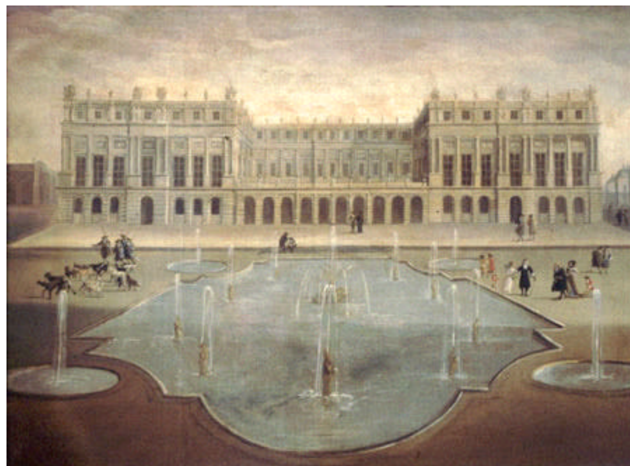
Angeles INVESTMENT ADVISORS

FIRST QUARTER 2004

APRIL 2004

Trust Me

Versailles is certainly a splendid monument to the glory of the Sun King, Louis XIV. Pictures cannot capture the magnitude of its magnificence, the overwhelming adornment of gold, silver and precious jewels on every wall, ceiling and piece of furniture in its hundreds of rooms, and the extraordinary detail, design and abundance of flora in its exquisite gardens. But if Versailles is testament to Louis' glory, it is also exemplar of his profligacy. When Louis died in 1715, the years of extravagance caught up to France. The country was in arrears to its creditors, high taxes stifled economic activity and France fell into a deep depression (economic as well as psychological). The French regent, the Duc d'Orleans (Louis' nephew, since his son, Louis XV, was just five years old), turned to a brilliant Scottish economist for help.



Joseph Schumpeter thought him a "brilliant" and "profound" economist, "in the front rank of monetary theorists of all times." The great Italian economist of the 18th century, Ferdinando Galiani, called him "a man of the rarest and most remarkable genius." John Law made two important contributions to economic theory. The first was the scarcity theory of value, which he illustrated by his famous "water-diamond paradox." Water is essential for life and diamonds are inconsequential (although some would disagree), yet water is cheap and diamonds are expensive. Law explained this paradox by citing the scarcity of diamonds and the plentitude of water. Law's second contribution to economics was the "real bills" doctrine that equated money with credit, and linked the growth of credit to the needs of trade. Thus supply of credit (money) would contract and expand as trade did. The real bills doctrine prevailed for over 200 years until the US Federal Reserve applied it disastrously in the early 1930s, reducing the money supply in order to match the declining demand for credit. As Milton Friedman observed, by following Law's doctrine the Fed turned an economic

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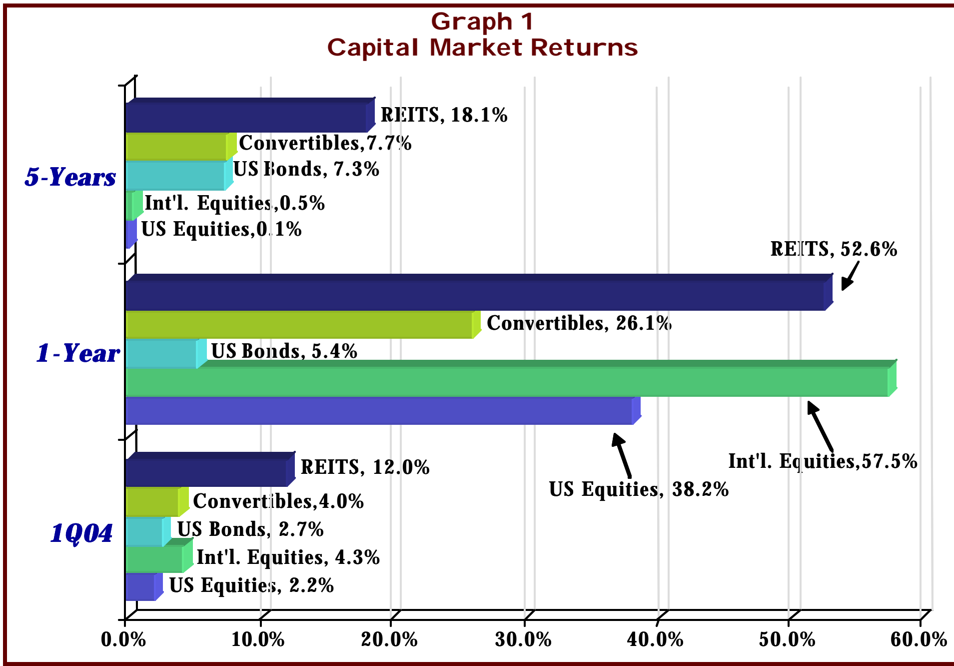


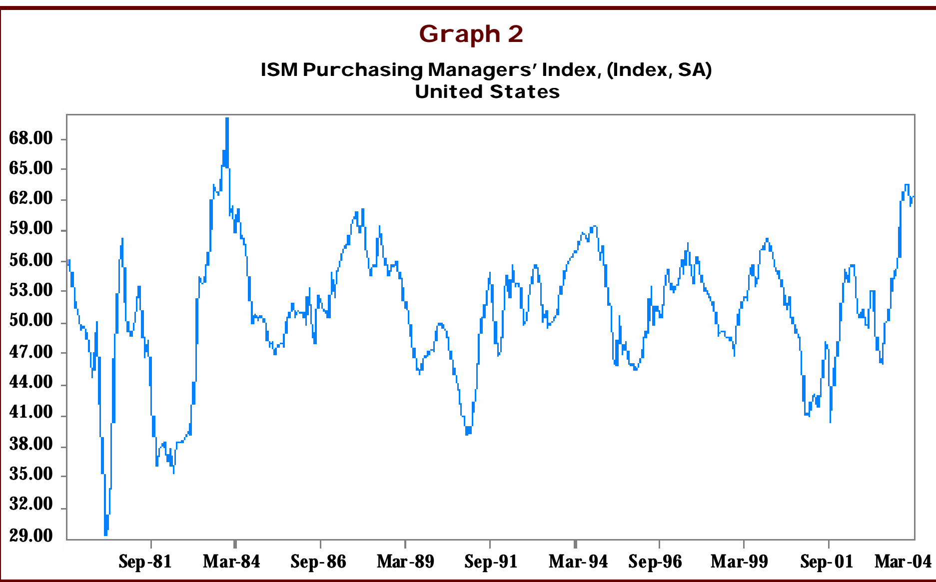
contraction into the Great Depression. But in 1715, John Law was the most noted and respected economist extant, and he knew how to get France out of its funk. To which we will return.

The first quarter of 2004 saw positive returns across all asset classes. Bonds outperformed stocks, convertibles outperformed bonds, international outperformed the US, and REITS swamped them all with a 12% return in the quarter (see Graph 1). The best performing country in the quarter was Colombia, up over 40%. Japanese real estate also gained 40%, as did the Russian energy companies (Gazprom, Yukos and Lukoil). We're still looking for the common thread that runs through Colombia, Japan property and Russian oil and gas, but for Japan, at least, we think we have an explanation (courtesy our friends at Nikko). Last year, the Hanshin Tigers won the country's baseball championship, as they did in 1985, 1964 and 1947. Each year marked the bottom of the Japanese capex cycle, and the stock market rallied in each subsequent year. So there you have it; 2004 will be a good year for the Japanese market.

The path of returns in the quarter was not smooth though, with a strong rally carrying over from last year till early March. Then, weak jobs data followed by the bombing in Madrid saw the market give up most of its gains. Hopes soon lifted, but were then thwarted when Dr. Greenspan gave fair warning that the period of easy money would be closing (possibly, at some point). As we entered April, bond prices plunged, and REITS, those stellar performers of the past few years, lost all their 1st quarter gains in less than a week.

Much of the economic data have been quite positive. GDP grew at a 4.2% annual rate in the first quarter, led by a resurgent manufacturing sector (see Graph 2).

Job growth had been noticeably lacking these past few years, but that



Source: economy.com

Table 1

The Aftermath of Secular Bear Markets

	Peak to Trough		Rebound Rally		What Next?	
	% Fall	Length	Rally from Trough	Length	Correction Following Rebound	Length
US 2000-03	-49	31 months	49	16 months	?	
Europe 2000-03	-58	30 months	51	12 months	?	
Median	**-56**	**29 months**	**70**	**17 months**	**-25**	**13 months**
Min	-86	12 months	41	8 months	-64	2 months
Max	-44	72 months	295	30 months	-10	38 months

Note: Rally in US and Europe based on recent high (11-Feb US, 8-Mar Europe). Based on sample of 17 previous secular bear markets since the 1930s.
Source: MSCI, Datastream, GF Data, Morgan Stanley Research

seems to be turning. Over 500,000 new jobs were added in the first quarter, the fastest pace in more than four years. So the economic news is unequivocally good. However, investors face two potential concerns: historical precedence and the specter of inflation (or, more accurately, monetary devaluation, as we shall argue later).

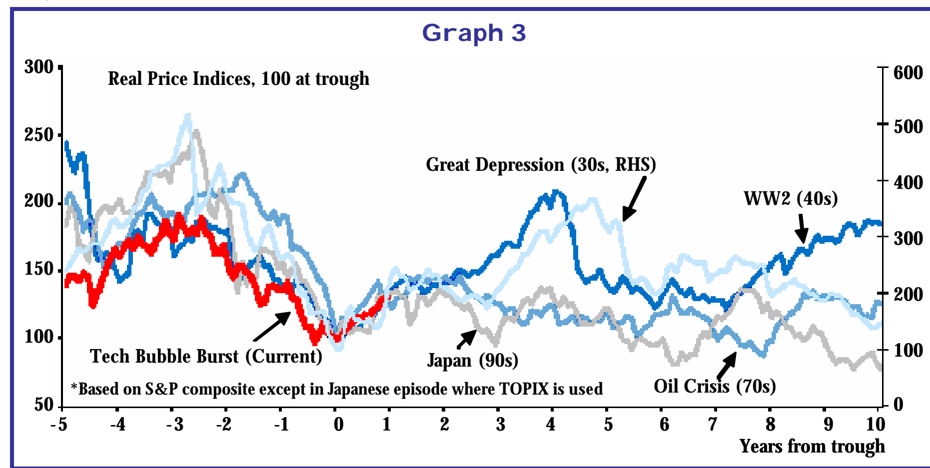
Despite our delight in our performance last year, let's not forget equities remain in a structural bear market. Perhaps we should review some definitions. Cyclical markets are generally tied to the monetary cycle, whereas structural bear markets are usually born from a serious misallocation of resources. Typically, a drop in the cost of capital leads to a savings and investment imbalance (too little of the former, too much of the latter). Structural bear markets cannot be cured by lower interest rates, but only when the overinvestment corrects and the returns on capital rise sufficiently to boost investment. No market period is ever identical, but we think this adequately describes the recent environment. Once the trough is reached in a structural bear market, we typically see about a 30% rebound in the market (as was the case in 2003), followed by a decline in the subsequent year (see Table 1). Higher volatility is also usually present.

Of the 16 equity bear markets in the US and Europe over the past 75 years, a change in the interest rate cycle was the most common factor coinciding with the market peak. Structural economic obstacles have also often been present, including high debt levels, fiscal and current account deficits, deflation and high inflation. Resolution of these structural issues has been the determinant of the future path of the markets, and in most cases, these issues were satisfactorily resolved, allowing markets to move higher (the notable exception being Japan in 1990s). Graph 3 art illustrates some of the key bear market progressions in the past 75 years.

Despite our delight in our performance last year, let's not forget equities remain in a structural bear market.

The good news is that some of the recent structural imbalances have corrected: corporate debt has declined (of course, the opposite is true of consum-

Graph 3



Courtesy: Goldman Sachs

ers), profits have increased and fiscal and monetary stimuli have been strongly applied.

Table 2

Decade	Total Return	Real Return	Change P/E	Inflation
1930s	-0.1%	2.0%	0.4	-2.0%
1940s	9.2%	3.8%	-6.3	5.4%
1950s	19.4%	17.2%	9.3	2.2%
1960s	7.8%	5.3%	-1.0	2.5%
1970s	5.9%	-1.5%	-7.6	7.4%
1980s	17.5%	12.5%	6.6	5.1%
1990s	18.2%	15.3%	7.7	2.9%

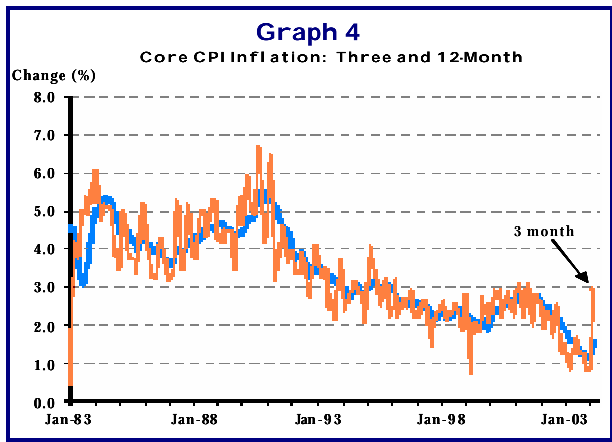
So it appears to us that, despite some notable differences, the markets have followed the historical script fairly closely: boom-bust-rebound. For the past nine years, the market has been directional (structural), and investment success was due to how much beta (equity market sensitivity) a portfolio had. The US equity market rose more than 20% p.a. for an unprecedented five consecutive years (1995-99), and the higher one's beta the better the performance. For the subsequent three straight years, the markets fell, and the lower the beta the better. Last year saw the usual 30% rebound, with high beta outperforming again. But markets are not always directional, and we can remember a period when the major indices made little progress but saw higher volatility. In that case, beta was less a determinant of investment success. Diversification across many assets, especially as correlation tended to fall, and greater nimbleness in portfolio structure and implementation were the key ingredients to success. We think this too could characterize the next few years for investors.

Inflation's trajectory matters more to investors than its absolute level. Rising inflation leads to multiple contraction, and a falling rate sees multiple expansion. Thus, equity returns were high in the 1980s because the *path* of inflation was lower, allowing the multiple to expand, despite the fact that inflation averaged over 5% p.a. that decade (see Table 2).

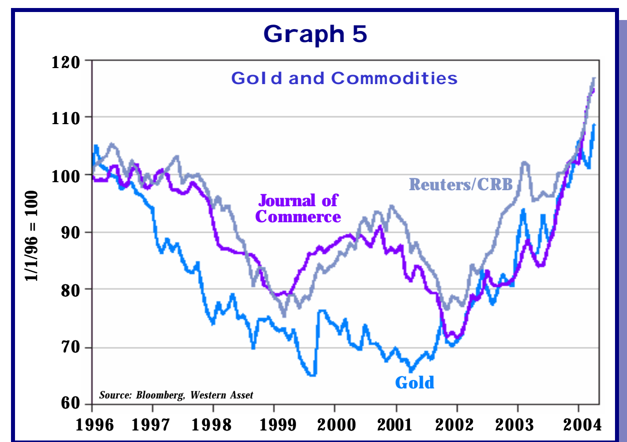
The direction of inflation matters because markets tend to become overvalued in a low inflation environment (high P/E multiples) and undervalued when inflation is high (low P/E multiples). This is because investors assume that inflation has little impact on nominal earnings growth, but this is not so. It is *real* earnings growth, not *nominal* earnings growth, that is relatively constant. High P/E multiples imply that investors believe that real earnings growth will be higher with low inflation but, again, real earnings growth does not fluctuate much with inflation. Hence markets tend to be overvalued in periods of low inflation and undervalued in periods of high inflation (John Campbell and Tuomo Vuolteenaho of Harvard recently compiled much of these data).

Inflation is rising. Core (ex-food and energy) CPI rose at an annual rate of 2.9% in the first quarter, up from 1.1% in 2003 (see Graph 4). We see it in commodity prices as well (Graph 5).

And this is exactly what central bankers want. Japan's deflationary decade and the near-deflationary experiences in the rest of the world following the collapse of capital spending in 2000 have prompted central

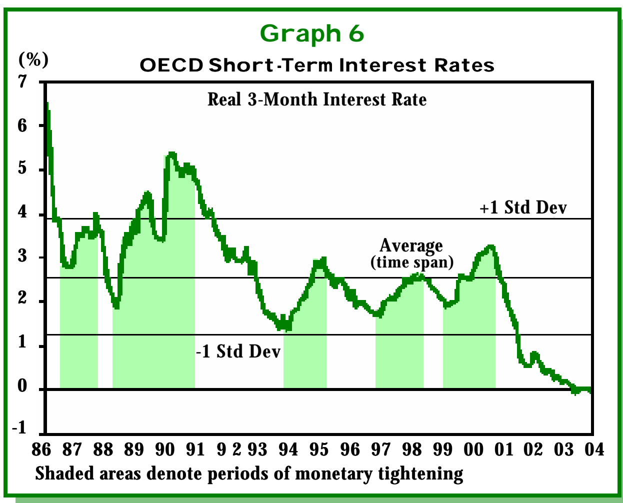


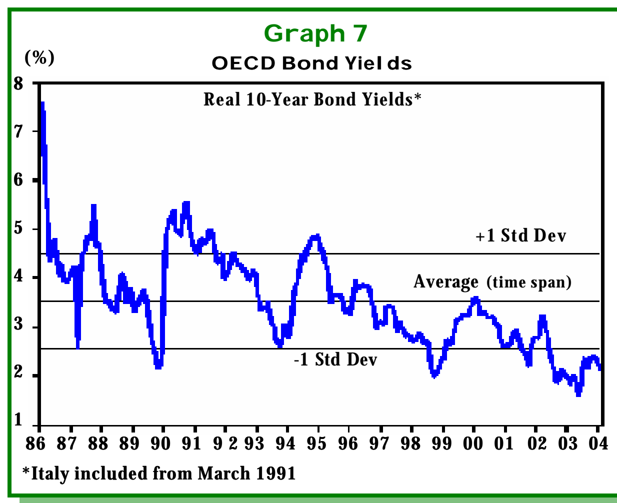
Source: Bureau of Labor Statistics and Lehman Brothers



bankers around the world to consider any and all mechanisms to avoid the deflation trap. Part of the assault on deflationary forces has been rhetorical, but central bankers have put their money where their mouths are and kept real interest rates as low as they have been for an extended period of time. Graphs 6 and 7 show the very low level of real rates in recent times, and Graph 8 notes the dramatic differential currently between short- and long-term rates as viewed over the past century.

A final reminder about inflation: it is a monetary phenomenon.

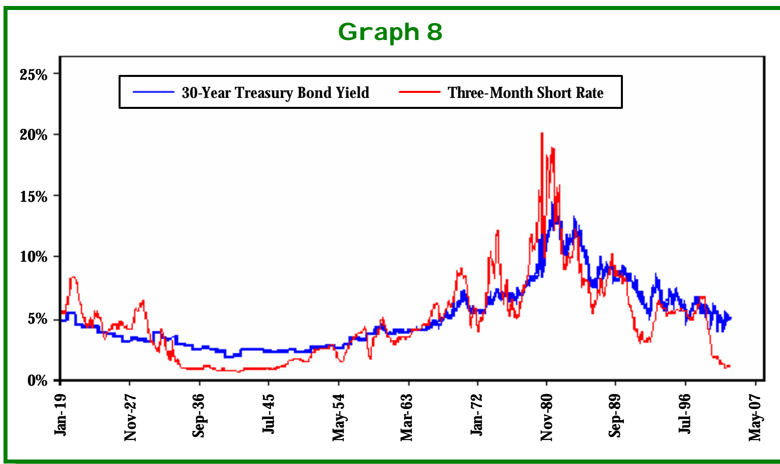




Graphs Courtesy of Goldman Sachs

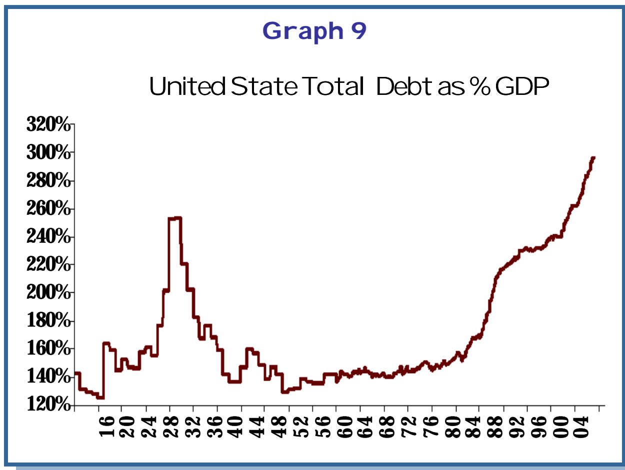
Avoiding deflation is an appropriate goal of central banks. But in keeping rates so low for so long, they have created two potential risks: inflation and asset bubbles. Inflation is rising, as we noted, but most believe that central bankers will be able to keep it contained. Perhaps that's true. We cast no aspersions on the many talents of central bankers, but we do advise investors to consider the consequences should this assumption, that inflation can be made to rise just enough to reduce the risks of deflation but not so far as to destroy purchasing power, be proven wrong.

A final reminder about inflation: it is a monetary phenomenon (as Milton Friedman, again, so aptly noted). Some argue that inflation can't rise so long as a billion Chinese (or another billion Indians) are willing to work for (nearly) free, so long as there is excess manufacturing capacity in the world, so long as there is a patch of land Wal-Mart can expand into. Not so. In the 1970s we created a new word, stagflation, to describe the surprising combination of stagnant growth and accelerating inflation. A rise in energy prices, *per se*, is not inflationary, unless central bankers wish to mask it with loose money. This is what happened in the 1970s, and today most are confident (central bankers especially) that they will be able to switch from loose to tight monetary policy at the right moment in the right amount.



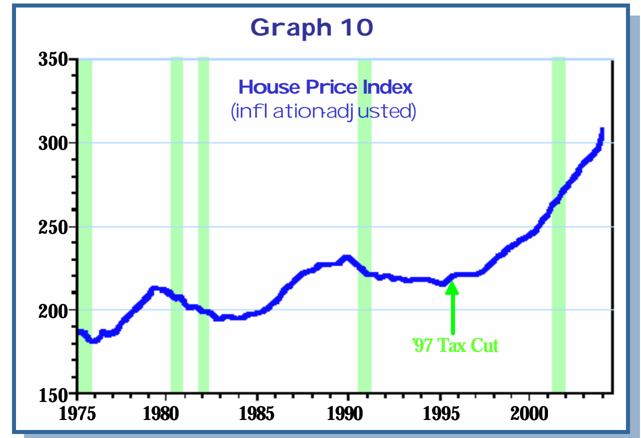
Leverage is the key to the second risk, that of promoting asset bubbles. Leverage is not a four-letter word, and neither is speculation, but exceptionally low nominal (and negative real) interest rates promotes the greater of both, and history is littered with the mess of highly levered speculators who thought they could jump off at the top only to end up splattered on the ground below.

Low interest rates have encouraged US consumers to increase their debt loads (see Graph 9) in order to consume more. From 1998-2003, US household debt as a percentage of GDP rose from 67% to 84%; it also rose from 72% to 92% in the UK and from 61% to 100% in Australia. That consumption demand encouraged a huge increase in fixed investments in manufacturing areas (principally China) in order to meet this rising consumption demand. Gross fixed investment as a percentage of GDP in China rose from 35% to 43% over this same period as domestic credit expanded from 117% of GDP to 160%.



We see evidence of increasing leverage in the bond market and in the housing market. The mortgage bond market is 2.3 times the size of the Treasury bond market, and most banks hedge their mortgage holdings by buying Treasuries (known as "convexity hedging"). Lower interest rates lead to a rising issuance of mortgages, which prompts dealers to buy more Treasuries, which lowers interest rates, all positively reinforcing. But when interest rates rise, the reverse happens: dealers sell their Treasury hedges which pushes rates higher, and so on. The size of the mortgage market magnifies the movement of interest rates, up and down. In the first week of April we saw one of the worst three-day periods in bond history as these positions were unwound following the employment data. In this levered world, markets move quickly and dramatically when they unwind.

Cheap money has also fled to the housing market, and not just in Santa Monica. Housing prices have accelerated in London (see Graph 11), Sydney, Shanghai and many other places.

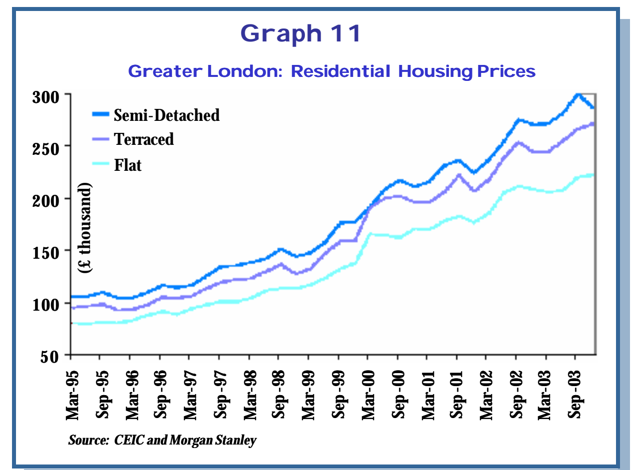


Source: Office of Federal Housing Enterprise Oversight (OFHEO)
Bureau of Economic Analysis

Easy money, then, raises the risks of inflation, as well as encourages leverage and speculation. Should that speculation lead to unsustainably high prices (a "bubble"), the collapse of those markets could have a deflationary impact as overcapacity is absorbed. And so, central bankers walk a very fine line between the risks of rising inflation and encouraging speculative activity that will ultimately be deflationary.

John Law was certain that if credit would be expanded, trade and commerce would also grow. To facilitate this credit expansion, he convinced the French regent to let him open a bank that would issue paper money, a new concept. Since the government accepted these notes as payment for taxes, and eventually guaranteed the bank's debts, Banque Generale was a big success in stimulating commerce throughout France.

So far, so good. Flush with initial success, Law reasoned that if people would accept paper money in



place of gold and silver, they would also accept promises of riches. In 1717, Law created the *Compagnie d'Occident*, known popularly as the Mississippi Company, which was given exclusive rights to all trade between France and its American territories. Then he was granted exclusive rights to all trade between France and the rest of the world, as well as the state monopoly on coinage and for the collection of taxes. In return for each of these privileges, the government was given shares in the Mississippi Company, which it used to repay creditors. Investors could buy shares in the company either with paper money issued by his bank, or with government debt. Thus France was able to exchange its debt for shares in the Mississippi Company.

In January 1719, the price per share of the company was set at 500 livres. By December, it had increased to more than 10,000 and Law ran the printing presses night and day to meet the demand for money to invest in his company. It was in 1719 that the word *millionaire* was invented.

By January 1720, inflation was rising at 23% per month. In May, Law abolished gold and silver coinage and prohibited anyone from owning gold in an attempt to support his bank's notes. Nonetheless, he was forced to devalue the share price to below where it all started, as people lost faith in both the promise of the Mississippi Company and the value of paper money. Not till the following century would France reintroduce paper money, and by then, she had sold the Mississippi territories to the new United States where it was known as the Louisiana Purchase.

The Mississippi Company was certainly a bubble, but whether it was fraud or just a (grand) plan gone awry is a matter of historical debate. Law's flaw (couldn't resist the rhyme) was in not recognizing the limits of supplying money into the economy. The flood of money created tremendous inflation, which eventually eroded public confidence in the value of that money, and turned people back to gold as the store of value. The pattern was to become familiar: excess liquidity, hyper inflation, speculation, bust.

We can't find a single country in the world today that wants to see its currency appreciate, and none, bar China, that has expressed concern with speculative excesses. Central bankers are pumping furiously. Monetary policy is likely to remain looser and longer than might otherwise have occurred in past eras. This may solve one problem, but risks creating others. Excess liquidity causes inflation, and rising inflation reduces real returns to investors. Excess liquidity also promotes speculation and leverage which, unchecked, can lead to deflating asset bubbles. Another great economist, Ludwig von Mises, said it well nearly a hundred years ago, *"When the inevitable consequences of inflation appear and prices soar, [people] think that commodities are becoming dearer and fail to see that money is getting cheaper."*

Money is getting cheaper.

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