Angeles
INVESTMENT ADVISORS

Commentary
Second Quarter 2014

Dig

Whiskey has been an indelible part of Scotland's identity for centuries. Historically, consumption was tolerated by the Church of Scotland, but only in moderation and in accordance with Scripture. Whiskey's precise origins in Scotland are unknown, but the earliest written reference is found in Church records of 1655 when one Robert Haig was summoned to appear before Church officials for operating his still on the Sabbath.[1]

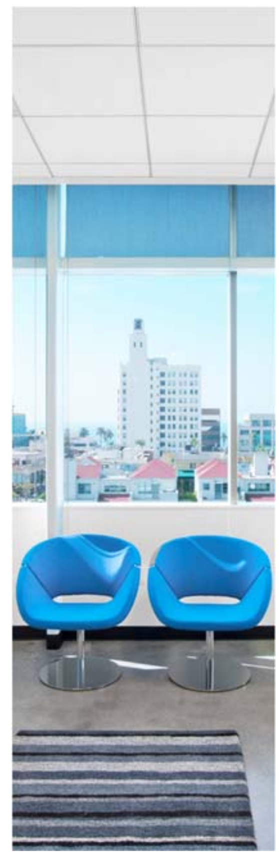
Two hundred years later, Robert's descendant, John Haig, was still operating the distillery, although by most accounts consumed himself a good portion of the production. The Haigs were not aristocracy, but the distillery made them reasonably wealthy, with a large house in Charlotte Square, Edinburgh. John and his wife, Rachel, had eleven children (eight survived), enough to ensure continuity of the family business.[2]

But not all the children had the desire to brew whiskey. A middle son, Douglas, became an expert horseman, and set his sights on a military career. He attended Oxford, where he distinguished himself exclusively on the polo field, and then entered the Royal Military Academy at Sandhurst where, again, his horsemanship stood out. After graduating, and before he took his first assignment in India, Douglas toured the United States with England's national polo team.

Lord Kitchener recalled Haig from India in 1898 to join the cavalry charge at Omdurman, the important English victory in Sudan that secured Egypt for British rule, and again a few years later against the Boers in South Africa. In 1909, Haig was put in charge of British forces in India, where he remained for the next five years until the world slid into the abyss of The Great War, and his role in history was cast.

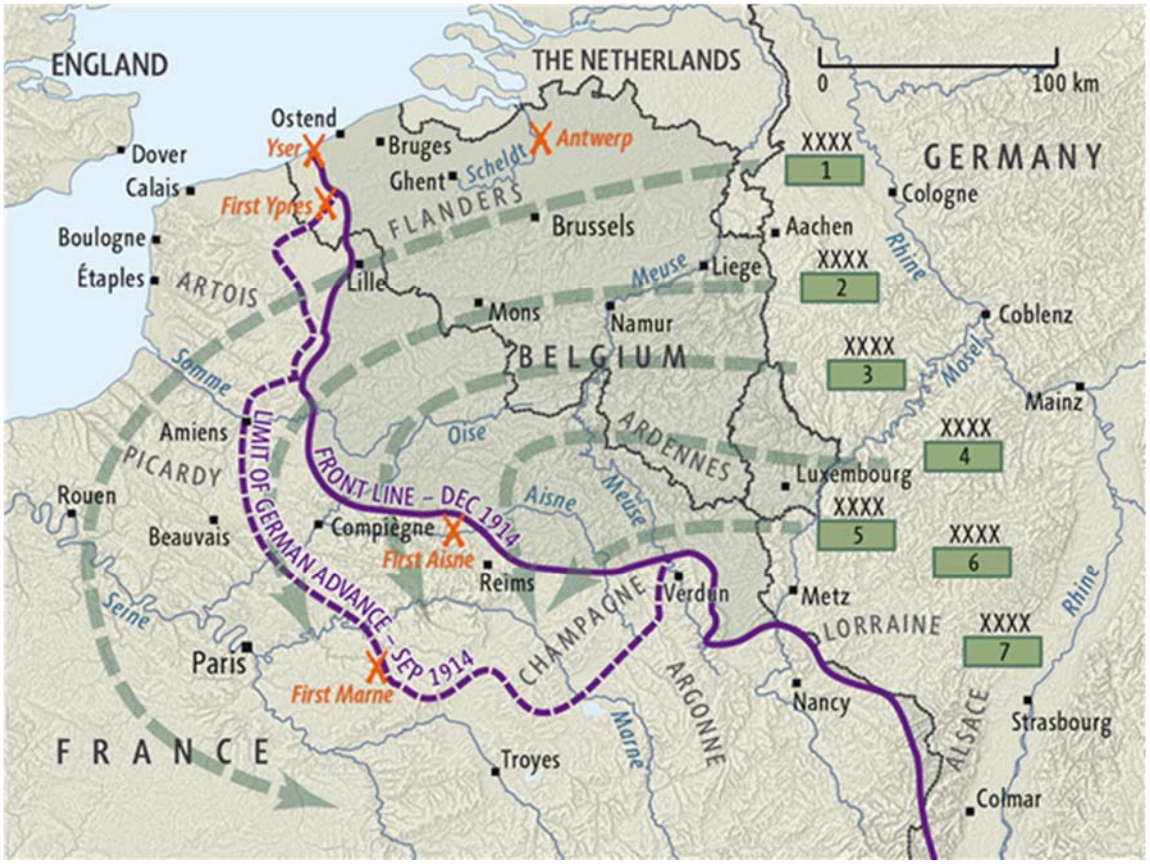
Exactly one hundred years ago, gunships of the Austro-Hungarian Empire cruised down the Danube to begin shelling Belgrade, capital of the rebel province of Serbia, thus initiating a world war. Haig returned from India to lead the 1st Army Corps under Sir John French, commander of the British Expeditionary Forces.

In 1905, Prussian Count Alfred von Schlieffen drew a plan of attack on the Western front that called for the capture of Paris from the north, via the neutral states of Luxembourg and Belgium. As the guns of August[3] roared across the Danube, the German army execut-



1 His guilt and punishment were either not recorded or did not survive.
2 Haig Whiskey is still produced today, promoted as Scotland's oldest distillery.
3 The title of historian Barbara Tuchman's seminal book on the war.

429 Santa Monica Blvd., Ste 650 • Santa Monica • California • 90401 • p (310) 393-6300 • f (310) 393-6200 • www.angelesadvisors.com



"...executed the Schlieffen Plan to near-perfection."

ed the Schlieffen Plan to near-perfection. Stubborn Belgian resistance slowed their advance, but within a month, the Kaiser's army was just 30 miles from Paris. The French government evacuated to Bordeaux.

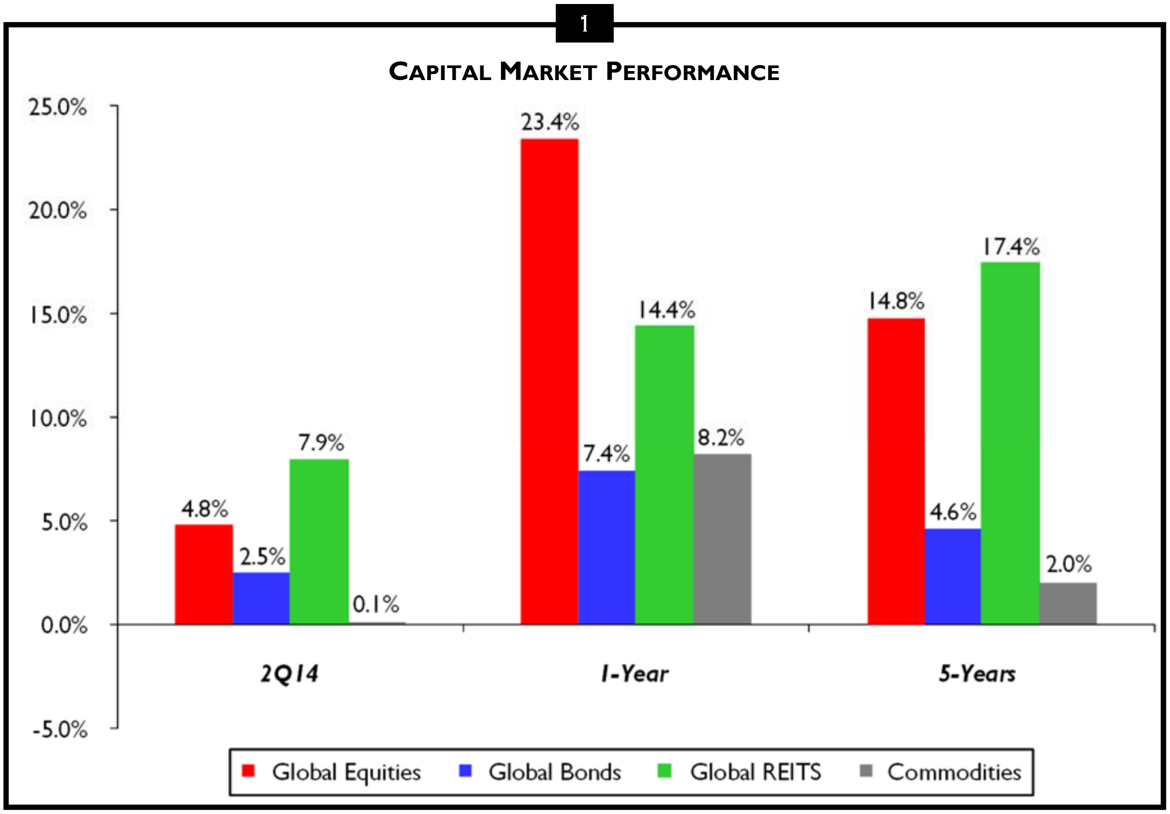
The First and Second Armies, forming the right wing of the German advance, planned to attack Paris from the west. But seeking to cut-off the retreating French army, the German right flank turned south-east, bypassing Paris to the north. The idea was to destroy the French army east of the capital, then turn back west to capture the city and end the war. The Germans failed at both goals. The maneuver east exposed the Germans to counter-attack from behind. Utilizing airplane reconnaissance for the first time in history, the French commander, Josef Joffre, spotted a gap between the German First and Second Armies along the Marne River, and on 5 September 1914 ordered the French and British forces to attack.

A fierce battle raged over the next few days, with more than one million troops on each side. In one of the more creative improvisations in military history, Joffre commandeered 600 Parisian taxicabs to bring 6,000 reservists to the front line in the early hours of the battle.

By 9 September, the German Army was in danger of being encircled and slaughtered. The German chief of staff, General Helmuth von Moltke (the Younger[4]), suffered a breakdown upon the news, and his replacement, Erich von Falkenhayn, ordered a retreat north across the Aisne River, where the Germans dug in. They pretty much stayed in that position for the next four years.

[4] To distinguish him from his uncle, Helmuth von Moltke (the Elder), a disciple of Clausewitz, and considered one of the great military strategists in history. His nephew, not so much.

1



"...conditions will get worse before they get more worse."

The Battle of the Marne saved the Allies from imminent defeat, turning an apparent German victory into the stalemate that was to characterize the war for the next four years. The battle also foretold the future of casualties, as each side suffered 250,000 dead or wounded over the course of just a few days.

By the end of the following year, the death toll and futility of the war caused Sir John French to suffer a breakdown. He was recalled to England, and succeeded by Douglas Haig as commander of the British Expeditionary Forces. Less than three years later, Haig would lead the Allies to victory, securing his place as one of Britain's greatest generals.

But was he? There is perhaps no more contentious debate in military history than Douglas Haig's rightful place as one of the great leaders of the British military, or as one of its most incompetent. We have an opinion which will be expressed in due course. Of course, there are investment lessons in the tale as well.

Capital markets advanced broadly in the second quarter of 2014, building on gains earlier in the year. The value of contrarian thinking was evident in the two best equity markets in the world last quarter, Ukraine and Argentina, up 26% and 17%, respectively. Worst, by far, was Ghana: with inflation running above 15% and a current account deficit of more than 10%, its currency (the cedi) has lost 15% of its value this year, and its stock market is down 20%. The country is unable to issue debt in the capital markets, and it seems likely that conditions will get worse before they get more worse.

News that the US economy shrank in the first quarter at an annual pace of 2.9% shocked investors. Most economists wrote it off to extremely bad weather,[5] and sure

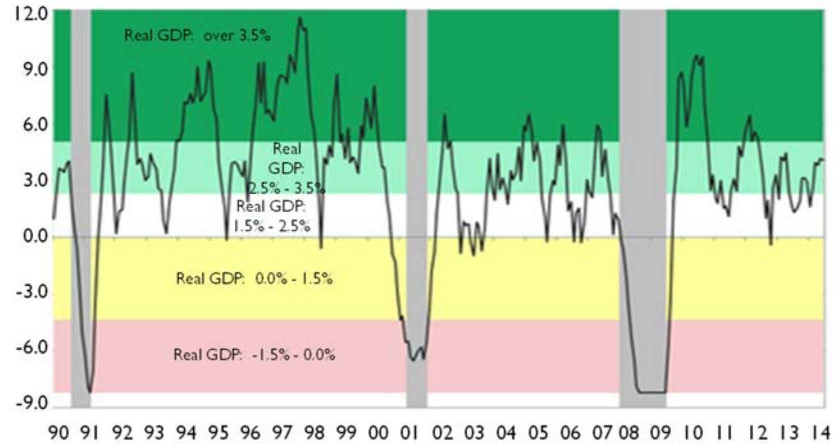
[5] Except in California; our problems are mostly man-made.

enough, the first quarter decline was revised higher and the second quarter roared back with 4% growth. Economists were right about the underlying strength of the economy, a rare correct call. Over the past year, Real GDP advanced 2.4% (4.1% in nominal terms), and most indicators point to stronger growth. Retail sales are 4.3% higher from a year ago, and automobile production, at 17 million new cars and trucks, is running at the fastest pace since 2006, up nearly 7% in the last twelve months. Industrial production rose at a 5.5% annualized pace in the second quarter, the best in almost four years. Taken together, underlying economic growth has accelerated from around 2.5% over the past few years, to closer to 3.5% now (Chart 2).

"...a rare correct call."

2

MANUFACTURING INDUSTRIAL PRODUCTION
6 MONTH PERCENT CHANGE; SAAR

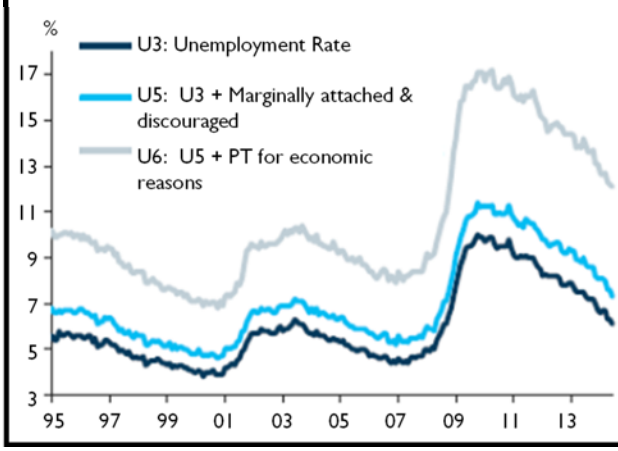


Note: Shaded regions consistent with noted 2 quarter real GDP growth. Growth rates have been truncated below at level consistent with –1.5% growth. Source: Federal Reserve, author's calculations though June 2014.

Employment growth has been especially robust. The private sector has added jobs for 52 consecutive months. More than 1.3 million new jobs were added in the past six months, the best first half of a year since 1998. A year ago, the unemployment rate stood at 7.5%. It has fallen to 6.1%, the biggest annual decline in 30 years.

3

UNEMPLOYMENT RATES



Source: BLS, Haver Analytics *Courtesy: Barclays Capital*

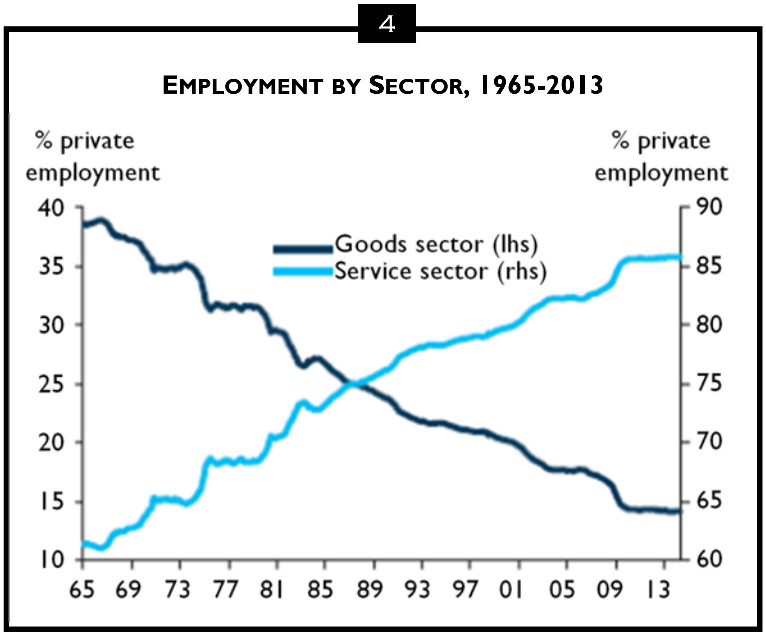
Recent employment gains are encouraging, but over the past few years a number of concerns have been raised about the condition of the labor market. One of the concerns we've discussed previously is the particularly high under-employment rate.[6] The traditional unemployment rate peaked at 10% in October 2009, below the December 1982 post-war high of 10.8%, but the broader measure, which includes discouraged and part-time workers looking for full-time work, rose to 17.2% in April 2010, well above any previous level. This measure has fallen to 12.1%, still an elevated level relative to history.

A closer look shows that the number of discouraged workers dropping out of the labor force is similar to previous cycles, but the number of part-time workers wanting full-time work was, and remains, unusually high (Chart 3). Why?

---

[6] The U-6 release from the Bureau of Labor Statistics.

4



Source: BLS, Haver Analytics — Courtesy: Barclays Capital

5

Notes: Real wages are in 2013 dollars. Fixed wages are what wages would have been in each year with education and age of the workforce fixed at their 1994 levels.
Source: U.S. Bureau of Labor Statistics, Current Population Survey, Outgoing Rotation Groups

The best explanation is the structural shift in the economy toward service jobs. Fifty years ago, 60% of jobs were in the service sector, 40% in goods industries. Today, services employ 85% of the labor force, with just 15% in the goods sector (Chart 4).[7] The average workweek in services is significantly shorter than in the goods sector,[8] and the number of part-time positions thus a lot higher. This structural shift in the economy toward the service sector suggests that the elevated number of part-time workers seeking full-time employment may remain high.[9] As we noted last quarter, there may be a lot less slack in the labor market than at first glance.

Two other controversies surrounding employment—the stagnation in real wages and rising wage inequality—are worth discussing as well. Wages represent 83% of household income, so they matter a lot for household spending and economic welfare. Over the past decade, real wages have grown just 1%,[10] and inequality has risen.[11] But the composition of the workforce has changed: older, and more educated, and this has important implications in this debate. Holding age and education steady at their 1994 levels, real wages would have declined by 5% over the past decade (Chart 5). Thus the stagnation in real wages is even worse than at first glance. There are numerous explanations for this, including globalization,[12] technology,[13] and slower overall economic growth, but whatever the causes, less-educated workers have been suffering with declining incomes for more than a decade.

"...structural shift in the economy toward service jobs.."

7 There's about 1.5% employed in agriculture, about 2.1 million people.

8 Approximately 32 hours in services versus 41 hours in goods.

9 The financial incentives of the Affordable Care Act are likely to encourage further part-time employment as employers with more than 50 employees will be required to pay for health care coverage for any employee working more than 30 hours per week.

10 Cumulatively, not annualized, from 2002-2013.

11 As measured by the Gini coefficient. The Gini coefficient ranges between 0 and 100, with a value of zero reflecting perfect equality and a value of 100 reflecting perfect inequality. A reading of 33, for example, means that if two people were drawn at random from the wage distribution, the expected difference in their wages is equal to 66 percent of the average wage in the distribution.

12 Which expands the labor pool, thus dampening wages.

13 Which enables more efficient production.

The rise of wage inequality is undisputed,[14] but an interesting aspect is how rising education levels have exacerbated this trend. The aging of the workforce has had little or no impact on rising inequality, but education has. Holding education levels constant with 1994 proportions shows only a very modest increase in inequality over the past decade (Chart 6). Higher educational achievement is not the only cause of rising inequality, and a better educated populace is certainly desirable. A less unequal economy may be a desirable social goal,[15] but it is a complex issue, and certainly goes well beyond the histrionics of "fair" tax rates. A better educated workforce benefits society in myriad ways, but it also is one of the contributors to wage inequality. The correct response, of course, is not a less educated workforce, it is better education for those in the lower socioeconomic tiers. The abysmal relative global ranking of primary and secondary education in the US is the root cause of stagnating wage growth and rising inequality.[16]

"...the root cause of stagnating wage growth and rising inequality."

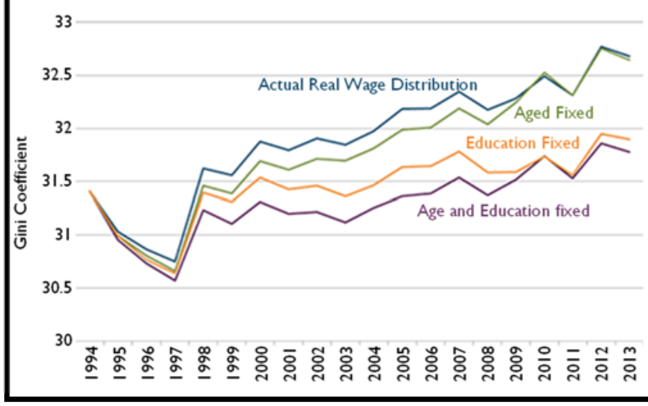
The structural shift in the economy toward service sector jobs helps to explain the rise in part-time workers, and disparity in education levels contribute to the stagnation of wages and higher wage inequality, adding complexity to all these issues. Equally complex, certainly connected and perhaps even more disconcerting, is the reduced dynamism of the economy, which can be seen in the lower levels of job creation and destruction and new business formation.[17]

New businesses account for 20% of total (gross) job creation in the US, and more than 50% coming out of recessions.[18] But the annual start-up rate fell from around 12% in the late 1980s to less than 8% following the recent recession. Nearly half of all businesses 25 years ago were young (less than five years old), versus only about one-third today.

The headline monthly employment number is reported net (i.e., a *net* 200,000 jobs were created last month), and masks the millions of

6

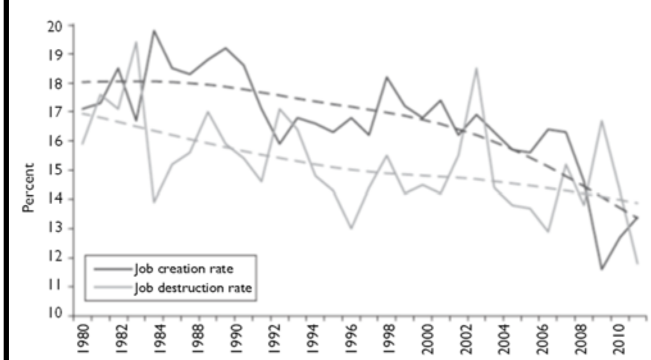
WAGE DISTRIBUTION GINI COEFFICIENTS OVER TIME



Notes: Real wages are in 2013 dollars. Fixed wages are what wages would have been in each year with education and age of the workforce fixed at their 1994 levels.
Source: U.S. Bureau of Labor Statistics, Current Population Survey, Outgoing Rotation Groups

7

US ANNUAL JOB CREATION & DESTRUCTION RATES
1980-2011



Source: Author calculations from the US Census Bureau's Business Dynamics Statistic.
Notes: The filter is Hodrick-Prescott with multiplier 400. The vertical axis does not begin at zero.

[14] It is important to note that inequality has risen in virtually every advanced economy.

[15] Or, it may not: a perfectly equal economy implies that everyone contributes precisely the same value, which is absurd. Therefore, a certain level of inequality is not only inevitable, but desirable, if it reflects the true contribution of each worker to the economy. I suspect this thought may provoke some reaction.

[16] It is ridiculous to rail against "unfair" taxes; there is no such thing as "fair" or "unfair." It is more expedient, unfortunately, for politicians to blame a group of citizens for the country's ills rather than accept that we are failing to educate adequately the majority of our children.

[17] *The Role of Entrepreneurship in US Job Creation and Economic Dynamism*, Ryan Decker, John Haltiwanger, Ron Jarmin, and Javier Miranda, *Journal of Economic Perspectives*—Volume 28, Number 3—Summer 2014.

[18] An exception was the 1991 recession, where start-ups accounted for more than 250% of new jobs, reflecting declines in employment at all other businesses.

jobs that were both created and eliminated each month. High levels of job creation and destruction speak to the dynamism of the employment market, and these numbers have been trending lower for decades, but there has been an especially swift decline in recent years (Chart 7, page 6).

The decline in entrepreneurial activity is found across all industrial sectors and in every state, suggesting that incentives for starting new businesses have diminished. New businesses play a critical role in the reallocation of resources from low productivity to high productivity, and there is evidence that new businesses are more innovative than existing firms, thus contributing disproportionally to economic growth and welfare. Addressing the (dis)incentives for entrepreneurship should be a priority.[19]

Multifactor productivity, measuring the output per unit of labor and capital, averaged around 2.3% annually for 60 years, 1947-2007. Since then, it has averaged less than 1%, and may now be close to zero. We have no doubt this is tied to the decline in new business formation, and the consequences for the economy are severe. The standard of living is determined by productivity, and the economy's potential is a function of labor force and productivity growth (Chart 8). The Census Bureau estimates labor growth at just 0.3% through 2030, far below the 1% of previous decades, as the population ages and immigration is expected to decline. If there is no increase in population or productivity, the economy will not grow. It would be a mistake to let

[19] Taxes, regulations, labor contracts are but a few of the barriers to entrepreneurship.

"The decline in entrepreneurial activity..."

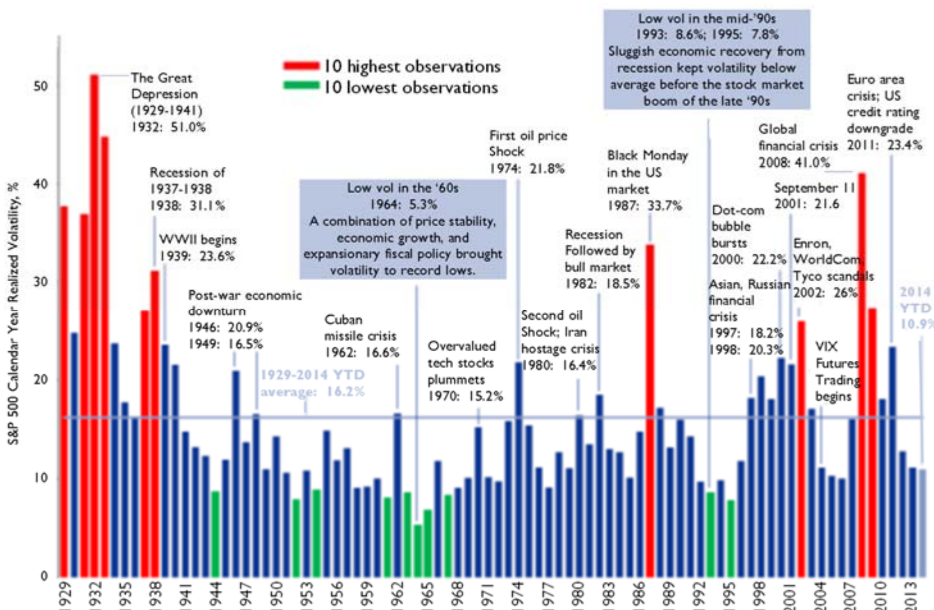
8

GROWTH OF LABOR FORCE & PRODUCTIVITY

Source: Bureau of Labor Statistics *Courtesy: The Economist.*

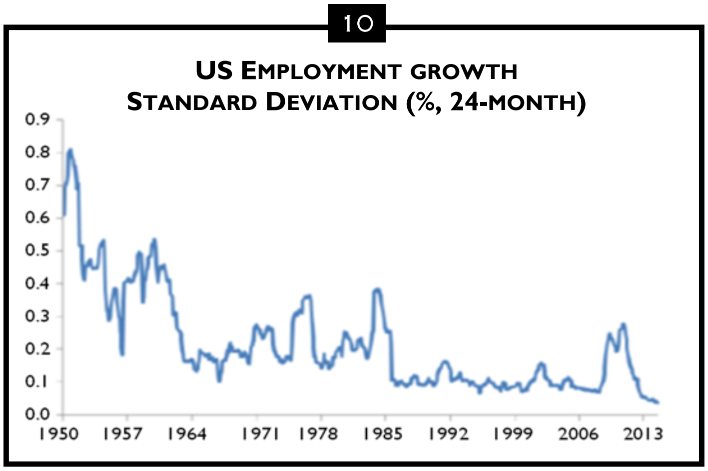
9

US EQUITY VOLATILITY, 1929-2013



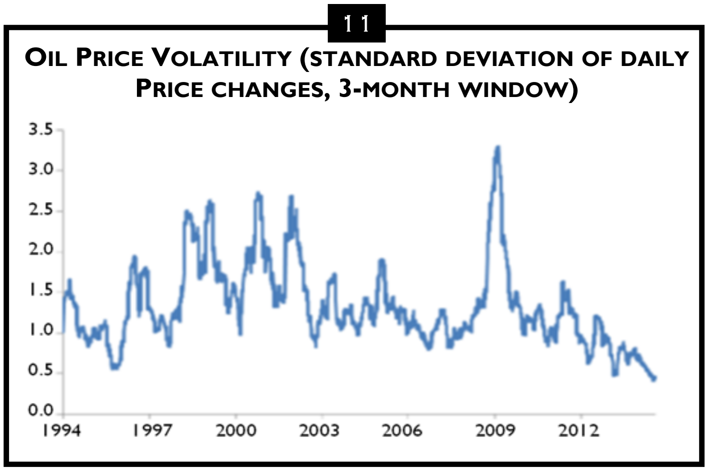
Source: Goldman Sachs Global Investment Research, various news sources.

10



Source: JPMSL, JPMAM; data through June 2014

11



Source: Bloomberg, JPMAM; data through July 28, 2014

"Volatility is indeed low, although not without precedence."

the cyclical acceleration in the economy, as welcomed as it is, divert our attention to the need to restore dynamism to the economy.

Volatility in the capital markets has been exceptionally low, raising fears that investors have become ignorant of the risks that threaten the economic recovery, or complacent in adding more risk to portfolios with less margin for safety.

Volatility is indeed low, although not without precedence (Chart 9, page 7). Low volatility in the capital markets mirrors the muted variation in macroeconomic data. Employment, for example, exhibits the lowest monthly volatility on record (Chart 10). Wars in Ukraine, Gaza, Syria, West Africa, confrontation in the South China Sea have all failed to jolt markets. Historically, geopolitical risks are transmitted to the global economy via oil prices, but, here too, prices have been remarkably calm, reflecting a much more efficient supply/demand equilibrium (Chart 11).

This moderation in macroeconomic volatility began more than a decade ago, interrupted by the financial crisis in 2008. There is some merit to the view that the financial crisis was a failure of regulatory oversight rather than a failure of monetary policy, and so this downward trend in volatility could persist.

The business cycle is also at a point where low volatility is expected. The global economy is neither in recession nor overheating, and monetary policy is providing ample liquidity. None of this analysis should be interpreted as there are no risks looming. As the economy gains traction, central banks will have to manage a transition from zero interest rates and quantitative easing to one that contains the risks of rising inflation yet does not choke off the recovery. That is a difficult balancing act, with considerable risks on all sides for investors. But the markets are aware of these risks, and have priced the forward volatility curve quite steeply, meaning volatility is already expected to rise, so there is little profit in forecasting a rise in volatility. Markets move when the *unexpected* occurs. For now, low volatility in the capital markets seems appropriate given the stability of macroeconomic data and our place in the sweet spot of the business cycle.

German victory was thwarted at the Marne, but the entire Western front soon coagulated into solidly entrenched positions. Frontal assaults, seeking to overwhelm the enemy position, became the favored strategy on both sides, resulting in enormous casualties with no strategic advantage.

In February 1916, the Germans attempted to capture the heights overlooking the town of Verdun, strategically located on the Meuse River close to the Belgian border. More than one million Germans crossed the west bank of the Meuse, but were repelled by more than one million French and British troops. Through July, the battle volleyed across the river, until both sides, exhausted, withdrew to their original positions. The only accomplishment was the nearly one million casualties between both armies.

Douglas Haig had taken command of the British Expeditionary Force in December 1915, and with the German failure to capture any advantage and suffer enormous casualties at Verdun, Haig was certain one massive push could topple the Germans and end the war. With French troops still occupied at Verdun, Haig was given charge of the offensive along the Somme River, northwest of Verdun. On 1 July 1916, Haig led the Anglo-French forces across the Somme near the town of Albert to meet the German Second Army. The Allies achieved some ground in the south, but in the north it was a disaster: 20,000 men were killed, another 40,000 wounded. The 60,000 casualties made it the single bloodiest day in British history. A few weeks later, Haig sent the newly arrived Australian forces south along the Somme to find and exploit any German weaknesses. Near Fromelles on 19 July, the Anglo-Australian army found themselves outnumbered 2:1, and took over 7,000 casualties, more than 5,500 Australian. This became the costliest day in Australia's history. Fighting continued along a 25 km front through November, when weather halted further operations. For his efforts, Haig had gained about 10 km of ground, at a cost of 620,000 Allied casualties (to 465,000 on the German side).

Haig continued his battle of attrition through the following year, most notably around the west Flanders town of Ypres, close to the French border. 250,000 British troops were killed or wounded to capture the town of Passchendaele. Prime Minister David Lloyd George wrote in his memoirs, "Passchendaele was indeed one of the greatest disasters of the war ... No soldier of any intelligence now defends this senseless campaign ..." But the Germans, too, were badly hurt, so much so that by the following year, 1918, Erich Ludendorff, chief of the German Army, concluded that Germany could not win a war of attrition, especially with the Americans about to join the Allies. Ludendorff planned a massive attack through Belgium to capture Paris and break the British and French armies. But to obscure his plan, he first ordered a large diversionary attack east of Reims, along the Marne River.

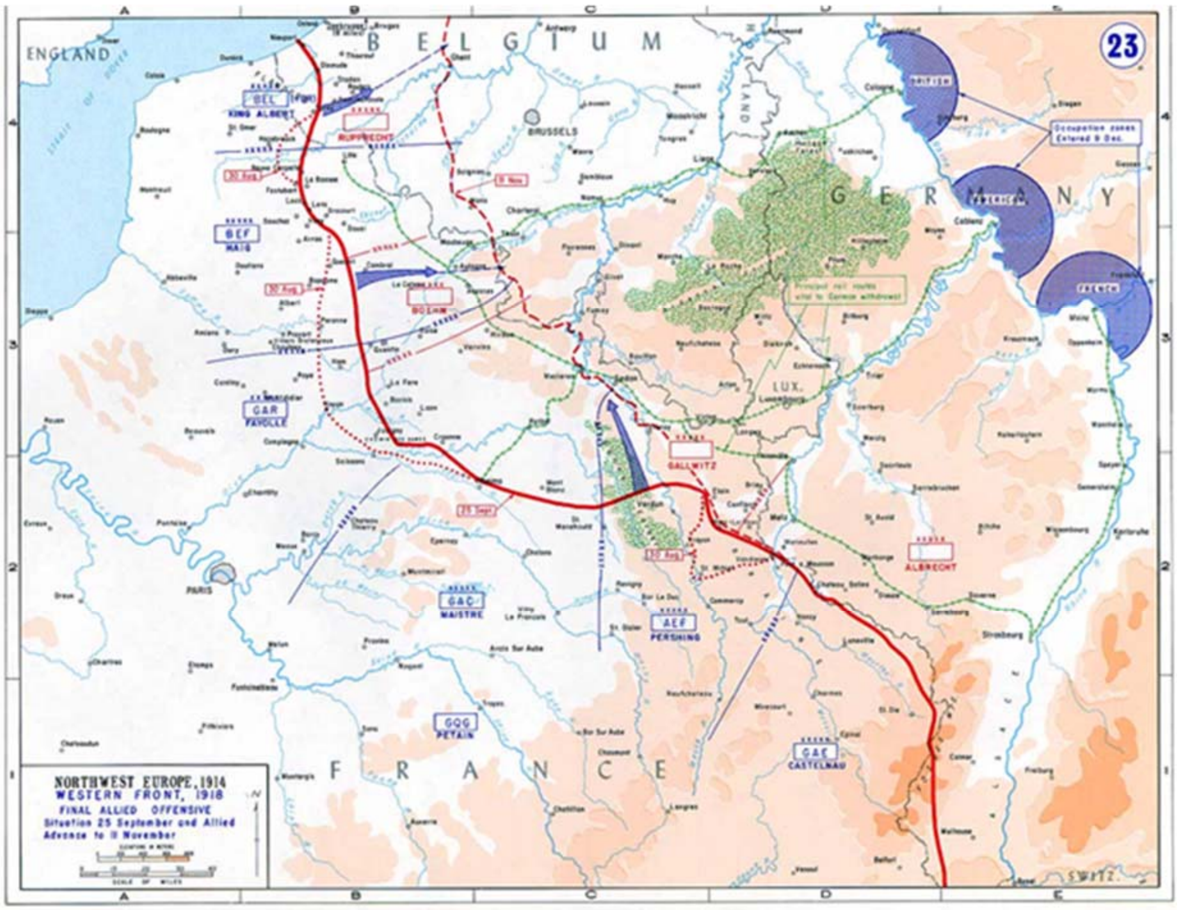
On 15 July, Ludendorff ordered the German attack, but it was quickly repulsed, and the next day, French Marshall Ferdinand Foch, chief of the Allied Forces, ordered a counterattack that over the next three weeks pushed the Germans back to the Aisne River. The First Battle of the Marne in 1914 saved the Allies from defeat, and this Second Battle broke the long stalemate in the Allies' favor. Bolstered by the arrival of General John J. Pershing and the American Expeditionary Force, Foch ordered an attack along the entire front, this time, a first in history, using tanks and airplanes as offensive weapons. In the next one hundred days, the Allies advanced the less than 100 km to the German border (Map, pg 10), where an armistice was signed on 11 November.

"...No soldier of any intelligence now defends this senseless campaign..."

Three years ago, the British National Army Museum held a poll of historians to name the greatest general in British history. The semifinalists were announced before a winner was chosen. The top five (in chronological order) were Oliver Cromwell, the Duke of Marlborough, the Duke of Wellington, Douglas Haig and Bill Slim.[20]

There is no quarrel with four of the five selections, but Douglas Haig is highly controversial. The arguments in his favor are two-fold: that he persevered through the darkest days of destruction, a period that literally broke the spirit of more than one leader; and, that he led

[20] The Duke of Wellington, conqueror of Napoleon at Waterloo, and Bill Slim, leader of the Burma campaign that defeated Japan in World War Two, tied for the top spot.



"The millions of casualties suffered under his command served no purpose."

his troops to ultimate victory.

On the other side of the ledger, Haig advanced no strategy except attrition, developed no tactics other than mass slaughter on both sides. The millions of casualties suffered under his command served no purpose. A desire for a decisive victory to break the stalemate was understandable, but he could think of no alternative to massive frontal assaults on entrenched positions that resulted in senseless slaughter time and again.

It may be human nature to seek an advantage, to abandon patience in challenging times until a better opportunity arises. The Allied offensive in the last 100 days brought the war to a successful conclusion because the Allies finally understood how to use technology to their advantage. Until the Second Battle of the Marne, tanks and airplanes provided support and reconnaissance, but in the summer of 1918, Foch used both offensively, and they were decisive in achieving victory. This lesson would be codified after the war by the great British strategist B. H. Liddell Hart and others. It proved its value in the opening battles of the next world war, as German tanks and airplanes led the swift advance through Poland, Belgium and France.

When conditions offer few opportunities, we may be tempted to take outsized risks to achieve our objectives. But prudence is in order. It is better to use this stalemate to dig in, but simultaneously, to plan strategically, address the long-term challenges, develop advantages, and wait for more opportune conditions. Douglas Haig failed in this regard, failure that was paid for in the blood of millions of young men.

Fortunately, our own actions will not have the same consequences as Haig's, but the path we choose does matter. We are in a generally benign economic environment, with both risks and prospective returns likely to be moderate. Near-term risks are building, but our greater challenges are strategic—education, economic dynamism. We ignore them at our peril.

MICHAEL A. ROSEN
PRINCIPAL & CHIEF INVESTMENT OFFICER
AUGUST 2014