Angeles INVESTMENT ADVISORS

Commentary
Fourth Quarter 2013

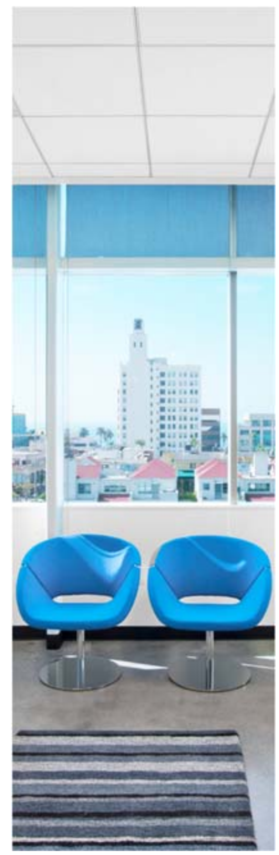
Weed[1]

Gardening goes back a long time in human history. Eden, after all, was a garden.[2] The Hanging Gardens of Babylon, thought to exist about 2,600 years ago, were one of the seven Wonders of the Ancient World.[3] There are depictions of gardens a thousand years earlier on Egyptian pottery, and it is safe to say that humans have been gardening shortly after we discovered agriculture.

Millions (billions?) enjoy gardening today, finding it relaxing, therapeutic, or just fun, but it is also hard work. Sure, sun and water are needed to varying degrees, but what will thrive and what will wilt depend on myriad factors, including the soil's depth, absorption and nutrient content. Today, all these elements can be measured precisely with tools readily available to every gardener. But for most of human existence, gardening was mostly through trial and error, and the secrets of success were passed down the generations. This was true across most trades, and it is no surprise, then, that families tended to specialize in particular crafts for generations.

Royalty, of course, could not be bothered to dig in the dirt, and so they hired help. In 1572, Charles IX, King of France, appointed Pierre Le Nôtre as head of the gardens at the Palais des Tuileries, the royal seat in Paris. In time, his son, Jean, succeeded him as head of the royal gardens, appointed by Charles' son, Louis XIII, thus establishing the Le Nôtres as the first family of gardening. When Jean's son, André, was born in 1613, it was assumed he would continue the family dynasty.

But André had different ideas. He spent his youth alongside his father in the gardens, but yearned to be an artist, and persuaded his father to apprentice him to the great painter Simon Vouet, whose studio was nearby at the Louvre. During his years with Vouet, André learned his art from the finest painters and architects in the world.



1 Now that I have your attention.

2 It is not clear if Adam and Eve had to tend the garden, or if its maintenance was included in the deal.

3 The Hanging Gardens, along with the Great Pyramid of Giza, the only surviving Wonder, were the only two non-Greek items. The original list was compiled by, naturally, Greeks. The other five Wonders: the Temple of Artemis, Statue of Zeus, Mausoleum at Halicarnassus, Colossus of Rhodes and the Lighthouse at Alexandria.

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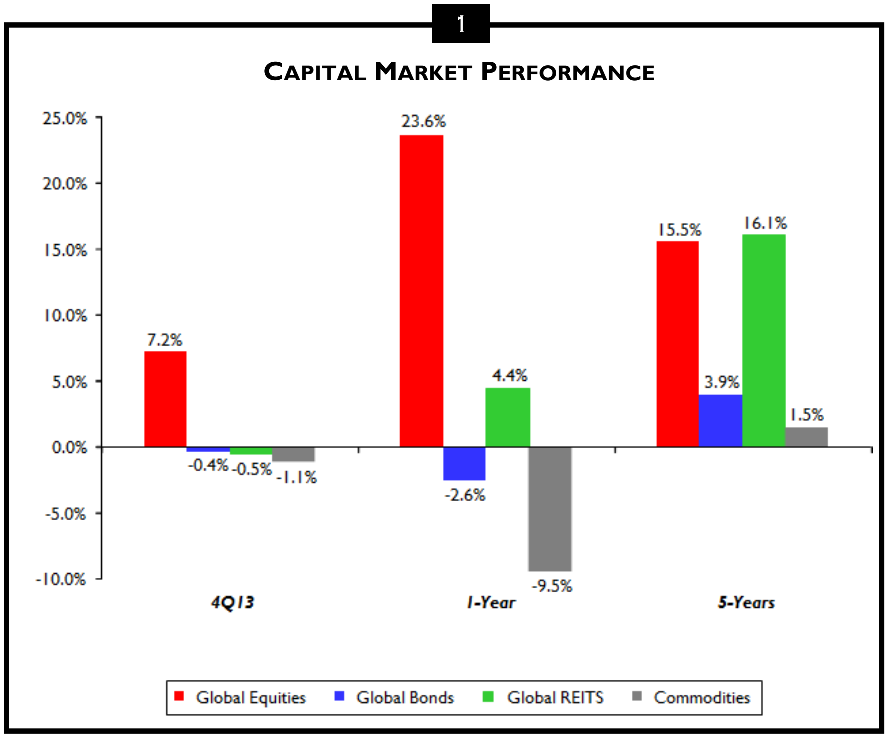
"Sunshine spread across most equity markets..."



In his early twenties, gardening (or maybe it was his father) called André back to the Tuileries. Shortly thereafter, the king's brother, Gaston, Duc d'Orléans, hired André to oversee the gardens at his residence, the Luxembourg Palace, and André created the justly acclaimed Luxembourg Gardens, splendid to this day. Two years later, his father retired, and King Louis appointed André as successor at the Tuileries, where he would spend the next 20 years, quietly, competently, as head of the royal gardens, as his father, and his father, had.

Gardeners generally toil in solitary contentment, if not obscurity, but André Le Nôtre was not destined for a humble life. Plucked from his daily routine to work on a new project, his design resulted in the downfall of the most powerful man in France, and then, remarkably, to the grandest project of all that would secure his fame as the greatest gardener in history.

Le Nôtre was, of course, more than a mere gardener: he was a visionary who, literally, shaped our world. That vision inspires us to contemplate our own environment, and gardening holds important lessons for investors, which we promise to cultivate in due time.

Sunshine spread across most equity markets in the final quarter of 2013. As usual, the US led the way with a 10% gain in the quarter, capping a stellar year, the best since 1997, adding nearly a third to its value. Europe and Japan were not far behind, each up almost 25% in the year.[4] Clouds covered the emerging markets, however, down 2% as a group, paced by Turkey, which lost 28% in 2013, half of which came in the fourth quarter. A deteriorating economy and political tensions are to blame. Faring nearly as badly were the Andean countries, which lost a quarter of their value last year on the back of plunging prices for its principal exports. Copper dropped 7% last year, aluminum fell 14% and gold and silver plummeted 28% and 36%, respectively. Some emerging equity markets did manage to break through the clouds for reasons that are nevertheless obscure: Argentina added 18% in the quarter and was up 64% for the year, and Bulgaria led all countries in the world by nearly doubling (+95%) in 2013.

[4] In USD terms; Japan gained 52% in Yen terms.

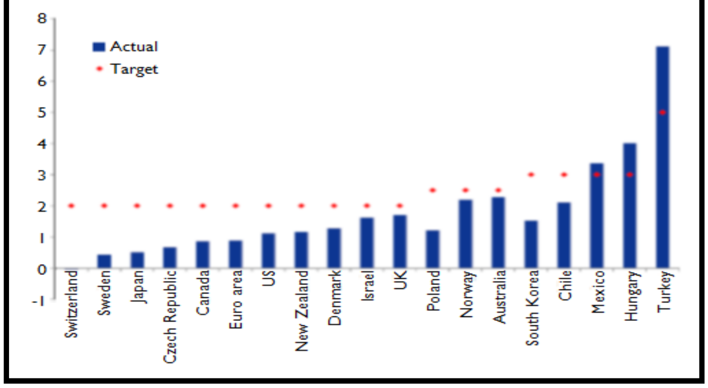
Clouds covered most other markets. We noted it was a tough year for commodities, although cocoa rose 20%, aided by a drought in Ghana and rather inelastic consumer demand.[5] But commodity prices are expected to be volatile. More surprising was the sharp decline in bond prices,[6] the worst since 1994. Normally, bonds lose value when inflation unexpectedly picks up, but that was not the case last year. In fact, inflation fell, and the worst performing sector of the bond market was inflation-protected securities (US TIPS lost almost 10%).

Inflation, or rather, its absence, is characteristic of the aftermath of disruptive, deleveraging events, such as the world experienced in 2008. Nearly every developed country is experiencing inflation below its preferred target (Chart 2). The debt implosion in 2008 led to a dramatic decline in demand, creating a huge output gap versus supply, forcing prices lower. The demand for cash rose, and has stayed elevated, even at zero yields, as households seek to delever. Corporations are also risk-averse, holding the highest level of cash balances in history, despite record profits (Chart 3).

Central banks responded to this unprecedented demand for cash by supplying it in virtually unlimited amounts. Rates were slashed to zero, and when even that did not diminish the demand for cash, "quantitative easing" was imple-

2

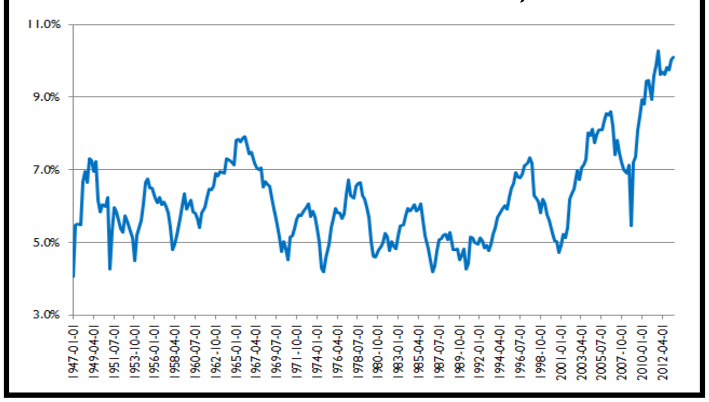
Core Inflation, Pct. Change, year ago



Source: OECD Graph Courtesy: Goldman Sachs

3

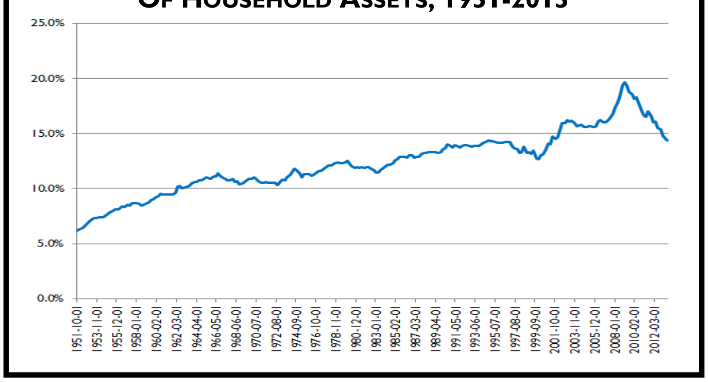
Corporate Profits as Pct. of GDP, 1947-2013



Source: Bureau of Economic Analysis

4

Household Liabilities as a Pct. of Household Assets, 1951-2013



Source: Federal Reserve System

"Clouds covered most other markets."

5 I confess my culpability.

6 Surprising to some, that is, as we noted a year ago (*Play Well,* January 2013) of the potential for negative returns in bonds.

mented to push even more reserves into the banking system. With households delevering, with banks delevering, with weak consumption demand limiting capital spending and hiring, these extraordinary monetary policies could be engaged without concern of stoking inflation.

That households and corporations remain highly risk-averse is abundantly clear. Households have shrunk their liabilities 25% over the past four years, the biggest deleveraging in over 70 years (Chart 4, page 3). Consumer delinquency rates are at record lows (Chart 5), and savings deposits have risen by $3 trillion over the past five years, even when earning zero yields (Chart 6).

"households and corporations remain highly risk-averse..."

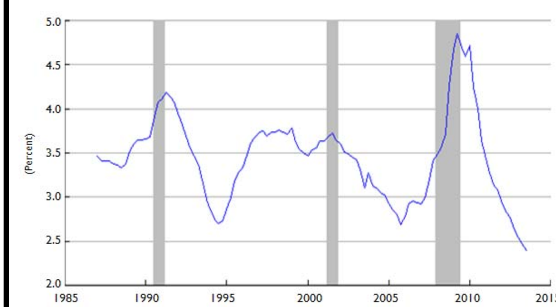
Despite record profits (Chart 3), capital spending is only about the same as in 2000, and private sector jobs are just 3% higher over the past 13 years (Chart 7).[7] Businesses have been very reluctant to invest and hire.

That households have retrenched is no surprise, given the over-indebtedness and subsequent significant loss of wealth they experienced. But corporate reluctance to invest in the wake of record profits is unusual. Businesses may lack confidence in consumer demand, but by most measures, the economy is picking up steam.

Consumer net worth is 10% higher than the pre-recession peak (Chart 8, page 5), retail sales and industrial production are also at record highs, and real GDP, the broadest measure of economic output, is $1 trillion greater than the previous (2007) peak. The current account deficit is just 2% of GDP, the best showing since the 1990s, as exports, led by petroleum and agricultural products, have soared 50% since 2009 (Chart 9, page 5).[8]

5

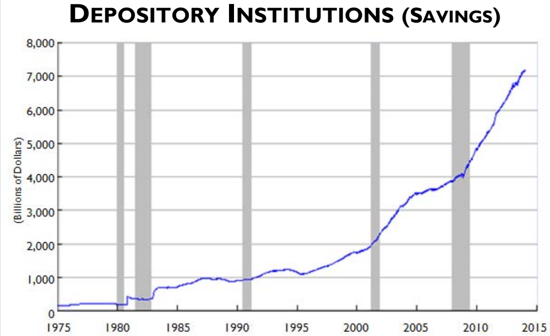
Delinquency Rate on Consumer Loans
All Commercial Banks (DRCLACBS)



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

6

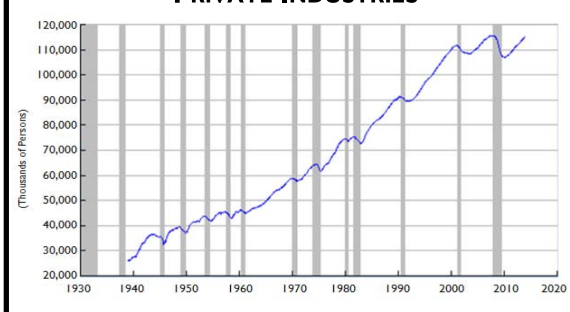
Total Savings Deposits at all Depository Institutions (Savings)



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

7

All Employees: Total Private Industries



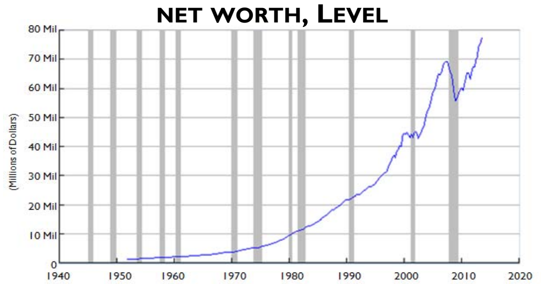
Source: US Department of Labor: Bureau of Labor Statistics
Shaded areas indicate US recessions. US research.stlouisfed.org

[7] 111,766,000 private sector workers in December 2000 versus 115,028,000 in December 2013, a 2.9% increase in 13 years.

[8] From $378.6 billion in 1Q 2009 to $568.5 billion in 3Q2013.

8

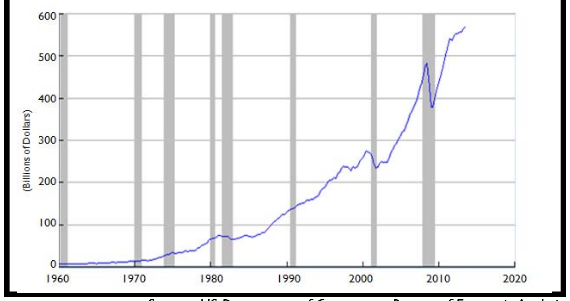
HOUSEHOLDS & NONPROFIT ORGS: NET WORTH, LEVEL



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

9

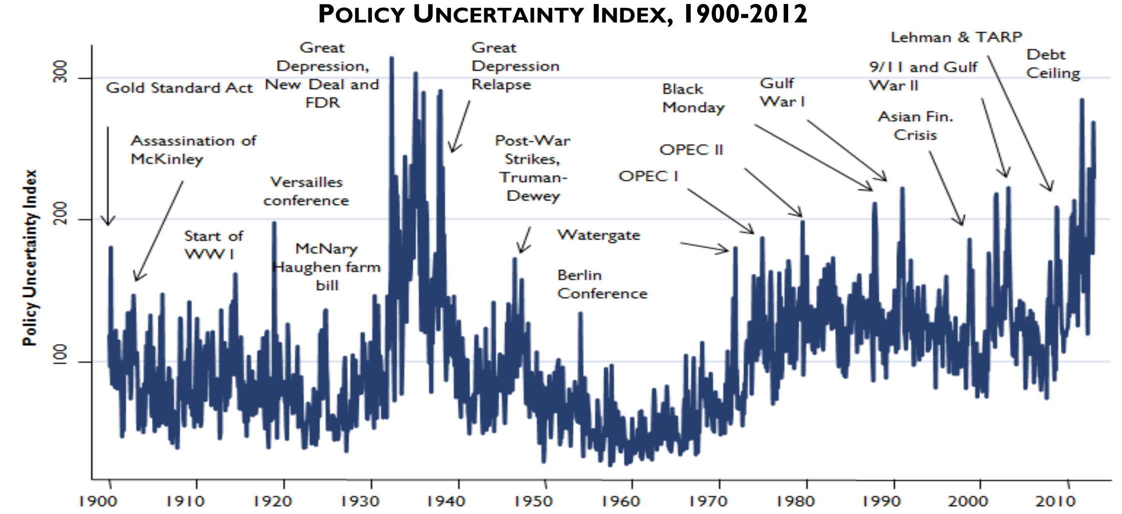
EXPORTS OF GOODS & SERVICES



Source: US Department of Commerce: Bureau of Economic Analysis
Shaded areas indicate US recessions. US research.stlouisfed.org

10

POLICY UNCERTAINTY INDEX, 1900-2012



Notes: Index of Policy-Related Economic Uncertainty composed of quarterly news articles containing uncertain or uncertainty, economic or economy, and policy relevant terms (scaled by the smoothed number of economicly article) in 6 newspapers (NYT, WP, BG, WSJ and CHT). Data normalized to 100

"The future is always uncertain, but it may be more so today..."

The future is always uncertain, but it may be more so today, and this uncertainty, especially about the future direction of government policies, may be weighing on investment. At a paper presented to the American Economic Association a few weeks ago[9], economists first tallied media references to economic or policy uncertainty over the past century and showed that uncertainty is higher now than at any time since the 1930s (Chart 10). They then established a high correlation between policy uncertainty and both government spending (Chart 11, page 6) and regulations (Chart 12, page 6), postulating that there might be a connection. In 2008, the Internal Revenue Service estimated that taxpayers spent more than six billion hours that year complying with the tax code, at a cost of hundreds of billions of dollars. These numbers exclude the costs of complying with the countless non-tax related laws and regulations.[10]

[9] Scott Baker (Stanford), Nicholas Bloom (Stanford), Brandice Canes-Wrone (Princeton), Steven Davis (Chicago) and Jonathan Rodden (Stanford), *Why Has U.S. Policy Uncertainty Risen Since 1960?*, January 2014.

[10] Actually, someone does count them. The number of regulations topped one million in 2010, and the print edition of the *Code of Federal* Regulations (yes, there is such a publication) runs 238 volumes. *The American Spectator* (5 June 2013) cites an estimated annual cost of compliance of $1.8 trillion, about half the federal budget.

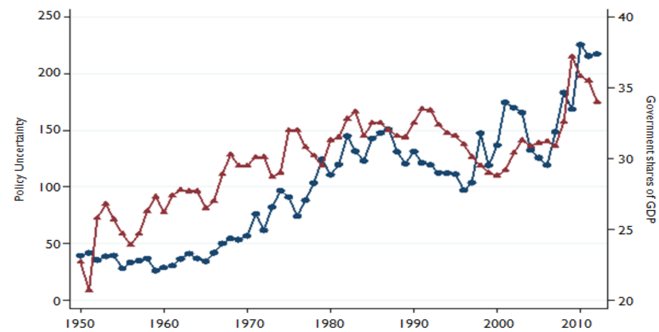
The growing complexity of laws and regulations favors entrenched interests, as complexity obscures the isolated beneficiaries and spreads the costs over many.[11] The sheer number and complexities of laws and regulations have thus become institutionalized. Undoubtedly, many policies and laws are necessary and desirable. And just because these data correlate with economic uncertainty, which may be impeding investment, does not establish causation. But it does seem reasonable to question the efficacy of ever more government spending and regulation without some sort of assessment of the value of the existing one million laws.

"Markets anticipate, more than they reflect."

Markets anticipate, more than they reflect. That is, markets anticipate future events rather than reflecting present (much less past) circumstances. As the legendary investor Benjamin Graham put it, the market is a voting machine in the short-term, a weighing machine in the long-term. The surge in equity prices last year correctly anticipated improving economic conditions as the year progressed. Stocks are volatile in the short-run, but Chart 13 shows that equities pretty accurately forecast the path of economic growth. Here we use a favorite, somewhat-obscure indicator of economic health, the amount of "stuff" (a technical term) moved around the country in trucks, as tallied by the American Trucking Association.

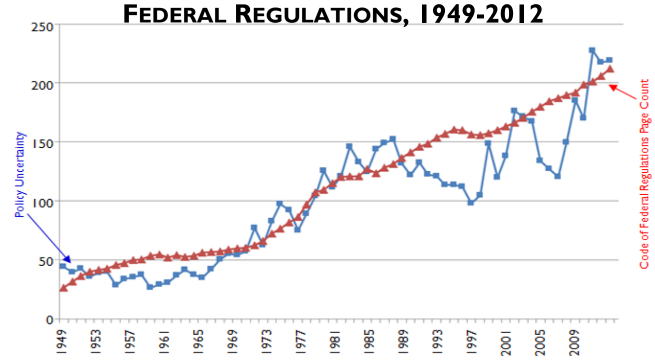
11

POLICY UNCERTAINTY & GOVERNMENT SPENDING 1950-212



12

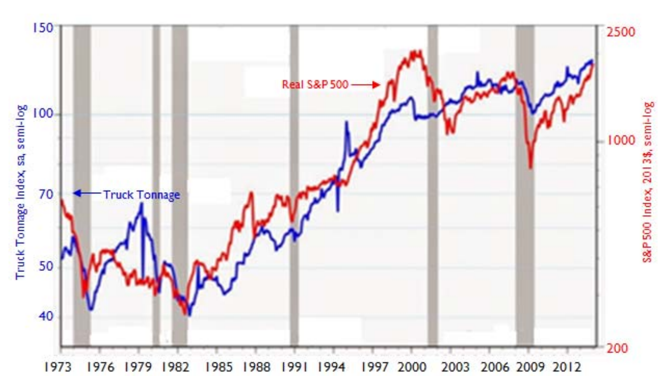
POLICY UNCERTAINTY & PAGES OF FEDERAL REGULATIONS, 1949-2012



Notes: Page counts from the *Code of Federal Regulations (CFR)*, which describes all Federal regulations in effect in a given year. CFR data from Dawson and Seater (2013), spliced to data from Crews (2013) for 2006 to 2012. The CFR and Policy Uncertainty series are scaled to 100 from 1949 to 2012.

13

TRUCK TONNAGE VS. REAL S&P 500

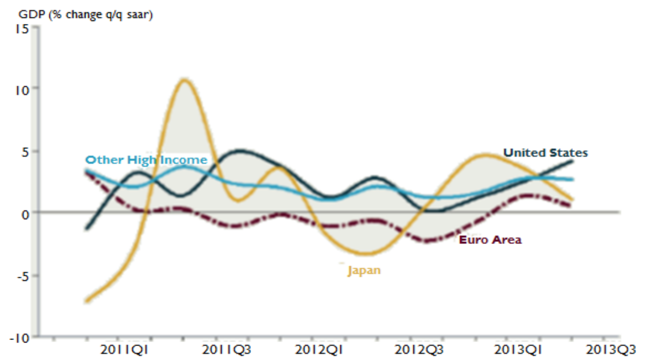


Source: American Trucking Assoc., Bloomberg, BLS scottgrannis.blogspot.com

[11] See Steven M. Teles, *Kludgeocracy in America*, National Affairs, Fall 2013

14

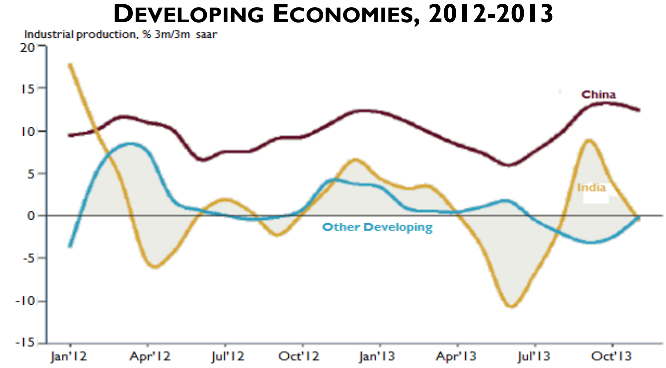
GDP CHANGE, DEVELOPED ECONOMIES, 2010-2013



Source: Bloomberg, World Bank

15

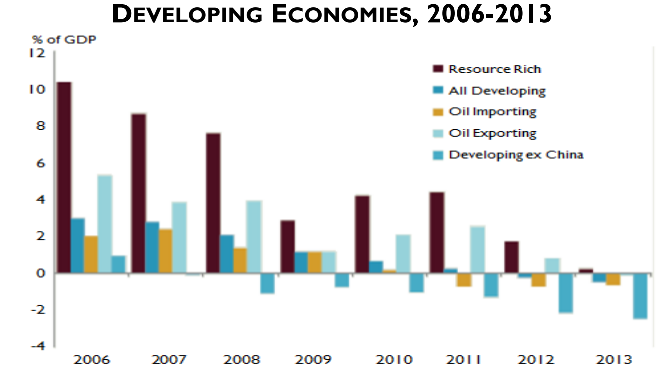
INDUSTRIAL PRODUCTION CHANGE DEVELOPING ECONOMIES, 2012-2013



Source: Thomson Datastream, World Bank

16

CURRENT ACCOUNT BALANCES DEVELOPING ECONOMIES, 2006-2013



Source: World Bank

The world economy is improving, forecast to grow at 3.2% in 2014, a marked gain from the 2.4% advance in 2013. In contrast with the previous decade, the developed economies are driving the acceleration in global growth. High-income countries (as the World Bank likes to call them) should see GDP growth nearly double from 1.3% in 2013 to 2.2% this year. Developing countries are also expected to see growth accelerate, from 4.8% to 5.3%.

These categories of developed and developing countries do not capture the full picture of the global economy. The engines of world growth are the United States and China, with the rest of the world contributing relatively little. The United States has seen 11 consecutive quarters of positive GDP growth, while Europe and Japan have seen little (Chart 14). The contrast is more striking among developing countries, with China far outpacing others (Chart 15). Industrial production among developing countries grew at a 13.8% annualized pace in the third quarter of 2013, but excluding China, growth was a meager 0.4%.

"The world economy is improving..."

Outside of China, emerging economies are under increasing strains. Fiscal deficits are significantly higher than they were just five years ago in about half of the countries, particularly among commodity producers. Monetary policies have generally been very loose, with rate cuts outnumbering hikes by nearly 5:1 over the past two years, leading to rising inflation. The twin stimuli of loose fiscal and monetary policies have boosted import demand, and with exports easing, current account balances have turned from surpluses of 3% of GDP on average to modest, but growing, deficits (Chart 16). For commodity exporters, the current account swing has been

more dramatic, as surpluses of 10% of GDP have vanished.

Loose fiscal and monetary policies have led to a surge in domestic credit formation (Chart 17). Outstanding credit exceeds 100% of GDP in 15 developing countries now.

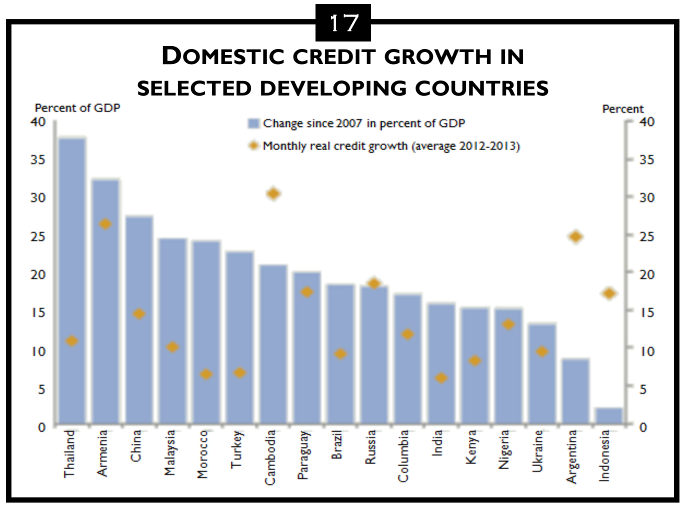
Prior to the 2008 financial crisis, emerging countries were running current account surpluses with low inflation, and were able to draw on their reserves to boost spending and avoid the economic calamity that swept through the developed world. Another financial crisis of that magnitude is certainly not expected, but with the current combination of fiscal and trade deficits, rising inflation and rapid credit growth, emerging economies are significantly more vulnerable to a rapid tightening of financial conditions.

"...while our economic environment is unusual, it is not unprecedented."

Euphoria among investors has been noticeably lacking these past few years, for many good reasons: twice this past decade equity wealth was slashed by half, the second time leading to the precipice of a full-scale, global economic collapse, generation-high unemployment and stagnant median wages for the better part of two decades, and let's add the bitter partisanship and astounding dysfunction of our political system. And yet, since 9 March 2009, 58 months, the US equity market has advanced 173%. We have a ways to go to match the greatest bull market of all time, the 582% gain over 150 months from December 1987 to March 2000, but the current advance is the fourth best of all time.[12]

This bull market may end the moment you read this, but it doesn't have to. Unique, exogenous events are always possible, but it is more likely that policy decisions will determine our economic course, and thus the path of capital markets.

We have written for the past five years that while our economic environment is unusual, it is not unprecedented. A debt-induced asset bubble was fostered and then imploded



Source: World Bank, IFS
Note: Real credit growth computed using official consumer price inflation data.

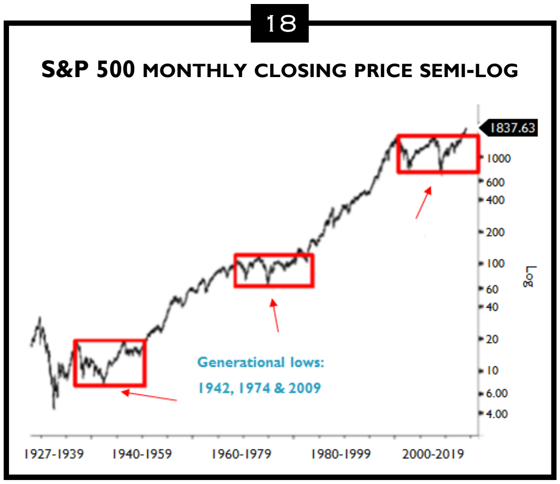
in a chaotic collapse, and our policy responses would determine how and when the economy would recover. The analogy to the 1930s is not perfect, but it is reasonably close to provide guidance.

A debt-fueled asset bubble collapsed beginning in 1929, and the fiscal and (more importantly) monetary response was a tightening in order to defend the dollar peg to gold. In March 1933, after a nearly 90% fall in the value of equities, the Federal Reserve severed the gold standard, and stocks soared 54% that year, the best calendar year performance in US history. Stocks continue to climb, up another 48% in 1934 and 34% in 1935. Inflation, which had been a negative 10% in 1931 and 1932, reached a positive 3% by 1935. Credit growth turned positive in 1934, and home prices rose 25% in both 1935 and 1936.

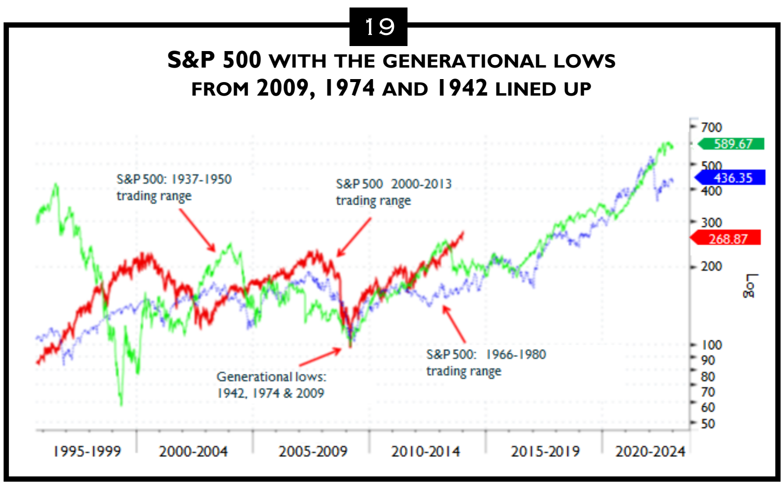
The loose monetary policy that fueled these gains produced a large increase in banks' excess reserves, and in 1935, staff members at the Fed produced a paper on how to reduce these balances. The Fed publically stated its concern about future inflation, but added that no action would be taken just

[12] In 2nd and 3rd places is the 267% gain over 87 months from June 1949 to August 1956 and the 229% rise in 61 months from August 1982 to August 1987.

yet. But starting in August 1936, and then again in March and May of 1937, the Fed doubled bank reserve requirements from 8% to 16%. Initially, the markets did not react: money continued to flow into the US from Europe as worries about a coming war sought a safe haven. At the second hike in March 1937, the markets reacted: yields rose and stocks fell 10% that month. The final reserve hike was approved two months later. Simultaneously, to combat rising fiscal deficits, Congress cut spending 10% in 1937, and another 10% in 1938, and raised taxes to fund the new Social Security program. This precipitous policy tightening sent the markets, and the economy, plunging. From March 1937 to March 1938, stocks fell 60%. The unemployment rate, which had fallen from 25% in 1933 to under 15% by 1937, rose to nearly 20% in 1938, and GDP dropped more than 6% that year.



Source: BofA, Merrill Lynch Global Research, Bloomberg



Source: BofA, Merrily Lynch Global Research, Bloomberg

"The details differ, but the parallels between then and now are evident..."

The details differ, but the parallels between then and now are evident: the loosening of monetary policy leading to a recovery in asset prices, rising concerns over future inflation and burgeoning excess reserves are common themes between then and today. Media pundits will work themselves (and some of their viewers) into a lather over Fed "tapering" or how "dovish" Janet Yellen will be compared with Ben Bernanke. It is far more likely that the Fed, conscious of the lessons of the 1930s, will be very measured in their policy shifts, both in magnitude and in time. Monetary policy will remain accommodative for the foreseeable future.

Generational lows in equities were seen in 1942, 1974 and, we believe, in 2009 (Chart 18). After new highs were achieved in 1951 and 1983, prices continued to advance to new highs for many years (Chart 19). We believe this great bull market in equities could have room to run, if history is a guide (and policy-makers don't screw-up—another technical term).

Nicolas Fouquet, protégé of the legendary Cardinal Mazarin and his successor as finance minister to Louis XIV, desired a chateau worthy of his stature. He purchased 1200 acres southeast of Paris and hired the prominent architect, Louis Le Vau to design a suitable palace. He also plucked André Le Nôtre from the Tuileries to design and build the most spectacular garden in France. Le Nôtre had carte blanche to create not only gardens, but the entire landscaping project. He experimented with perspective, creating a garden that appeared larger than it really was, adding peb-

ble alleys, statues, fountains, basins, and canals.

On a beautiful summer evening in August 1661, Fouquet was ready to unveil his chateau and grounds, Vaux-le-Vicomte, to the important people of France. He invited 1,000 to dinner and a play (a new work written for the occasion by Molière), and to stroll the grounds amid thousands of glittering lanterns. Among the guests was the Sun King himself.

"The extraordinary artistry and sheer virtuosity...

Dazzled by the opulence of Vaux-le-Vicomte, and enraged that it was more elegant than anything he possessed, Louis XIV had Fouquet arrested three weeks later on charges of embezzlement, and had all the furnishings of Vaux-le-Vicomte moved to his hunting lodge southwest of Paris. Fouquet, the most powerful man in France, had overplayed his hand. He would spend the rest of his life in prison.

The King's hunting lodge was a modest dwelling on 25 square miles of mostly swamp land. Once Fouquet was in prison, Louis tasked Le Vau and Le Nôtre with turning the lodge and the grounds into a residence worthy of the Sun King.

The challenges were immense. From an engineering perspective, swamps had to be drained, tons of earth removed and reshaped by manual labor. It was equally an artistic challenge, to create a coherent spatial composition over 2000 acres.

Le Nôtre applied the "tricks" he learned as a painter to alter perspective as one walked through the gardens. By varying the relationships among levels, heights and distances, at certain points, the garden's enormity appeared to be reduced, while at others, there was an illusion of infinite depth. The symmetry of principal walkways cut by secondary walking paths contrasted with the surprising placement of fountains and clipped yew hedges that were a topiarist's dream. Trellises and tree canopies emphasized perspective and played shadow and light against each other. Foretelling a Disneyland feature 300 years in the future, Le Nôtre channeled water from the Seine to create a Grand Canal, complete with mini-ships visitors could sail.

The extraordinary artistry and sheer virtuosity of Le Nôtre's gardens at Versailles remain one of the wonders of the world. They have influenced urban design—Pierre L'Enfant's schematic for Washington, DC, for example, is closely patterned after Versailles—and even modern art. Peter Walker, architect of New York's September 11th memorial, acknowledges that his waterfall design with a void representing the twin towers was copied from Le Nôtre.

Underneath (literally) Versailles (and every other garden), lie the basic principles of gardening. To live, plants need six nutrients. Carbon, hydrogen and oxygen are transmitted by air and water. Nitrogen, phosphorus and potassium are found in the soil, to varying degrees. As plants grow, they deplete these nutrients, which then must be replaced. Hence, it is appropriate, even necessary, to apply fertilizer to resupply lost nutrients. Too much fertilizer, however, can be harmful, for example, by promoting foliage growth at the cost of stunting the development of fruit or flowers.

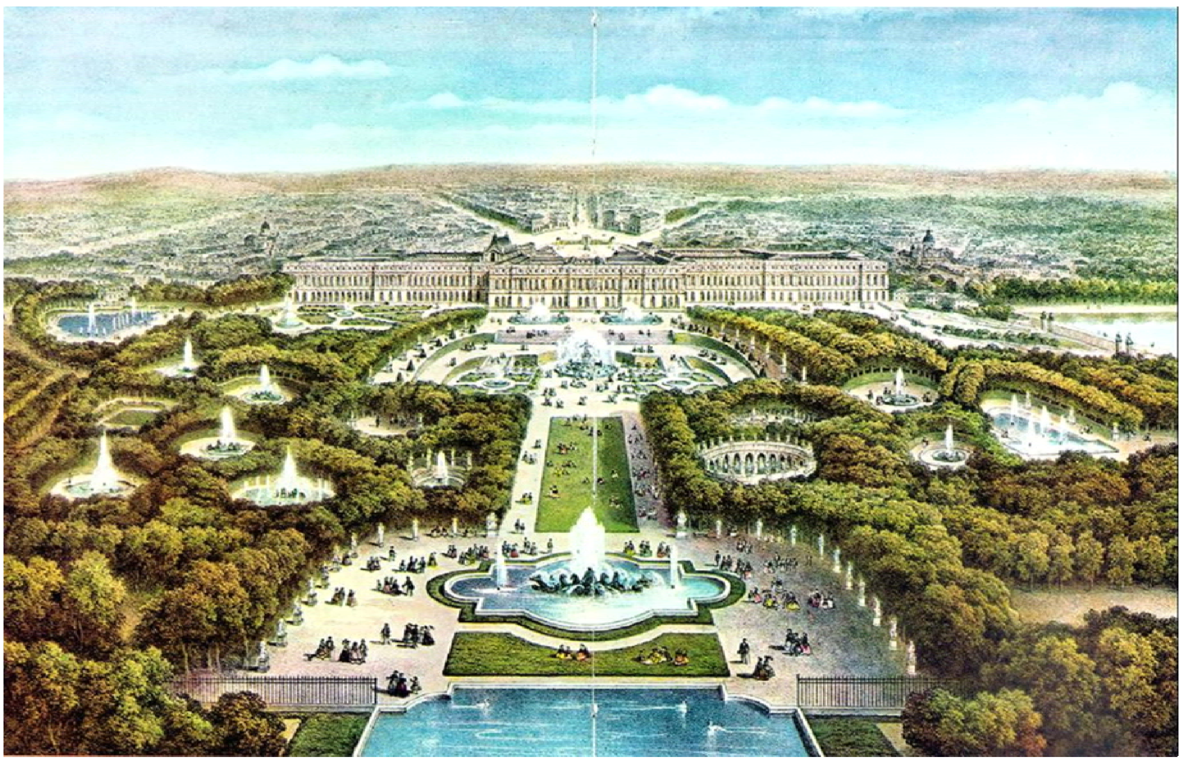
Additionally, gardeners must be vigilant in removing weeds. Left unchecked, weeds will absorb water and nutrients, block sunlight, and choke and kill the roots meant for other plants. Both fertilizer and weeding are necessary to ensure a healthy garden.

The global financial crisis in 2008 was akin to a severe drought. The correct response was showering the capital markets with ample liquidity and fertilizer. Five years later, though, we might be advised also to weed our gardens. For policymakers, this means expending some effort to cull the inefficient, inconsistent and overly complex laws and regulations that create policy uncertainty and impede our economic growth. For investors, remember both to harvest your

fruit as well as to eradicate the weeds growing in portfolios.

There will be growth in the spring, as the omniscient Chauncy Gardner promised,[13] but it would be stronger if we would weed our gardens. Our economies and portfolios would be healthier, and we might even aspire to the vision of André Le Nôtre.

[13] From the truly brilliant 1979 Hal Ashby movie, *Being There,* in which Peter Sellers plays Chauncy Gardner, a simpleton gardener, and powerful advisor to the President (Jack Warden). I couldn't help the reference.



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MICHAEL A. ROSEN
PRINCIPAL & CHIEF INVESTMENT OFFICER
JANUARY 2014