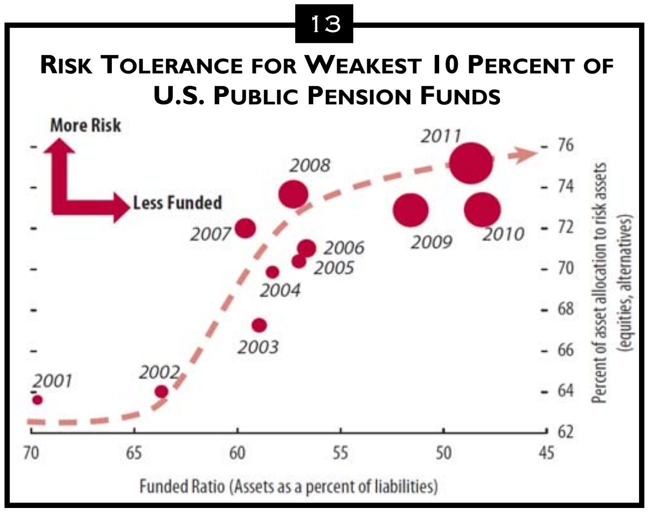
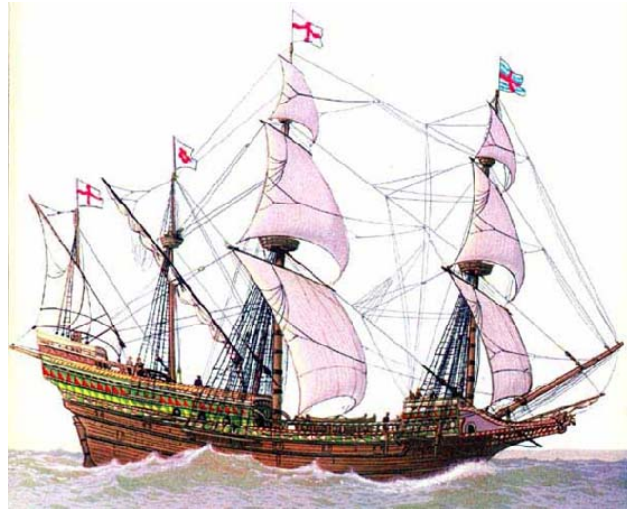


Sources: Boston College Center for Retirement Research; and IMF staff estimates.
Note: Size of bubble represents allocation to alternative investments; 2011 is 25.5 percent.

Second sons do not inherit the family wealth; they have to make their own way in the world. And so, John, the second son of William Hawkins, a wealthy merchant of the bustling port of Plymouth, took to the sea with his younger cousin and discovered the profits that could be made exchanging African slaves for New World sugar and hides.



He married well, the daughter of the treasurer of the Royal Navy. His father-in-law began supplying him with ships, and he led successful voyages in 1562 and again in 1564, capturing hundreds of slaves in West Africa and selling them in Cuba and Venezuela before returning to England with his bounty.

Portugal controlled West Africa and Spain ruled the New World, and English sea dogs were not welcome. Putting into the port of Veracruz, Mexico to ride out a storm in 1568, the English were attacked, and lost their ships and cargo. All but two were killed or captured , and it was a year before John Hawkins and his cousin, Francis Drake, arrived home in England.

With the consent of the Queen, Hawkins pretended to join the Navy of Philip II in return for a payment and the release of his shipmates. Taken into the confidence of the Spanish ambassador to England, Hawkins learned of the Ridolfi plot to overthrow Elizabeth, and was able to warn the government, thus saving the Queen. When Elizabeth sent Drake around the world to pillage Spanish cities, she appointed Hawkins to replace his father-in-law as treasurer of the Royal Navy, instructing him to build her a navy that could defeat Philip.

Naval strategy in the 16th century called for ships to fire a heavy volley at close range, ram and board the enemy ships, and fight hand-to-hand. Large ships, heavy guns and lots of men were the keys to victory. Hawkins knew he could never muster the fleet that Philip could, he would always be outnumbered. Instead, Hawkins imagined a different way of fighting that could counter Philip's advantage in size and number. He imagined a fast, maneuverable ship that could fire continuously from afar, destroying enemy vessels before they could board the English ships.

Hawkins re-designed the ship of the day by extending its length and reducing its breadth, lowering the forecastle and sterncastle, placing the main mast forward and using flatter sails. All of these design changes resulted in the fastest, sleekest ship the world had seen. And rather than mount heavy cannon along the sides, Hawkins chose to put smaller artillery pieces on wheels, thus being able to fire, wheel a new gun in while reloading the first one, and repeat as many times as necessary.

On 28 May 1588, 130 ships with 2,431 guns and 30,000 men left Lisbon for the invasion of England. The plan was for the fleet, led by the Duke of Medina Sidonia, to meet up with the land forces of the Duke of Parma near Dunkirk, cross the Channel and land in force near Kent.

Philip's Grand Strategy hinged on controlling the sea, to enable the Duke of Parma to join the fleet and cross the English Channel. As the Armada sailed into the Channel, nothing the English tried could slow the advance of

130 ships. On 3-4 August, a battle was fought off the Isle of Wight, with little effect on the Spanish fleet. The English withdrew.

Then, four days later, the great Armada passed by the coastal village of Gravelines, just 15 miles from its rendezvous with the Duke of Parma. The three English admirals—Francis Drake, John Hawkins and Martin Frobisher— chose this time and place for the decisive battle. They converged rapidly on the Spanish Armada with an artillery bombardment of a magnitude and duration that had never been seen before. Spanish guns were able to fire their first shot, but were unable to re-load amidst the constant shelling. The Royal Navy maneuvered up-wind to prevent the Spanish from closing, and English cannon was fired as quickly as one could be wheeled in while another was being re-loaded.

In the course of a single day, the largest naval force in history had been destroyed, England, and Elizabeth, had been saved. The day marked the apex of Spanish power, it would never recover, and the beginning of England's ascent as the dominant force in the world for the next 300 years.

The Spanish made many tactical and strategic mistakes, and English seamanship was of the highest caliber that day. But England was saved in the preceding years by the foresight of a pirate-turned-bureaucrat, who understood that England could win only by fighting on her own terms, and who designed a ship that would do just that.

The stakes for us may not be life-and-death as it was for the English that August day in 1588. But when the next crisis hits, and it surely will, success will be defined by who is prepared and ready. John Hawkins made sure that England was prepared, and at Gravelines, she was ready.

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

MICHAEL A. ROSEN
PRINCIPAL & CHIEF INVESTMENT OFFICER
APRIL 2013

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