Angeles
INVESTMENT ADVISORS

FIRST QUARTER 2005

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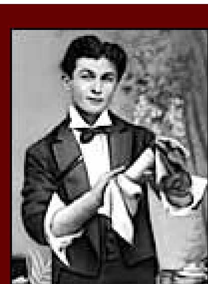
Smoke and Mirrors

Rabbi Mayer Weisz was the son of a respected rabbi, but his family was mired in poverty when a son, Erich, was born in Bucharest, 1874. Four years later, the family emigrated to Wisconsin, where Mayer was to lead a small congregation. The family moved from small town Appleton to Milwaukee, and eventually to New York. Young Erich spent more time on the streets than in school, and his career choices were limited. To escape this fate, he performed magic tricks on the street, but at the age of 22, gave up and placed a newspaper ad offering to sell all of his equipment for $20. There were no takers.



Erich saw some success with tricks that he invented. The Needle Trick involved swallowing dozens of needles and a length of thread, then regurgitating them with the needles all neatly threaded (don't try this at home). Erich combined great athletic ability (or certainly, unusual ability: he could untie knots with his toes and dislocate any of his joints) with a natural flair for showmanship.

Most of the time, things are as they appear. We can offer rational explanations for why bonds yield what they do, why stocks are valued as they are, and because there are rational reasons for current valuations, it is reasonable to expect they will continue. Rational, reasonable, but not necessarily so. In this letter, we'll examine the current market environment, and try to distinguish between the reasonable and the illusory.

Negative returns were posted across all major asset classes in the first quarter of 2005 (see Graph 1). Rising interest rates was the culprit, as inflation pressures build. Not surprisingly, commodities posted strong returns, with the CRB Index jumping more than 10% to a near-all time high (see Graph 2, page 2). There was good money to be made in Eastern Europe, too, as the Estonian market rose 30% (in US$ terms) and Slovakia gained 26%.

There are interesting developments in Eastern Europe. A year ago, 10 countries of the East joined the EU to the (understandable) yawns of investors. Collectively, these 10 countries had the equivalent economic output of the Netherlands, and a standard of living well below (about two-thirds) that of Western Europe. If any thought was given to this EU enlargement, it was in the context of how the EU would impact the development of these eastern countries.

But perhaps we should ask the opposite: what impact will these Eastern European countries have on the West? Here is a collective population of 80 million people (about the size of Germany), highly educated, with wages one-fifth that of Western

INSIDE GRAPHS:

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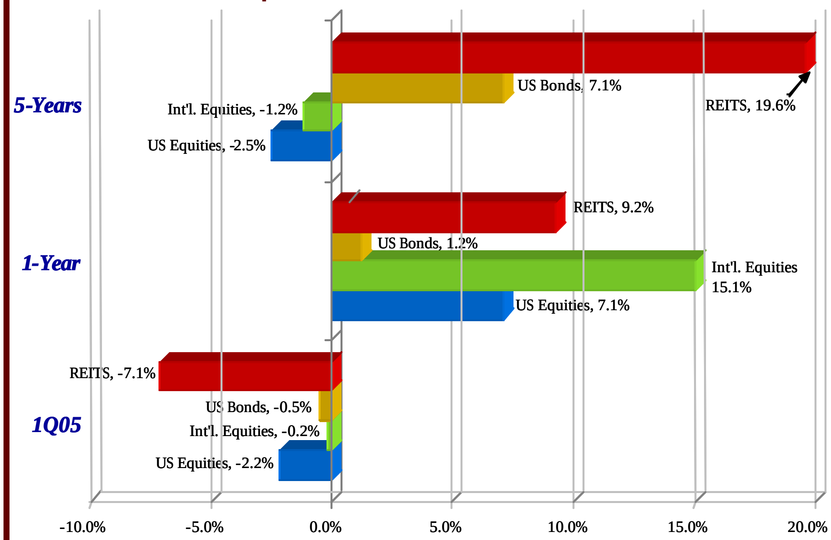
Europe, tax rates about one-half of the west, with economies that are growing 2-3 times as fast as the rest of Europe. Already, countries that border the east (Austria, Germany, Greece, Finland) have cut their taxes to be more competitive. Most observers assumed that the eastern countries would adapt to the ways of Western Europe, but it may turn out that the "American" model of lower taxes, less bureaucracy and less regulation, delivered via an opening from the east, may be the cure for "Eurosclerosis," and help spur the necessary liberalizing reforms in Europe. Or, perhaps a strikingly different outcome: the dynamism of Eastern Europe will accelerate the relative decline of the West. Either outcome seems possible. Either way, the development of Eastern Europe continues to hold for investors important implications.

1

Capital Market Performance

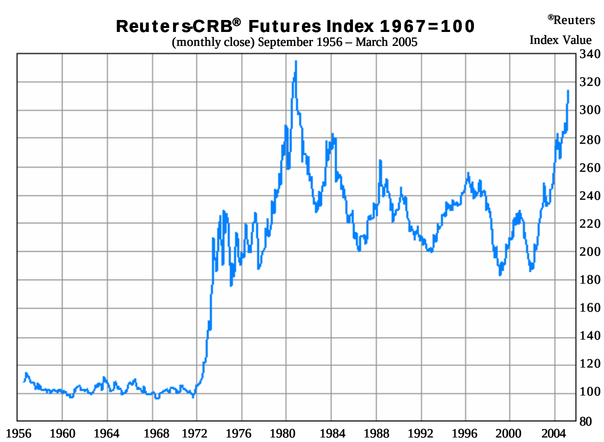


Emerging markets, broadly (not just Eastern Europe), have been a bright spot for investors over the past few years. And for good reason. Their economies are booming, and nearly without exception (Turkey being most prominent), all are running current account surpluses (see Graph 3) helped by the combination of high commodity prices and depreciated currencies. Private investors have poured money into these countries, more than doubling in just the past two years, from $125 billion in 2002 to $279 billion last year. The equity markets of these countries have compounded at nearly 20% for the past three years, and average bond spreads over US Treasuries have fallen to less than 4%, from over 10% a few years ago. We have to go back to the 19th century to find a period where spreads were as tight (for those who must know, between 1870 and 1913, yield spreads for emerging countries averaged 326 basis points over gilts).

These strong current economic conditions are projected to continue indefinitely, and why not? As good as conditions are today, the future looks even brighter. With growing populations that are becoming better educated and more highly skilled, with liberalized economies driven by growing competition, some of

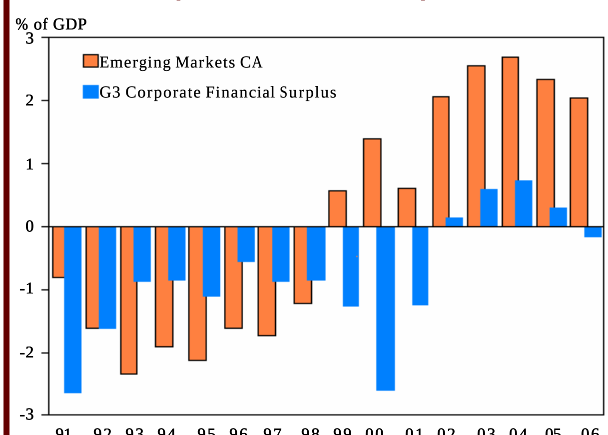
2

Commodities Index

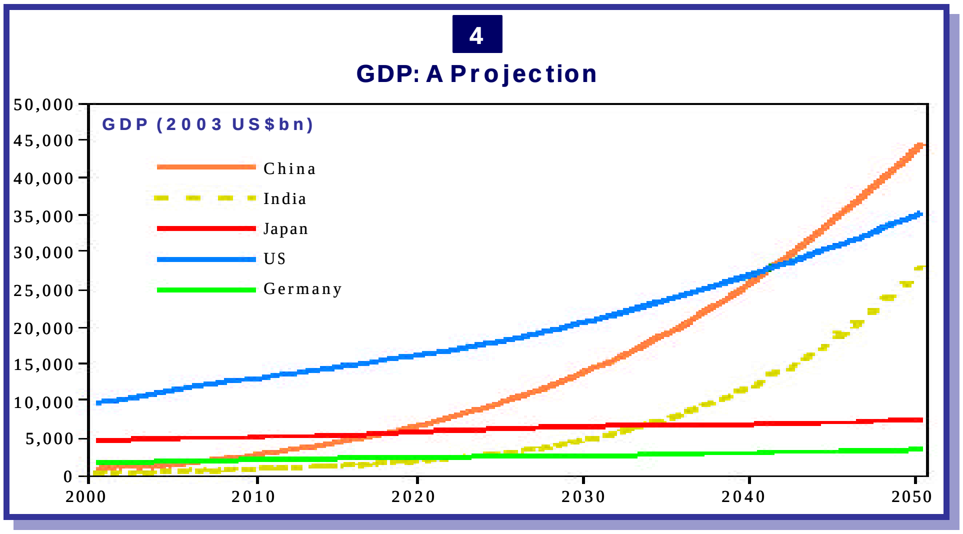


3

Corporate and EM Surpluses



Graph courtesy Goldman Sachs



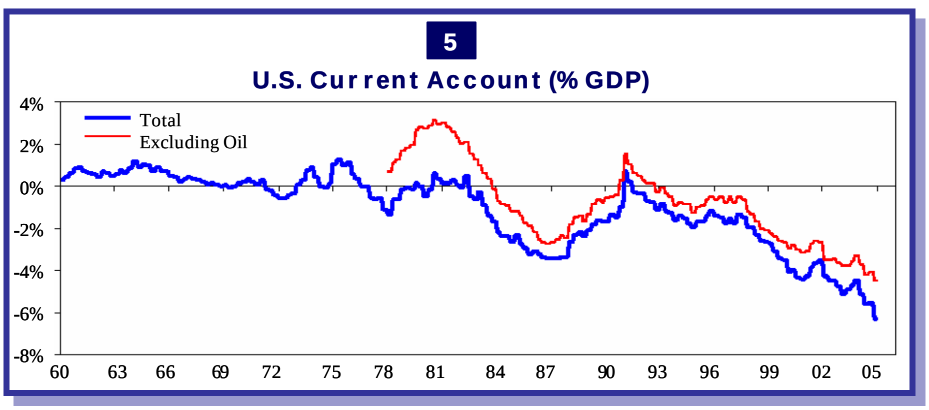
Source: Goldman Sachs

these countries are poised to dominate the world economy in the not-too-distant future. China's economy should pass Germany's in the next 3-4 years, Japan's within a decade, and become the world's largest in a generation, with India not far behind (Graph 4).

China's future certainly looks sparkling, and that nice, smooth trajectory in Graph 4 may indeed be our economic future. But China is not without its challenges. Most immediately is a financial system that is dysfunctional. Government banks have been forced to lend to inefficient public companies, and these bad loans total in the hundreds of billions of dollars. The legal system is immature, and intellectual property rights not recognized. The legal structure may matter less when a country is beginning its development and is importing its required knowledge, but eventually growth must be sustained by generating knowledge, and a system of legal protections is a prerequisite.

Let us not forget too that China has been blessed with far-sighted leadership over the past 25 years that has guided the country through economic liberalization, strong growth and internal peace (mostly; we haven't forgotten Tiananmen Square). But poor leadership is a risk that could reverse the present course (Mao's Great Leap Backwards destroyed the economy, and killed millions of people in the process).

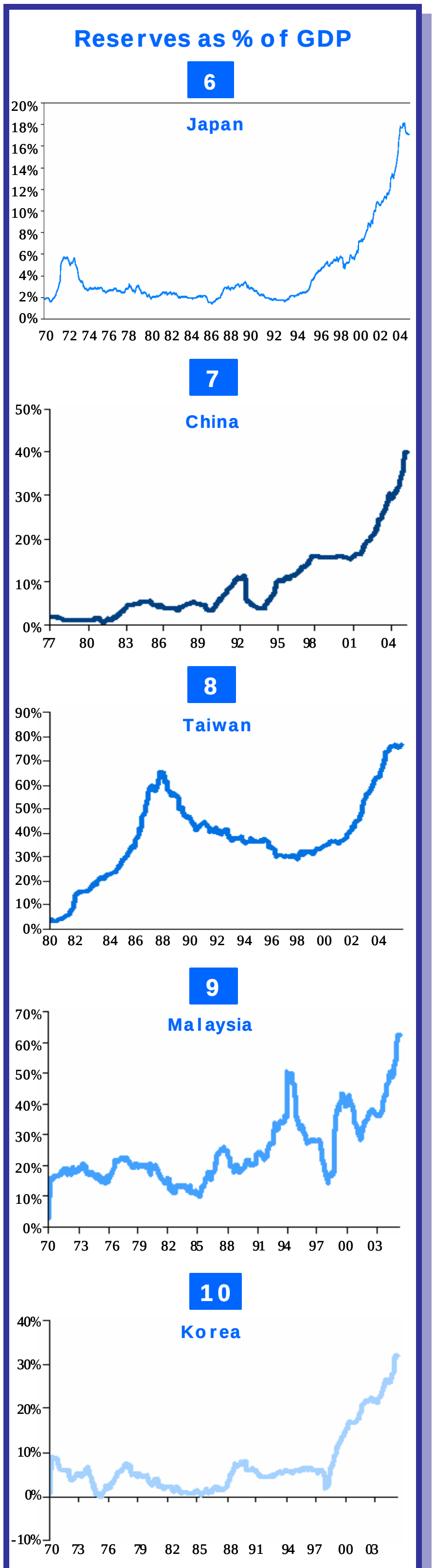
It seems that every decade or so, "experts" agree that some other country will soon overtake the US to be the world's dominant economy. It was the Soviet Union in the 1960s, Germany in the 1970s, Japan in the 1980s, and now China. Gary Becker, a Nobel Laureate, has pointed out that as countries develop, they often impose policies that retard further progress. Legislation in Germany raised the cost of labor prohibitively, and Japan imposed costly regulations on services and foreign investment and protected an inefficient banking system. Both have yet to recover from these mistakes.



Graph Courtesy Bridgewater Associates

Our point is not that China or other emerging markets will soon (ex) implode, or that thirty years from now China will not be the world's largest economy. It's that the path of economic progress is not necessarily as smooth or as fast as a magician's hand. We are wary of extrapolating trends, particularly smooth ones.

Bretton Woods is a pretty little town in the mountains of New Hampshire that gave its name to the post-World War Two international monetary accord that established fixed exchange rates pegged to the US dollar and convertible to gold. By the late 1960s, the combination of rising US inflation and growing fiscal deficits, as we tried to fight a



Source: Bridgewater Associates

war in Vietnam and a war against poverty simultaneously, put the dollar under considerable pressure. Other central banks were forced to accumulate ever mounting piles of dollars in order to finance US spending and maintain the currency peg. This "game" was sustained until one of the players (France, as it happens) decided to cash in its chips and sell its dollars. This precipitated a run on the dollar, and in 1971, the system collapsed.

Today, things are different. There is a "virtuous" cycle between Asia and the United States, wherein the US gives Asia dollars for goods, and Asia buys our debt with those dollars, keeping interest rates down, spurring demand for more Asian goods, and so on. Thus, the system benefits both the US consumer and the Asian exporter. Hence, the US trade deficit continues to grow, now at a record 6% of GDP and climbing (or falling-see Graph 5 on page 3), as does the pile of dollar reserves held by Asian central banks (see Graphs 6-10).

The cheap financing provided by the rest of the world encourages consumption over savings and the accumulation of debt. Accordingly, our savings rate have declined (see Graph 11, pg. 5) and our debt is at levels not seen in over a century (see Graph 12, pg. 5).

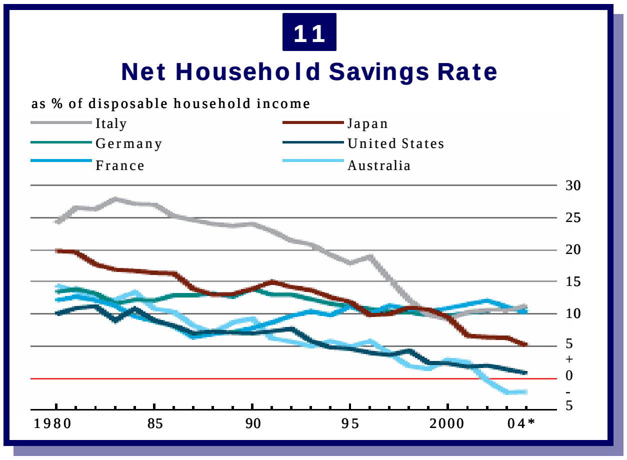
But imbalances, by definition, require two sides. If the West saves too little, Asians must save too much. Some, Ben Bernanke in particular, have pointed to low interest rates as evidence that the "problem" is too much savings in the world, not too little. As long as capital can flow across borders, Americans can consume and Asians can save to their hearts delight. Perhaps.

> ***"In 2001, the Fed slashed the Fed funds rate 475 basis points, but long-term yields were unchanged."***

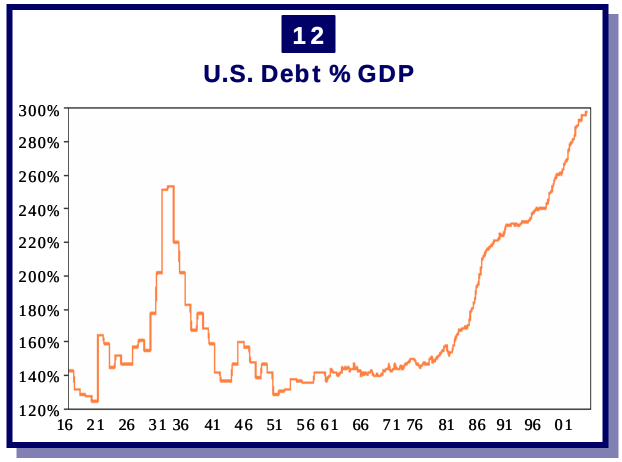
We have two observations about this enormous global savings-investment imbalance. The first is that we are struck by the similarity of declining savings rates and declining interest rates over the past 25 years, and think it is not coincidental. Low yields discourage savings, and high rates of return encourage savings. Should this low yield environment change, a similar shift in savings patterns could be expected.

The second observation is that any system that is imbalanced must find a way to get back into equilibrium or risk toppling. For now, it is in the interests of all parties to sustain these flows and propagate these imbalances. Hence, we can expect the US current account deficit to continue to grow, and Asian central banks to continue to accumulate ever more dollar reserves.

To sustain global economic growth, we need to correct these imbalances. The preferred path is for a gradual rise in savings in the US and the creation of domestic consumption abroad, and the world then tilts smoothly back toward a more balanced economy. The less favorable scenario is a global downturn, instigated by the dumping of dollar assets, a rise in interest rates and a collapse in property markets from Shanghai to Santa Monica. Of these two scenarios, we clearly favor the former, and we even



Source: OECD **Estimate*
Graph Courtesy The Economist



Source: Bridgewater Associates

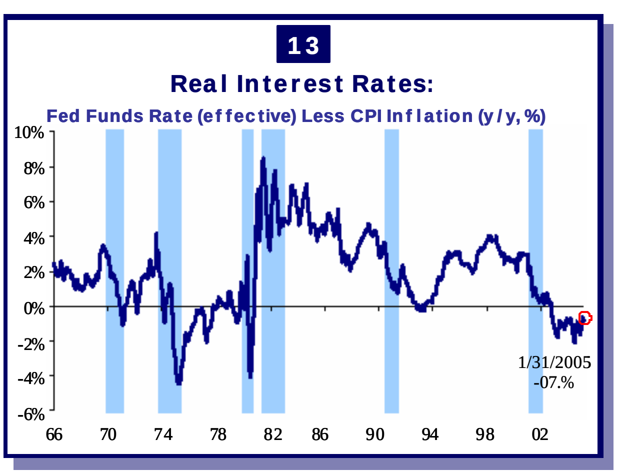
believe it the likely outcome. But investors should be attuned to the risks of the latter.

Conundrum is how Alan Greenspan explained the low levels of long bond yields. This seems an appropriate phrase coming from the master monetary magician himself, so as a public service to the Fed Chairman, we'll examine some of the possible explanations for why bond yields aren't higher.

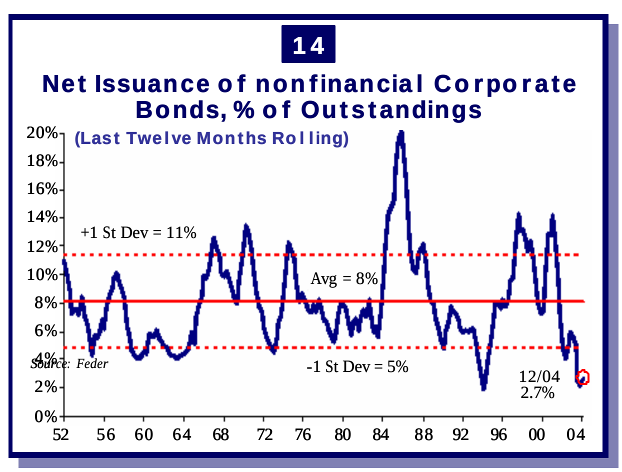
Increased purchases of our debt by foreigners is a factor, but its impact is probably limited. Economists at Goldman Sachs estimate that central bank buying may have contributed about 40 basis points to the decline in bond yields, so this is a partial explanation only, given that short-term yields have risen nearly 200 basis points.

Improved macroeconomic conditions also offer a marginal explanation. Higher productivity through technology and globalization, more credible and successful policy-making, and lower inflation and inflation volatility have all led to declining yields over the past 20 years. These long-term structural trends may indeed account for the fall in bond yields, but still, the level of real interest rates is well below the levels we have seen in more "normal" times (that is, aside from periods of high inflation or recession) (see Graph 13).

It may be useful to think of this past year as an unwinding of a previous period. In 2001, the Fed slashed the Fed funds rate 475 basis points, but long-term yields were unchanged. Only in mid-2002 did the market accept that loose monetary policy was structural, and long-term rates moved down. Today, short-term rates are rising, but only moving the yield curve to a more "normal" shape. The spread between the Fed funds rate and the ten-year Treasury currently stands at about 140 basis points, higher than the long-term (since 1954) average spread of 90 basis points. So, short-term rates could rise further without long-term rates moving,



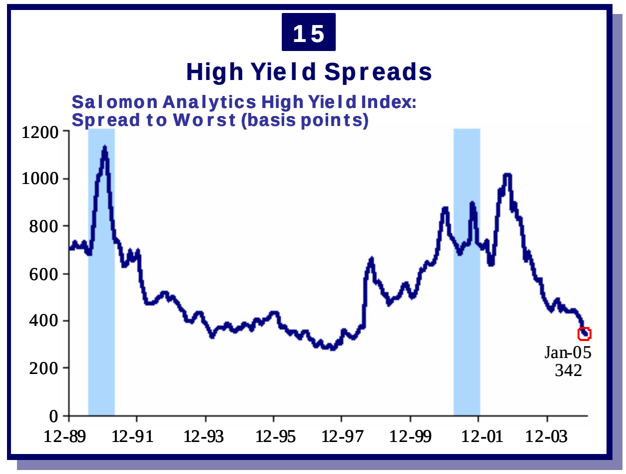
Note: Blue shading denotes periods of economic recession.
Source: Federal Reserve Board, Bureau of Labor Statistics, Morgan Stanley Research



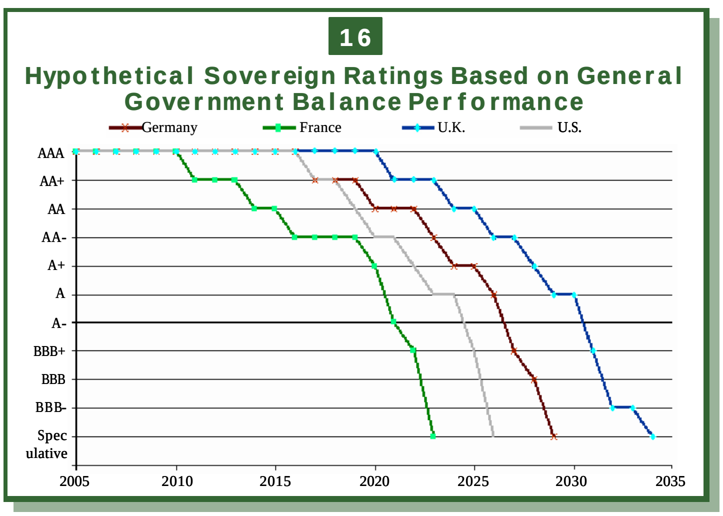
Source: Federal Reserve, Haver, Morgan Stanley Research and still the yield curve would not be considered flat. Thus, the low level of long-term rates reflects rationally the abnormal conditions of monetary policy over the past four years.

We offer one additional point to help explain low bond yields: companies are borrowing less. Since the mild recession in 2001, corporations have slashed costs, boosted profits to record levels and paid down debt substantially. Graph 14 (pg. 5) notes that the net new issuance of corporate debt is near an all-time low.

As a consequence, default rates fell to 2% last year, down from 10% in 2002 and well below the long-term average of 5%. The combination of less supply of corporate debt and strengthening balance sheets has dramatically lowered the premium investors require to hold corporate debt (Graph 15 shows high yield spreads to Treasuries).



Note: Blue shading denotes periods of economic recession.
Source: Salomon Analytics, Morgan Stanley Credit Strategy Research

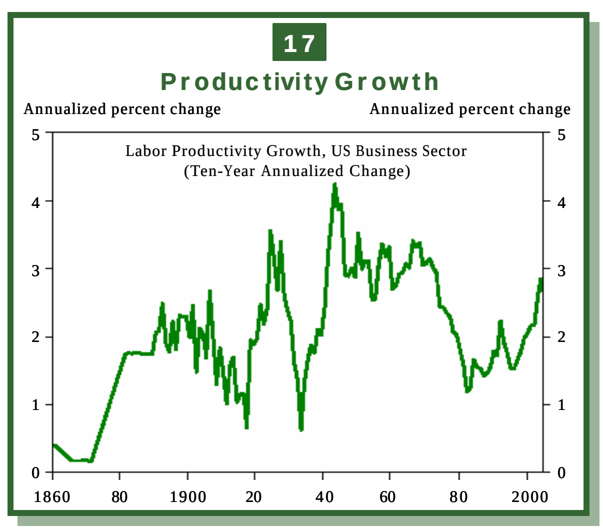


Source: Standard and Poor's

We think all of these reasons account for the level of bond yields. Under these circumstances, bonds seem appropriately priced. But *under these circumstances* is a misleading phrase because *these circumstances* will not continue indefinitely. There is a cyclicality to all these trends, and while we cannot know *when* conditions will change, we know with certainty that they will change, and not in the distant future. Record corporate profits, record low corporate debt issuance, (near) record low real interest rates will revert to the mean, for mean reversion is one of the most prominent economic phenomena. While we enjoy this bond nirvana now, a glance out a few decades (not an unreasonable time frame for a pension fund or perpetual endowment or foundation) may paint a very different portrait. Graph 16 is not a prediction, just a warning from S&P, who projected the path of credit ratings for sovereign debt if present patterns of profligacy persist: junk status within a generation.

The great majority of the time, the markets accurately reflect current conditions. We have seen significant improvement in the financial conditions among corporations and in the emerging economies of the world. Productivity growth in the United States, a measure of economic efficiency and the principal determinant of long-term standards of living, has been more robust than any time in the past 50 years, and among the strongest periods in our history (Graph 17).

These developments give us great optimism. To a large extent, markets reflect all this. The great challenge for investors is not foresee-



Source: "Computer and Dynamo" (David). Productivity Trends in the United States (Kendrick). Department of Labor ing the future (we are still searching for that perfect crystal ball). *The great challenge is understanding what future expectations are already priced into the markets, and assessing whether the risks have been adequately accounted.* Success in investing does not come from knowing that inflation will rise or profit margins will fall or any of the other myriad factors that drive markets. Success in investing comes from knowing whether the markets have appropriately priced the ranges of expected outcomes. This may be a fine point, even a subtle one, but we think it a critical, if not *the* critical distinction of investment success.

"The great challenge is understanding what future expectations are already priced into the markets, and assessing whether the risks have been adequately accounted."

Erich Weisz became more successful as he developed new tricks. The Handcuff Challenge was particularly popular. He would ask the audience for a pair of handcuffs, usually supplied by the local constable, and he managed to escape from every one of them. This excited audiences, and Erich expanded the trick to involve more elaborate escapes: getting out of a straight-jacket, then doing it hanging upside-down, then with chains and locks around him, then sealed in a box, etc. He escaped from a padlocked box tossed into a river, and from being handcuffed in a giant paper bag without ripping it. Each new act brought him greater acclaim till he became famous worldwide.

Erich struck a friendship with Arthur Conan Doyle, an educated, erudite man who nonetheless believed in communicating with the dead. Erich attended a séance in which Conan Doyle was to contact his mother, and exposed the set-up as a fraud. It ended their friendship. But exposing the truths about these frauds became a passion for Erich. In 1923, *Scientific American* offered a $2,500 prize to anyone who could prove their psychic powers were genuine, and Erich was asked to join the judges' panel. The panel was persuaded by a medium in Boston named Margery, and announced she had won the award. Erich was shocked, went to Boston, and proved the fraud. *Scientific American* was embarrassed, and severed its ties with him.

When Erich died in 1926, the solutions to many of his famous "impossible" escapes were revealed, but not all of them. A few mysteries remain to this day, and the legend of Erich Weisz has only grown larger.

We think we can explain most economic and capital market events. There are usually rational and reasonable explanations for these phenomena, appropriately reflected in the markets. Usually, but not always. There are some mysteries that remain hidden to our scrutiny. Perhaps that's as it should be, and we think Erich Weisz, whom you may remember as Harry Houdini, would have approved.

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