Angeles
INVESTMENT ADVISORS

FOURTH QUARTER 2001 COMMENTARY **JANUARY 2002**

ODE TO JOY

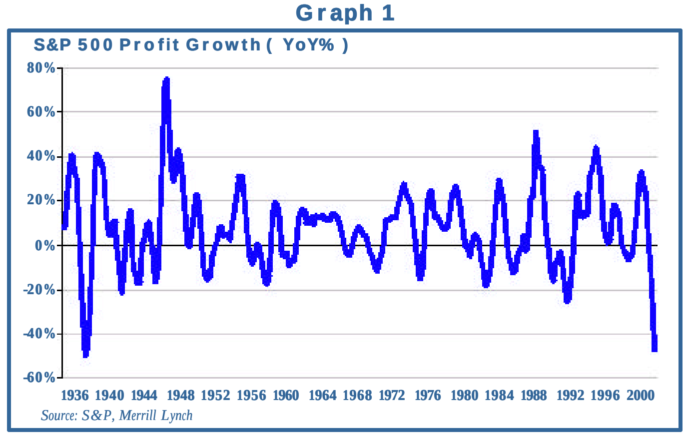
Beethoven's ninth, and final, symphony premiered in Vienna on 7 May 1824 with the composer himself presiding over the orchestra. Beethoven had no idea how the piece would be received since he knew he had broken all the rules about how symphonies were to be constructed. Prior to the Ninth, Beethoven was acknowledged as the expert in creating whole symphonies from just a few musical ideas. The Ninth was revolutionary for introducing multiple, conflicting themes, for interrupting the expected musical flow, and leaving the audience in suspense as to how it would all be resolved. This musical struggle starts with the first notes and continues to the very end.

Just as Beethoven borrowed from, and broke with, the past, we'll try in this letter to contrast our current markets with previous periods, and also to understand the limitations of those analogies. We are not composers, so we can't be certain as to where the music will take us. But we can observe the rhythms of the investment world, the movements and patterns that help define the context of our environment.

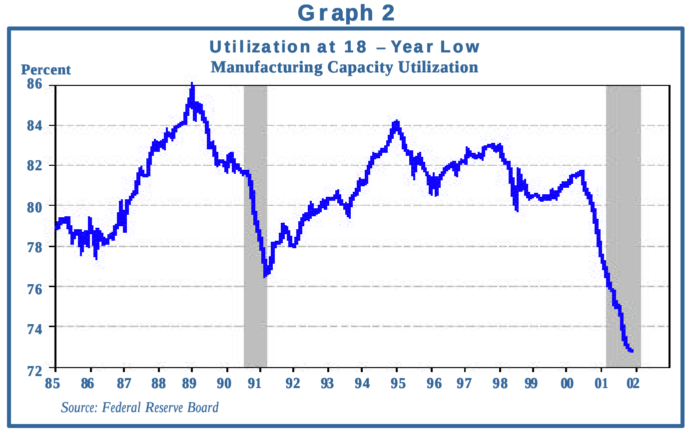
We do observe over long periods predominant investment themes that, when disrupted, result in a cauldron of uncertainty. Out of this cauldron will come a new thematic period that differs from the past. We think we are now at this disruptive stage, and while we certainly don't have all the answers, we will try to bring some perspective to these dynamics and their implications for investors.

The opening notes of the Ninth Symphony are, quite unexpectedly, ominous with harmonic instability, a good description of the start of the final quarter of 2001. The National Bureau of Economic Research (NBER) declared a recession had started in March, and the economic data certainly supported that. In 2001, corporate profits took their biggest tumble, year-over-year, since 1938 (graph 1). The result was that spending was slashed, industrial output plunged, plant capacity was idled (graph 2), and unemployment jumped (graph 3).

Graph 1

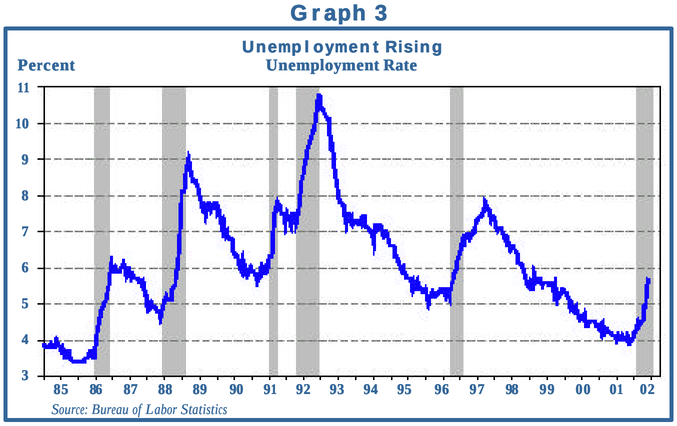


Graph 2



While there are similarities with past recessions, this economic downturn is of a fundamentally different character. All post-WW2 recessions were precipitated by rising inflation, which caused the Fed to tighten monetary

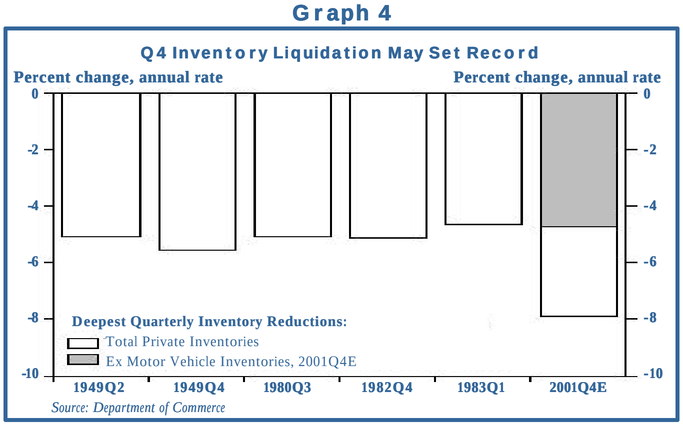
Graph 3



policy. This reduced demand, which required supply to contract through inventory adjustment. The eleven cuts in the Fed funds target last year, from 6.50% to 1.75%, and the moderate, and declining, rate of inflation indicate that the cause of the current recession differs from the typical inventory adjustment cycle. We have to reach back for parallels to the 19th and early 20th centuries when overinvestment, caused by low capital costs and/or speculation, precipitated economic downturns. That seems a closer explanation for the current cycle where a surge in capital spending in the late 1990s, especially in technology equipment, was supported by both low costs of capital (free for many internet start-ups) and speculation. Overinvestment does more than reduce profit margins; it destroys capital. Hence, the plunge in profits and the surge in accounting write-offs as companies seek to repair their balance sheets.

This repair process involves job cuts, capital spending cuts and inventory liquidation, all of which businesses are doing furiously. Graph 4 compares the inventory reduction in the fourth quarter with previous

Graph 4

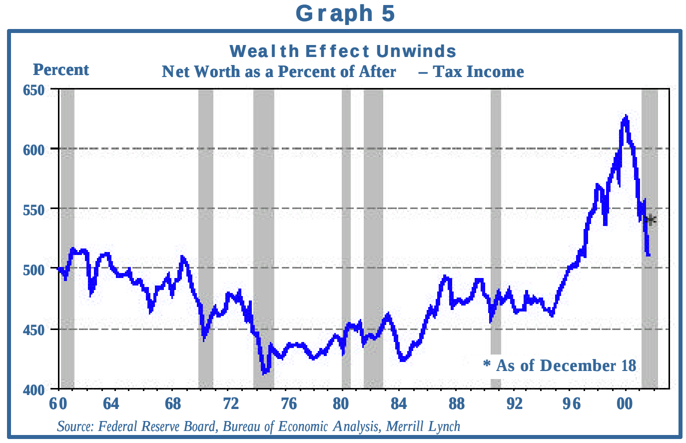


recessions, and this will certainly be a new record.

Businesses are doing the right things, but it will take more to spur economic recovery. Demand must rise, and there are two principal concerns we have about the vigor of the coming rebound: consumers and globalization.

Despite the 1.5 million job losses last year and the steep decline in net worth (graph 5), consumer spending has held up well. Last summer's tax rebates and the drop in oil prices added about $100 billion of economic stimulus (about 1% of GDP). Zero-percent financing accelerated auto purchases, but it may be that this has just borrowed from future growth. With a low savings rate and a lot of debt (graph 6), we wonder if consumers can continue to be a source of economic strength. But we may get lucky. If consumer spending

Graph 5

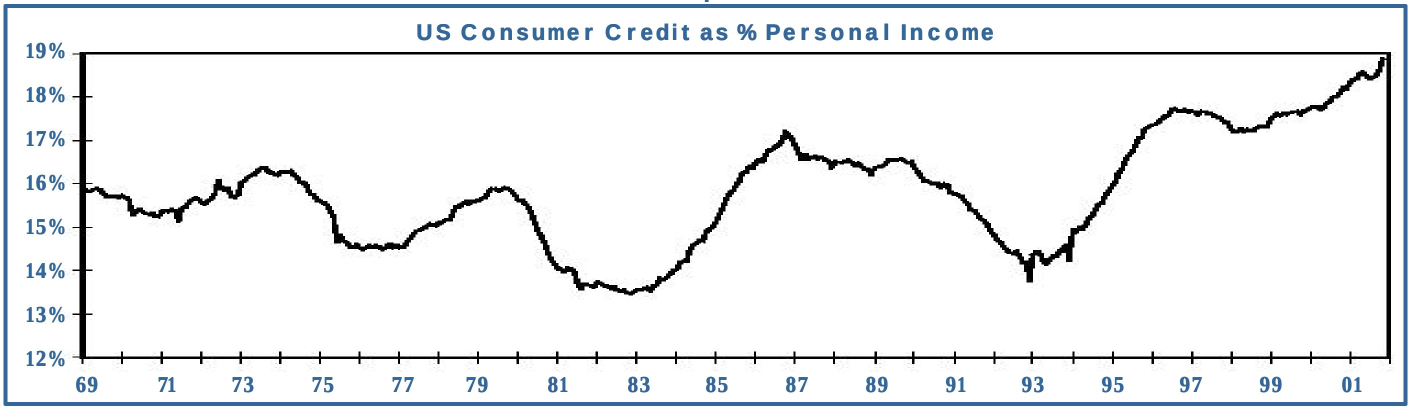


holds up and businesses restore profitability, job cuts will slow and personal income will rise, and the mild recession will give way to recovery.

The second economic concern is globalization. From 1994-2000, world trade expanded at twice the rate of GDP growth, and trade as a percentage of world GDP moved from 19% to 24% over the decade, higher even than when Britannia ruled the waves (and the trade routes) of the 19th century. A virtuous cycle ensued, as overseas investments helped companies improve profits and efficiency and spurred economic advancement by the foreign recipients of this investment.

In 2000, trade volumes grew a record 12.4%, but in 2001 growth came to a screeching halt. The consequence was a synchronous global recession, affecting every economy in the world. Europe is in a

Graph 6



recession that is likely to be deeper and longer than in the US, while Japan's problems appear nearly hopeless. East Asia is dependent on exports to the US, and not only has US demand dried up, China looms as a serious economic threat. The fallout from Argentina's default seems contained (Brazil might disagree), but the last time Argentina defaulted (1892), a global depression ensued.

The concern we have about globalization is that we need more of it, not less. Trade creates wealth for all partners, just as protectionism impoverishes all. The prospect of currency devaluations, trade disputes and populist protests must all be contained, countered and reversed.

In the near term, these headwinds will likely dampen our economic rebound. Businesses need to complete the cycle of reducing inventory, slashing capital spending and cutting jobs in order to restore profits. Only then will the economy grow. But it will have to grow without the help of exports or from consumers borrowing faster than their incomes rise, as was the case over the previous decade. And this will likely make the economic recovery, already beginning, less vigorous than we've seen in the past.

Audiences would expect a slow, relaxed second movement but, of course, Beethoven crosses them up by throwing thunderbolts from the timpani in the opening notes of that movement. The economy deteriorated into the fourth quarter, but stocks surged, with the riskier sectors of the markets leading the charge: small cap beat large cap, emerging markets trumped developed ones, and high yield outpaced all other bonds. Returns for the high-income asset classes of real estate and convertibles fell between stocks and bonds. The details can be seen in the accompanying table.

Table 1

Capital Market Returns

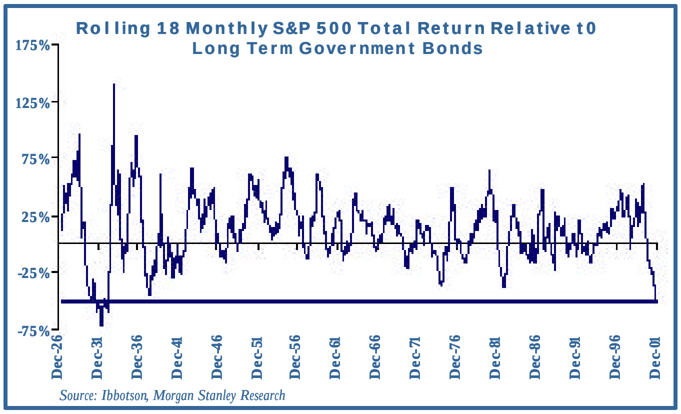
		Annualized	
	4Q01	1-Year	5-Year
US Stocks	11.8%	-11.5%	10.1%
Large Cap	11.1%	-12.5%	10.5%
Small Cap	21.1%	2.5%	7.5%
Int'l Stocks	7.0%	-21.4%	0.9%
Emerging	26.6%	-2.4%	-5.7%
US Bonds	0.1%	8.4%	7.4%
High Yield	5.8%	5.3%	3.1%
Int'l Bonds	-3.2%	-0.1%	2.2%
Real Estate	5.0%	13.9%	6.4%
Convertibles	7.0%	-4.4%	9.4%

Technology stocks were leaders in 2001, with the top two positive contributors to the S&P 500 Index: Microsoft (up 53%) and IBM (+43%).

Technology was also the biggest drag on the Index last year, as Cisco (-53%), EMC (-79%) and Oracle (-53%) were the three largest *negative* contributors to the S&P 500. All in all, technology saw its share of the S&P 500 Index fall from 21.4% to 17.6% over the year, with consumer discretionary seeing the biggest rise (10.3% to 13.1%) and financials becoming the single largest sector (17.8% of the Index).

Despite an impressive fourth quarter, 2001 marked the second consecutive annual decline in stock prices for the first time since the calamitous days of 1973-74, and for only the second time in 60 years. Bonds outperformed stocks by a magnitude not seen since the early 1930s (graph 7), but the contrarian in us thinks that's unlikely to continue.

Graph 7



The Ninth Symphony contains many musical themes, each one presented in multiple variation, and each one eventually fragmenting, to be resurrected in brief glimpses later in the work. Only one of these themes is carried throughout, often in disguise, a hint as to how the piece will end. When we look back over the past few decades, we, too, see many themes that, for a time, appear to be dominant over all others, whether it's the value of the dollar, trade and budget deficits, technological and political revolutions, and others. But over the long term, what matters most to investors is inflation.

Inflation (CPI) peaked in 1946 at 18.2%, following the end of price controls established during the war, and bottomed in the late 1960s. The next peak in inflation was in June 1980, at 13.6%, then falling to 1.6% by the end of 1998. The inflation cycle corresponds reasonably closely with three broad bull-bear-bull market cycles over this time (graph 8).

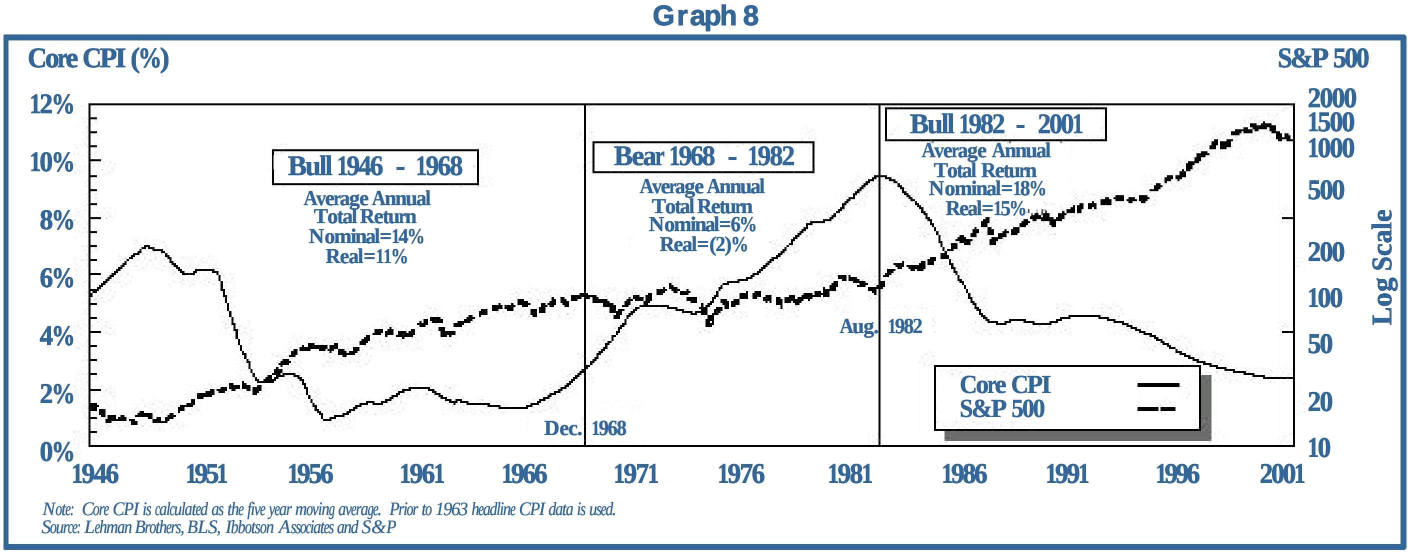
For bond investors, we really see two distinct periods, with September 1981 marking the turning point from bear to bull market (graph 9).

While inflation/disinflation has been a theme throughout this long period, in each decade we saw other dominant themes play out, changing when a recession interceded.

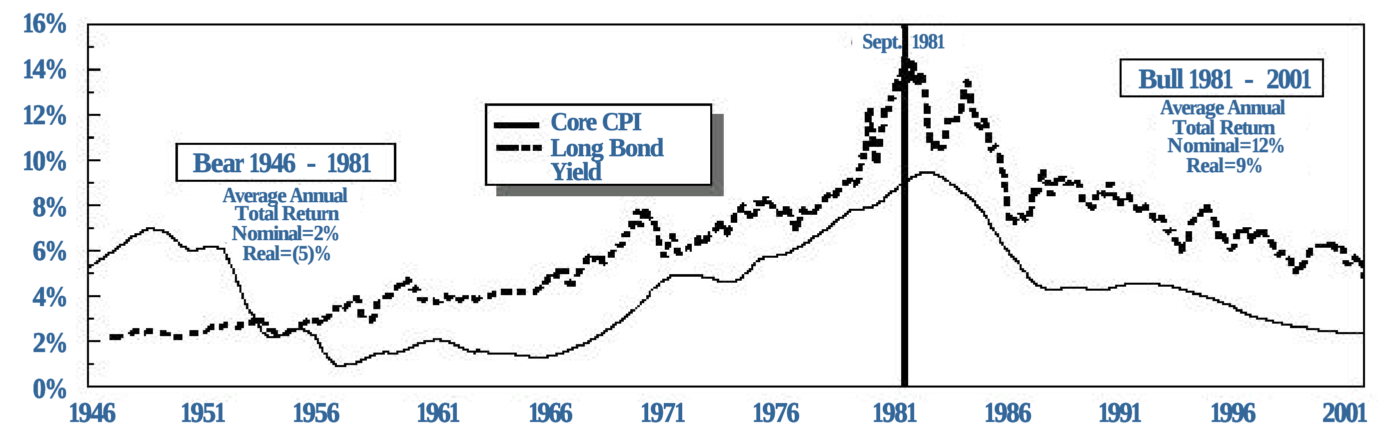
The US stock market peaked in 1968, and then deteriorated gradually over the next few years, even as a speculative frenzy drove up the prices of a select few (the "Nifty Fifty") "can't-miss" stocks (sound familiar?). Nearly two decades of strong economic growth came to an abrupt end in the very nasty recession of 1973-74. A series of colossal policy blunders marked the decade, from price controls to monetary whipsawing to government bailouts (Lockheed-1971, New York City-1975, Penn Central-1976, Chrysler-1979). Cash and hard assets were the places to hide in this decade. Bondholders were decimated with inflation. With nominal yields of 5% and inflation at 10%, bonds were known as certificates of confiscation. Stocks barely performed better.

The inflationary theme was disrupted by the brutal twin recessions of 1980-82 brought on by the new Fed chairman's attack on the monetary aggregates. Paul Volker's approach was exactly correct, but it was highly

Graph 8



Graph 9



Note: Long Bond Yield after 1/1/2000 based on Corporate yield less fixed spread of 140bps between Corporate and Treasury of 12/31/99. Core CPI is calculated as the five year moving average. Prior to 1963 headline CPI data is used.
Source: Lehman Brothers, BLS, FRB and Ibbotson Associates

controversial at the time, and it was uncertain as to whether he would be allowed to see his policy through. Coming out of this recession, truly a new paradigm emerged with the beginning of disinflation, the trend of a declining rate of inflation. Investors would have done well to move from cash and hard assets to long-term bonds and long-duration stocks like consumer staples and healthcare.

The disinflation trend continued into the 1990s, but the other big idea was the substitution of capital for labor as the cost of capital declined and productivity climbed. These themes favored financials and technology.

Over the past thirty years, inflation, first rising then falling, was a constant theme. But in the early 1970s, 80s, 90s and today, recessions marked the beginning of both a new decade and a new investment environment. The lessons we take are twofold. First, our view on the direction of inflation is very important and, secondly, the investment environment following recessions can be expected to favor very different asset classes than in the prior periods.

Let's tackle inflation first by assuming three possibilities: rising inflation, declining inflation, and steady inflation around today's level of about 2%. Let's also remember that inflation may be defined as too much money chasing too few goods. To the first scenario, rising inflation, we attach a small probability in the next year or so. True, monetary policy has been very accommodating, but with so much unused capacity around the world and inventories still to be reduced, it seems that we will likely see too many goods not too much money. For this reason, inflation typically falls in the early stages of economic recovery. That said, we reiterate our support for TIPS because we think the assumed inflation rate on ten-year TIPS of 1½% is too low and TIPS still provide good risk-adjusted returns.

As to the second scenario of declining inflation, we attach a small, but not insignificant probability. With inflation below 2% (and below 1% by the better deflator number), we are perilously close to deflation. Deflation is an entirely different phenomenon than just very low inflation; it is highly destructive of economies (as the world learned in the 1930s). Should protectionism and currency devaluation become common policies, the risks of deflation will rise. For now, we think it unlikely, but a little too much of a possibility for comfort. The third scenario, steady, moderate inflation, we think looks most likely in the near future.

These three scenarios have very different implications for investors. In a period of rising inflation, cash and TIPS and hard assets such as real estate should perform best. In a deflationary world, high quality fixed income looks most attractive. In a low inflation environment, we can expect good real returns from stocks, although with nominal returns that are likely to appear disappointing.

We can try to put numbers around this scenario for expected asset class returns. We start with an inflation estimate and assume cash returns will be a little higher than inflation, as it has over the past century. We also assume that bond returns will equal the current yield, plus or minus any directional move. For expected stock returns, we assume that the price appreciation for stocks approximates the growth rate in earnings. Add the dividend yield to get total return for stocks.

The next table puts it all together using round numbers and one possible set of assumptions that includes an agnostic view on the direction of interest rates and the P/E multiple in the market.

Table 2

Inflation Assumption	**2.0%**
Cash Return=(Inflation + a premium)	**3.0%**
Bond Yields	**5.5%**
Bond Returns=(Yield=/- rates falling/rising)	**5.5%**
Dividend Yield	**1.5%**
Earnings Growth	**7.0%**
Stock Return=(dividend yield + earnings growth +/- multiple expansion/contraction)	**8.5%**

You can plug in your own assumptions and come up with different expected returns, but the formula can't really be changed. In this environment of low inflation and low nominal returns, investors will be challenged to achieve their investment hurdles. For example, a 70/30 mix of stocks and bonds yields a return of 8.1%, below the actuarial assumed return for most pension funds and just a little ahead of the typical foundation spending requirement of inflation plus 5% plus growth of corpus. We think diversification becomes ever more important for investors as no single asset class is likely to dominate, and we believe that assets that generate returns from cash flows rather than from price appreciation (convertibles, real estate, high yield), are likely to perform well.

Not till the final coda of the final movement did Beethoven tie the disparate themes of the Ninth Symphony together: joy and awe, celebration and worship, faith and hope. Joy (*freude*) was the triumphant theme in the end, as Schiller's words close the piece:

Do you sense a Creator, world?
Seek Him beyond the canopy of stars!
Beyond the stars He must live.

Beethoven had no idea how the audience would react to such a radical departure from tradition. But he was also completely deaf. It was only when a choir member turned him around that he could see the audience's thunderous applause for his magnificent work. We know the coming investment environment will both draw on and be different from the past. We also know that predominant themes will become apparent. Of course, we won't really know how it all turns out until we turn around.

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