Angeles
INVESTMENT ADVISORS

SECOND QUARTER 2003

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Cubism

In a small town near Málaga, Spain in 1884, a three-year old boy began scribbling. These were lines and shapes and spirals, and no one, even his proud father, a respected artist himself, believed the boy had much talent. As he entered his teenage years, the family moved to Barcelona, and the boy continued his scribbling. The center of the art world then was Paris, Barcelona being a small, provincial outpost, and the teenage boy would make frequent trips over the next few years, invigorated by the excitement of *fin d'siècle* Paris.

The prevalent style in art at the time was Impressionism, which had dominated the art world for the previous few decades, but by the turn of the century, there were glimpses of something new afoot. Henri Rousseau had introduced a primitive, flat style, so unlike the Impressionists, and Henri Matisse was mixing dissonant colors that disturbed more than excited the public. Their style was thought to be so wild that it was called *Fauvism* or *wild beast*. Even the great Impressionist, Paul Cézanne, in the last years of his life, experimented by adding shapes—cylinders, spheres, cones—to his work. Our young, aspiring Spanish painter was influenced by these trends, and in the early years of the 20th century his first public efforts were met with acceptance but hardly acclaim.

The painting at the top is *Les Demoiselles D'Avignon*. It was painted in 1907, and it is the most important artwork of the 20th century. When completed, Pablo Picasso was so afraid of it that he showed it only to a few, close friends. Even his closest friend and artistic comrade, Georges Braque, said Picasso must have been "drinking turpentine and spitting fire" when he painted it. It was not shown in public for ten years.

Les Demoiselles D'Avignon marks a radical break from the tradition of portraying objects as they are and in their context, and no painting signaled a faster change in the history of art. If Picasso

INSIDE GRAPHS:

ANGELES NEWS

We would like to welcome aboard:

Andrew E. Rasmusen
our new
Senior Consultant

&

Ramon R. Gonzalez
our new
Investment Analyst

had only altered the subjects of the painting, in this case five prostitutes, he would have made an important contribution to art. The women are composed of flat, splintered planes, and their eyes are asymmetrical with expressions that may be, alternatively, interrogatory, indifferent or remote. But Picasso also altered (distorted) empty space, which normally recedes, but instead comes forward like jagged shards of broken glass. In doing so, Picasso challenged the assumptions of what is solid and what is void, what is opaque and what is transparent.

> "But this notion of *challenging the compositional possibilities of everything* does seem to have some applicability and merit to our world of investing."

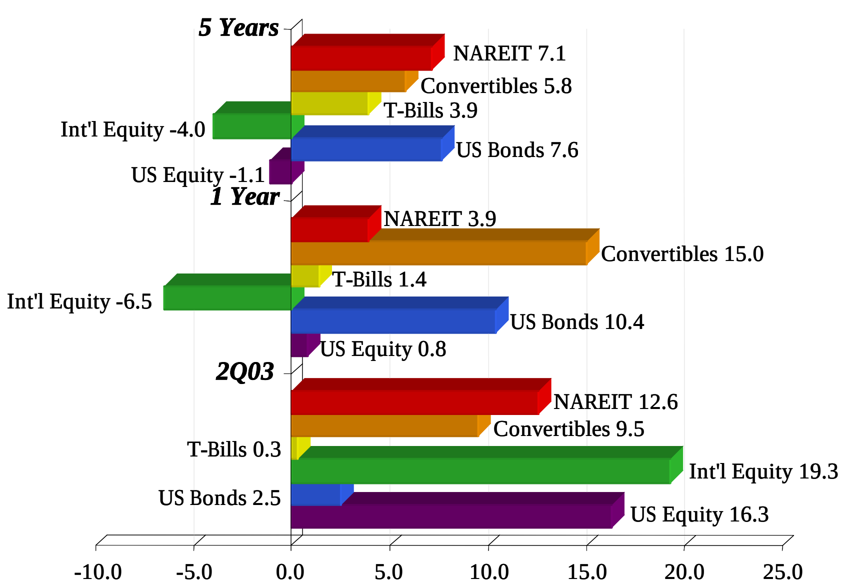
Every painter moves or changes something: perhaps a cloud is reoriented in a landscape, or a feature emphasized in a portrait or still-life. So too does Cubism move or fragment, changing three-dimensional forms into flat areas of pattern and color, intertwining and overlapping the shapes so they are seen from front and back simultaneously. While Cubism fragmented with a freshness and boldness not seen before, Picasso's peculiar genius was in creating an entirely new universe by challenging the compositional possibilities of everything: the subjects, the background, even the empty space between.

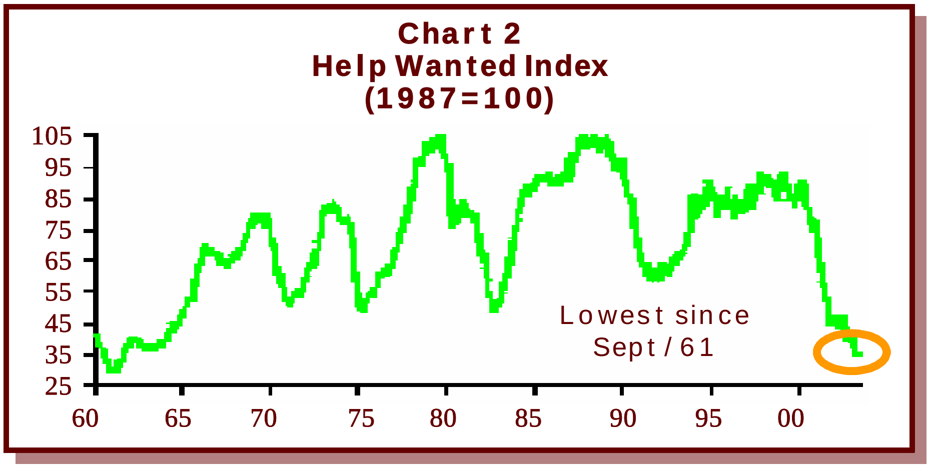
We certainly do not have Picasso's genius, artistic or otherwise. But this notion of *challenging the compositional possibilities of everything* does seem to have some applicability and merit to our world of investing. We have written often in the past about valuation discrepancies in the markets, and the investment opportunities that arise. Our shift from assets dependent on capital appreciation (equities) to those driven by income has worked well these past few years. We identified overlooked and underappreciated areas of investing, such as TIPS, convertibles and real estate securities, and these have helped cushion the fall from the equity bubble. We still believe these themes and asset classes have value, but the extreme valuation differences that existed a few years ago have largely dissipated, and the incremental value these strategies brought us is likely to be less in the future.

As current valuation discrepancies have lessened, our concern has grown over some structural developments that are likely to have profound long-term consequences for investors. Indeed, as Rich Bernstein of Merrill Lynch notes, as investment horizons shorten, short-term arbitrage opportunities diminish but long-term structural imbalances can grow. This will be our focus in this letter, but first, we'll review some of the more mundane developments in the months just past.

It was a good quarter, a very good quarter, for investors (see Chart 1). All principal asset classes and major industry sectors posted gains, indicating a broad-based advance in equity markets. Overseas markets performed even better, especially emerging markets. Dollar-based investors enjoyed an 88% return in Venezuela, and nearly 50% returns in Russia and Indonesia. Even the worst market, Hungary, managed a 1% rise. Bond investors were kept happy too, with solid returns in the quarter, and even real estate showed a double-digit gain in the three

Chart 1
Capital Market Return





visible pick-up in hiring (see Chart 2).

A hiring boom could be a long time away. The normal economic cycle will determine part of the supply/demand relationship, but there is a longer-term issue developing as well. Capital spending has stabilized over the past year while payrolls continue to shrink. Productivity growth remains high, meaning more output can be generated per unit of input. The IT (information technology) price deflator is currently at 1988 levels. In other words, there has been no change in IT input costs in the past fifteen years. In that same time, labor costs have risen 70%. Even in a cyclical upturn, the demand for labor may be muted as businesses rely on productivity gains to boost output rather than adding staff. In addition, the staff that is added will more and more be located abroad. Since 1992, 1.3 million jobs have moved overseas (that's more than 10,000 per month), and Forrester Research estimates that 3 million IT outsourcing jobs will be generated offshore by 2015. Chinese manufacturing and Indian IT services will likely dominate global job growth in the coming decade.

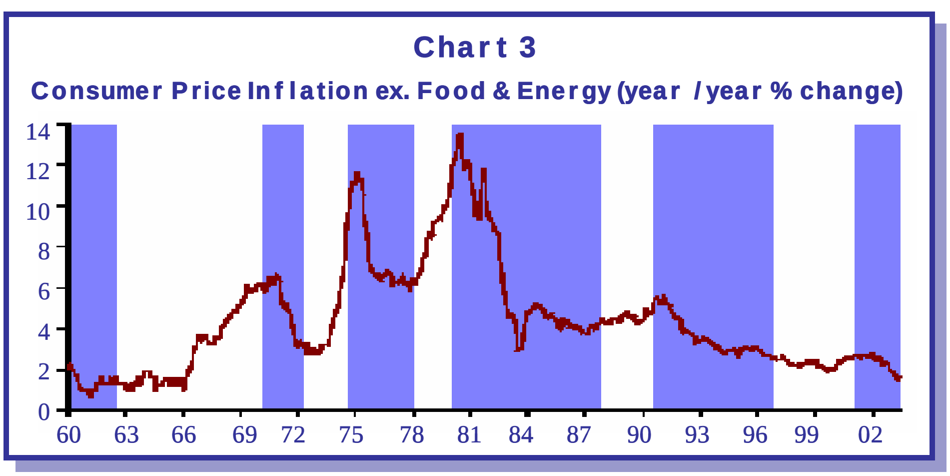
Inflation remains low, less than 2% p.a., but it could go lower and stay there for some time. We *feel* inflation is unusually low because our personal memories go back only so far (see Chart 3). But if we peer

months ending June. Plenty of good cheer for all.

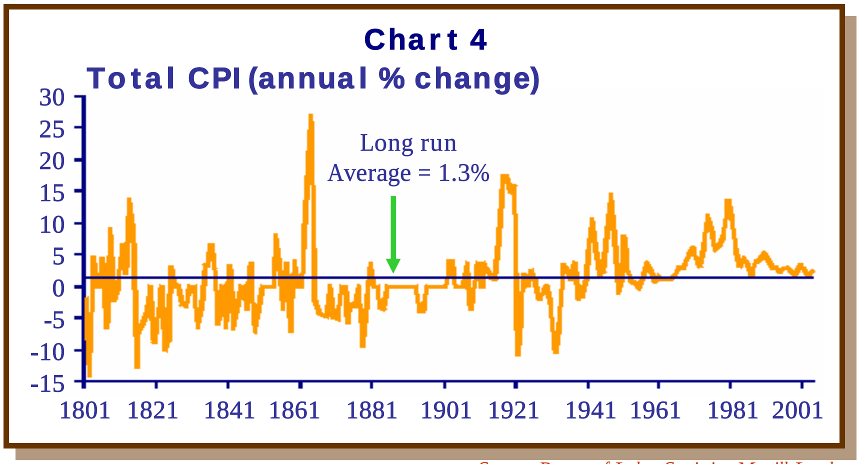
Corporate profits have been ahead of expectations, although reported and reality are not necessarily the same concept. Ford Motor, for example, earned a $718 million profit last quarter: $3 million from the car business and $715 million from Ford Motor Credit. GM earned half its quarterly profit from GMAC's mortgage business. Valuation can also be deceptive. GMAC, for instance, reports a book value of its assets of $18 billion. General Motors' entire market capitalization is about $20 billion. Oh, and there is a pension gap of about $19 billion. What are we missing?

Modest improvement in the economic data, along with the conclusion of the Iraq war and another easing by the Fed, all gave investors a bit more confidence. Retail sales continue to grow, fueled by easy credit and falling prices, and industrial production also appears to be recovering. The new tax cuts kick in this quarter, and the consensus view is that overall economic growth should accelerate in the second half of the year.

But economic challenges abound. The labor market continues to weaken. The level of employment is at a nearly four-year low, off 2.6 million from its peak in February 2001. The average length of time of unemployment rose to a record high of 12.3 weeks, and there is no



Shaded areas are regions when an output gap exists
Source: Bureau of Labor Statistics, Merrill Lynch



Source: Bureau of Labor Statistics, Merrill Lynch

back further in history, low, or even declining prices is not uncommon (see Chart 4).

Inflation is nowhere to be found abroad either. Prices in Hong Kong have fallen 55 consecutive months, and 43 straight months in Japan. Short-term interest rates in Europe are at their lowest since 1875, and in early June, the two-year Japanese government bond was offered at a yield of 3.9 basis points; it was oversubscribed 115 times.

Fiscal stimulus from Washington is certainly welcomed, and should add about $50 billion this year and $75 billion next year. Unfortunately, a lot of this is already offset at state and local governments, which represent almost twice the level of aggregate spending as does the federal government. More than $30 billion, from a combination of less spending and higher taxes, is expected at the state and local levels, but it could be just the beginning.

The federal budget deficit is now estimated at $455 billion this year, up 50% from estimates just six months ago. Who misses its budget by 50% in six months? California, alone, has a $40 billion budget gap to fill. Recalling the governor may not help fill it, but it will probably make a lot of people feel better.

A large part of these budget gaps will be filled by debt. In less than two years, governments have gone from net savers to net debtors. Low interest rates have encouraged consumer debt through lower servicing costs, and rising home prices have promoted the withdrawal of equity. Low rates give the illusion of serviceable debt loads, but the economy is as levered today as at anytime in the past century (see Chart 5), and an upturn in rates could be a serious drag on the economy.

Debt is one of our long-term structural concerns. It's not just the level of the accompanying chart, or the likelihood it will continue to grow. There are rather substantial future liabilities we've committed ourselves to that are not included in these data. Five years from now, the 77 million baby boomers will begin to collect Social Security payments, and in eight years Medicare payments will be added. By 2030, when the last of that generation retires, the elderly population will have doubled while the number of workers supporting them will have risen just 18%. A recent study at the Cleveland Fed estimated the present value of all the revenue the government can expect to collect in the future versus the present value of all future expenditure commitments. The shortfall came to $44 trillion *in present value terms.* Today's federal govern-

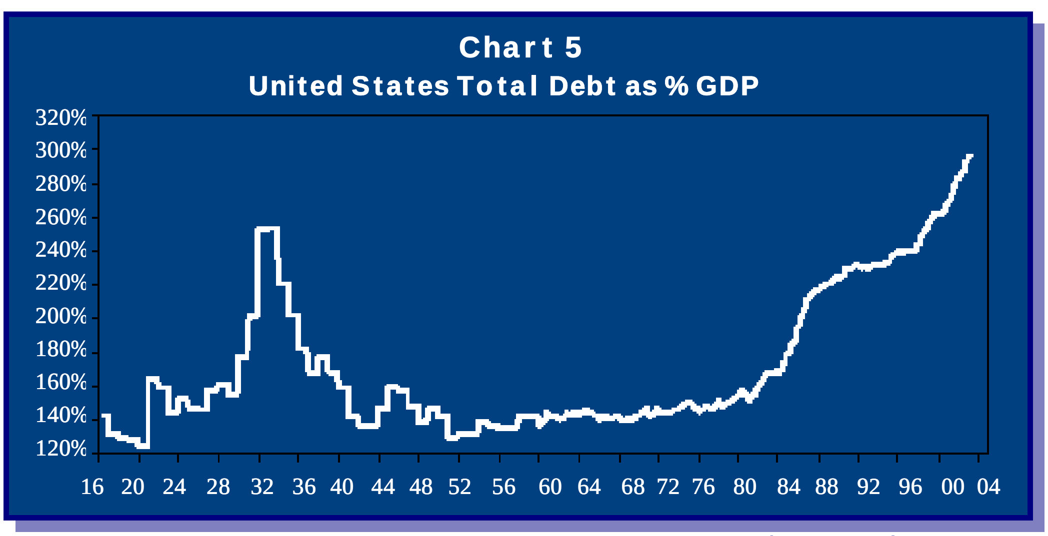


Chart courtesy Bridgewater Associates

ment debt of $6.5 trillion pales by comparison. Admittedly, these projections are fraught with estimation errors, but it's still an unsettling thought.

Some have suggested that the growing debt burden raises the likelihood of future inflation. Since inflation erodes the value of money, debtors benefit from inflation, thus the government, a big debtor and sole owner of the money presses, is incented to create inflation. There are two fallacies to this reasoning. First, is that, unlike the past, the majority of these future liabilities are not in the form of bonds, but are statutory promises to pay benefits, and Social Security benefits contain an inflation-adjustment provision. So higher inflation will not reduce the real costs of these commitments. Secondly, fully one-third of the federal debt comes due in less than one year, so refinancing costs would rise with higher inflation.

Inflation may be higher in the future, but rising debt levels will not be the cause of it. Based on the long-term chart of prices on the previous page, inflation could remain quiescent for some time to come. And the burden of growing debt could become more troublesome.

"There is a profound structural change underway in global capital flows with immense implications for investors."

There is a profound structural change underway in global capital flows with immense implications for investors. These dynamics affect every corner of the globe, determining who will grow wealthy and who will slip behind and these forces are already in motion. [How's that for bold statements? Nothing ambiguous from us!].

The story plays out most clearly in the one, true global market: currencies. We are agnostic on the direction of the dollar, but note that for all the talk of the demise of the US dollar, its depreciating value and loss of hegemony, supplanted by the euro or the yen, there is an alternative view of even greater dollar dominance, even more widespread acceptance as the global currency standard. The reason for this is partly by default, partly because of developments in Asia, especially China, and partly because of the nature of the American economy.

The recent rise of the euro may have largely run its course, as it is now overvalued by most measures, but it could persist as a strong currency. A weak euro allowed Europe to grow through exports. A strong euro eliminates this option, so the only path available to maintain economic growth in Europe is to increase domestic demand. If this happened, Europe could become a much-needed engine of growth for the world, as was the American economy for much of the past decade: a strong currency fueling domestic demand for goods supplied by the rest of the world. Europe could take up this mantle of economic leadership, but it faces a number of challenges: rigid labor markets, declining competitiveness and growing political incoherence. High (double-digit) unemployment in the majority of the region demands easier monetary and fiscal policies, but the new central bank has been slow to ease and the Maastricht Treaty proscribes further fiscal deficits. As economic growth slows, rather than implementing the necessary structural changes to allow market forces to burn the deadwood and germinate the seeds of economic revival, Europe may, instinctively, protect its social structures from these market forces. For example, France's answer to high unemployment and stagnant growth is to mandate that people work less. The preference of social benefits over consumption could keep the currency high. Europe could head down the Japanese path: a strong currency but stagnant growth and declining competitiveness.

Two further points about Europe's future. One, is that it may not be so bad for Europeans. A decline in competitiveness is only relative to the rest of the world; living standards can continue to grow in absolute terms. Europe, like Japan, is rich and comfortable, and a slow decline in relative standards may be preferable to the discord and suffering raw capitalism can bring. Secondly, Europe could change. *The Wall Street Journal* noted that the current economic malaise is causing some in Germany to rethink their choices. Germany is still the third largest economy in the world, and is suffering its second recession in three years with 11% unemployment, social spending that is twice the percentage as in the US, and fewer workers relative to the growing number of pensioners. The creation of a welfare state has led to a permanent and growing underclass of unemployed. In the US, 6% of the unemployed have been so for more than a year. In Germany, that percentage of long-term unemployed is 50%. Whether these conditions lead to the dismantling of the social welfare system remains to be seen. It's also possible that the addition of countries from Eastern Europe to the union will rejuvenate the region. These nations lived with the results of a massive welfare state, rejoiced

Current Account Deficits → Currency Depreciation

	Current Account % of GDP	Date of Peak	Depreciation (%)	# of Quarters
Australia (1989)	-5.3	Q4:1998	-21.9%	19
Canada (1975)	-5.2	Q1:1975	-15.6%	12
Canada (1981)	-4.0	Q1:1981	-15.5%	22
Canada (1993)	-4.2	Q3:1993	-16.7%	27
Denmark (1979)*	-4.4	Q4:1979	-54.3%	21
Finland (1975)*	-9.0	Q1:1974	-47.4%	42
Finland (1991)	-5.2	Q3:1989	-35.7%	15
Ireland (1974)*	-9.1	Q2:1974	-31.3%	10
Ireland (1981)*	-13.0	Q1:1988	-44.0%	28
Korea (1996)	-5.8	Q4:1996	-37.6%	13
New Zealand (1974)*	-11.3	Q3:1974	-53.9%	35
New Zealand (1984)*	-8.4	Q1:1984	-30.8%	5
New Zealand (1997)*	-6.5	Q4:1997	-41.4%	8
Spain (1976)	-4.1	Q1:1976	-63.6%	36
UK (1989)	-5.1	Q4:1988	-18.5%	17
Italy (1974)*	-4.4	Q1:1974	-67.9%	45
Average	**-6.6**		**-37.3%**	**22**
Median	**-5.2**		**-36.7%**	**20**
U.S. (2002)	***-5.2***	***Q4:2002***		

**Annual average*   *Source: Haver Analytics, Merrill Lynch*

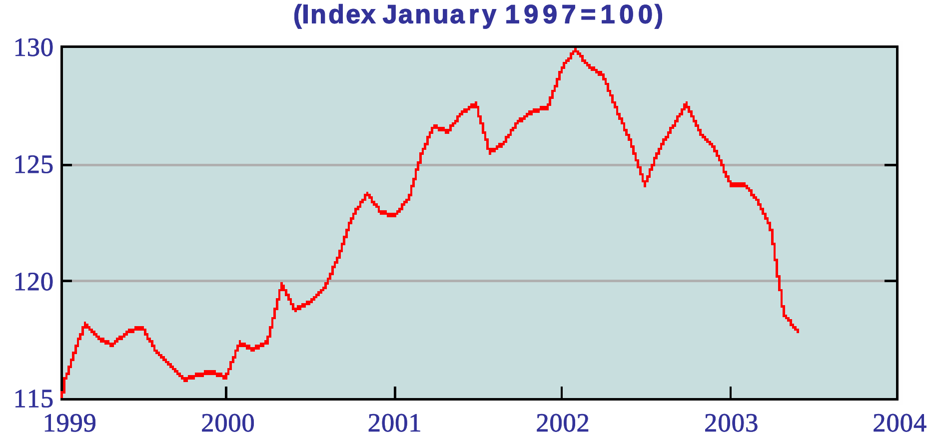
in dismantling it, and it's hard to see that they would acquiesce to the French-German model being imposed on them. Political tensions are likely to grow, and there could be some exciting investment opportunities, especially in Eastern Europe.

The bear case for the US dollar is the burgeoning current account deficit, currently in excess of 5% of GDP and growing. History is not supportive of a currency in this predicament. As the table shows, large current account deficits invariably lead to currency depreciation lasting a number of years.

The problem with this argument is that the dollar has been depreciating against the wrong currencies (mainly the euro). Our trade deficit is most significant with East Asia and oil exporters, and the dollar has not depreciated against those currencies. The strongest currency in the world is the Aussie dollar, which is also running a large current account deficit. At first glance, the trade-weighted dollar has indeed fallen from its peak 18 months ago (see Chart 6). But step back a bit (as with art), and the picture looks very different (see Chart 7).

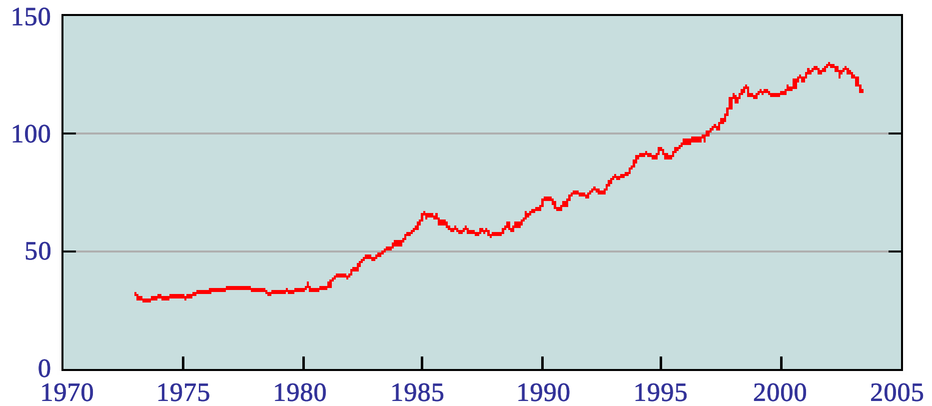
The dollar hasn't collapsed, and may not, for two reasons. First, no one wants it to fall. A dollar collapse would be highly deflationary for the world. It would reduce the demand for goods from the largest consumer (the US) and improve the competitiveness of the lowest cost

Chart 6
Trade Weighted Exchange Index: Broad (Index January 1997=100)



Source: Federal Reserve Bank

Chart 7
Trade Weighted Exchange Index: Broad
(Index January 1997=100)



Source: Federal Reserve Bank

manufacturer (China). The second reason the dollar may not collapse is that the dollar is not the source of our current account deficit. Rather, it's that entire industries are moving offshore, especially to Asia, especially to China, and this is permanent.

A depreciation of the dollar, even a large one, would not change this inexorable course of history. China's competitiveness is not a function of a weak currency, it is a function of rapid productivity growth and a huge labor surplus. Andy Xie of Morgan Stanley believes that even if the peg were broken, the renminbi would still track the dollar because the peg links production costs with selling prices. In other words, it is China that determines the marginal cost of production in the world and the US that sets selling prices as the (almost) only and largest consumer of goods in the world.

> *"A depreciation of the dollar, even a large one, would not change this inexorable course of history."*

This duopoly in which world prices are set by China and the US, is perpetuated because (1) Europe will not be the global consumer that the US is, and (2) Asia has huge excess savings due to low consumption, savings that are recycled back to dollars. Asset appreciation is not a source of wealth in Asia due to over investment and low profitability, so wealth is achieved via savings, which depresses consumption. Financial reforms could boost consumption by improving the prospects for asset appreciation, but that hasn't happened, as the empty office buildings, insolvent banks and insurers, and unprofitable factories throughout East Asia attest. Export earnings are recycled back into dollars to prevent their currencies from appreciating and exacerbating the deflation prevalent in the region.

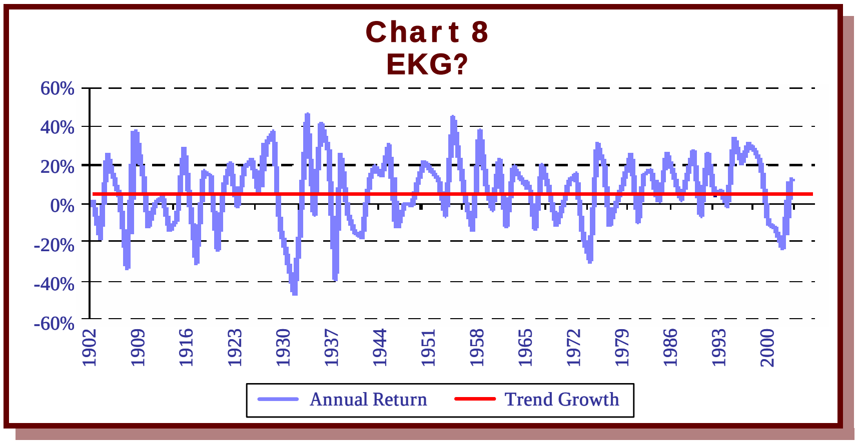
Xie's concern is that there is too much money. Monetary stimulus is masked by deflation, and only serves to prop up GDP but ultimately destroys value by encouraging excess capacity formation. If financial markets can't generate sufficient returns, investors turn their money over to the government, thus lowering interest rates (and returns) and raising government spending (and fiscal deficits).

Equity investing in the region becomes challenging, with booms and busts as capital is attracted then destroyed, but the more constant challenge will be the impact of China. As China effectively re-prices costs for more and more industries, traditional valuation metrics such as book value become less meaningful to investors.

If these dynamics play out as described, the linkage between the dominant producer (China) and the dominant consumer (the US) grows ever closer. If so, Europe and Japan could become marginalized economically. Since the dollar determines both the costs and prices of goods sold, the dollar would grow in importance and dominance.

We have outlined a very different world over the next twenty years than we've experienced in the past twenty years: a world of low inflation, low interest rates, low nominal growth and low nominal returns, but also a world of more complexity.

It is in the currency markets that much of this could play out. In the past, we have thought of currencies only as "noise": a variable that should either be fully hedged so as to exclude it from our analysis, or to be ignored as fluctuations "wash out" over time. But take



Source: Global Financial Database and Smith Barney

a look at the accompanying chart: one could say it, too, looks like random fluctuations, or noise. It is, in fact, a graph of the annual return of the S&P 500 Index since 1902 (see Chart 8). Is it possible to profit from this "noise?"

We have moved from an investment environment, roughly 1982-2000, that emphasized capital appreciation above all else, and so favored equities and long duration bonds, to one where income and protection of capital was most highly valued. We could be on the verge of another seismic shift—from capital appreciation to income and now to volatility, especially in currencies. In the absence of extreme divergences in asset valuations, it is in the currency markets that investors could reflect the changing perceptions of relative wealth. In the environment we've described, absolute returns from the capital markets are likely to fall short of investors' requirements for spending or to meet future obligations. It is a world in which relative returns and their associated tools of tracking error, information ratio, etc. may lose importance to more flexible approaches.

Should this description be accurate, one implication would be to shift from narrow specialists to broader strategies that seek to exploit long-term imbalances among asset classes. Tactical asset allocation was what it was called a decade ago, and it largely failed because it was in an environment of high returns and low volatility. But low returns and high volatility is a more favorable backdrop for exploring this approach. Even *strategic* asset allocation can become more dynamic as (if) we see widely divergent valuations or imbalances.

Another implication is that we should change our perspective on currencies. Currencies, after all, represent relative prices of national wealth and income. Currencies may not carry any long-term expected return over cash, but in a world where the relative prices of national wealth and income are dynamic, currencies could be a source of alpha (excess return) in portfolios.

Pablo Picasso said that "a painting is not thought out and settled in advance. While it is being done, it changes as one's thoughts change. And when it's finished, it goes on changing, according to the state of mind of whoever is looking at it."

This thought may be a little unsettling as we try to make sense of the complex dynamics of investing. But by challenging our assumptions we hope to gain a better perspective and insight into our world. Isn't that what great art is all about?

MICHAEL A. ROSEN
PRINCIPAL & CHIEF INVESTMENT OFFICER
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