Angeles
INVESTMENT ADVISORS

FOURTH QUARTER 2006

LION'S GATE

Thomas Raffles was one of those extraordinary individuals who made the British Empire the British Empire. He joined the British East India Company in 1805 as a clerk, but one with high ambitions for adventure. At the time, the Dutch East Indies Company had a monopoly on the riches of Southeast Asia, and while many in Britain dreamed of supplanting the Dutch, it was Raffles—a clerk in the employ of a private company, with no military training or service—who led a series of skirmishes that weakened and then evicted the Dutch in their key outpost of Java. Raffles knew that a strong, permanent British military presence in the region was necessary, and he petitioned the Governor-General of India for permission to lead an expedition to find and establish a suitable fortress that would solidify and expand British influence in Southeast Asia. In early 1819, he found the place: a deep harbor, fresh water, plenty of timber, and strategically located on a critical trade route. Singapore (*singa pura*, *Lion's Gate,* in Sanskrit) would become the true "jewel in the crown" of the British Empire, the center not only of trade between Asia and Europe, but also the military bastion that enabled the Royal Navy to rule, uncontested, over the Indian and Pacific Oceans.

Thomas Raffles chose well. Singapore is an island 85 miles north of the equator that sits at the base of the Malay Peninsula, 400 miles of impenetrable mountains and jungle. By the 1930s, more than half the world's tin and most of the world's rubber was produced there, all of which was transported on a single-gauge railroad to its terminus at Singapore, the world's largest port. The island commands the Straits of Malacca, the most important

INSIDE GRAPHS:

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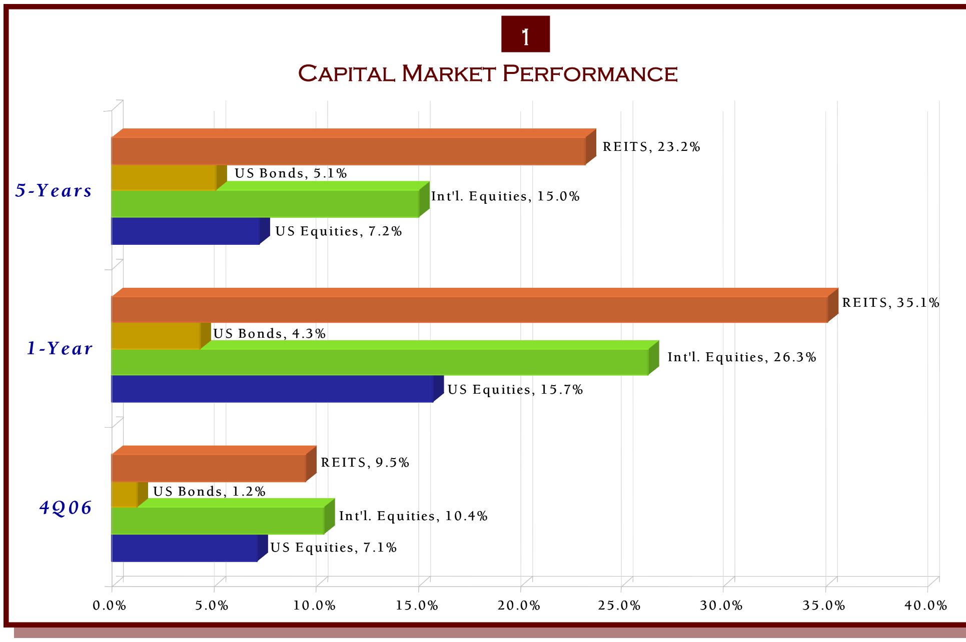


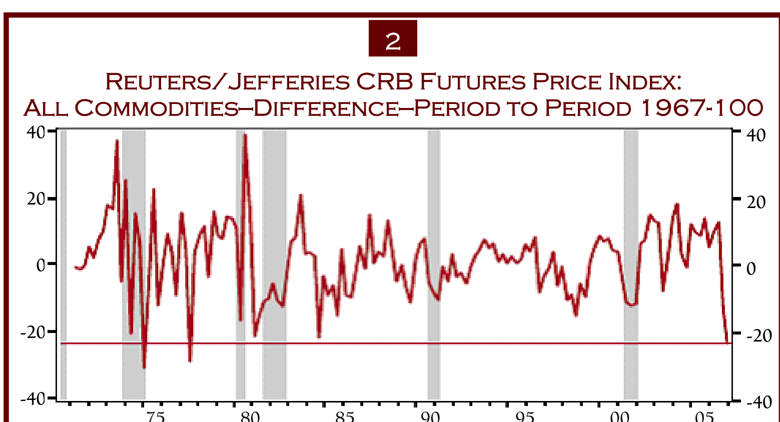
trade route in the world, and one of only a handful of critical "chokepoints" on the globe for military planners (arguably even more vital than Gibraltar, Hormuz or Suez).

At an enormous cost (over £60mm), the British constructed in 1938 the largest, most modern naval base in the world, with every amenity for its sailors (including 17 football fields). The only thing lacking at the Singapore Naval Base was a navy.

Britain had a two-hemisphere empire but a one-hemisphere navy in 1938, so the Admiralty's plan in the event of war was to send its ships from Southampton, around Africa, and on to Singapore. The plan assumed fair warning of an attack, which was not entirely unreasonable given that an assault down the Malay Peninsula was unimaginable through that impassable terrain, and a naval threat would likely be detected in plenty of time. The nearest (potential) hostile navy was in Tokyo, 3,000 miles from Singapore.

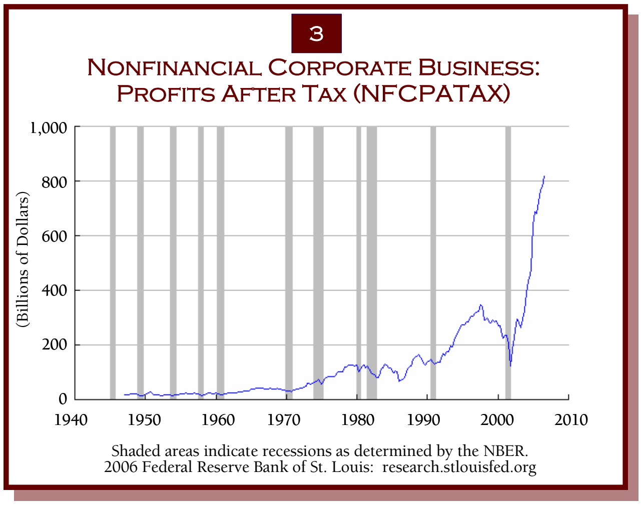
Since its opening in 1887, the Raffles Hotel, still one of the great hotels of the world, had been the center of British social life on the island. Each Sunday morning the crème of society gathered at the hotel for brunch. It was another typically warm morning in early December of 1941 when rumors began circulating at the hotel that, incredibly, 550 miles to the north the Japanese had landed in Malaysia. It was inconceivable, not just to those gathered at the Raffles Hotel that morning but to virtually everyone around the world, that just 55 days later Singapore, the "Gibraltar of Asia," would fall to those same Japanese troops. It was unimaginable to those sitting in the beautiful gardens of the Raffles Hotel that warm Sunday morning that the next four years would be a living hell for those who survived, that the grandeur and glory of British Singapore would soon be erased for all time, the city left in shambles and its residents impoverished for decades to come.

Success is sustained, in military affairs and in the financial markets, not by anticipating every contingency, but by being alert to and preparing for the worst of them. The British planners at Whitehall and on the ground in Singapore were unprepared for and, worse, complacent about the imminent threat they faced. Investors had much to celebrate in 2006, with double-digit returns for nearly all, and even if there is no obvious, immediate threat to this bull market in 2007, the past is instructive in understanding the present and helping to anticipate, or at least prepare for, the future. So we'll review 2006 in hopes of gaining some insight into 2007 and beyond.



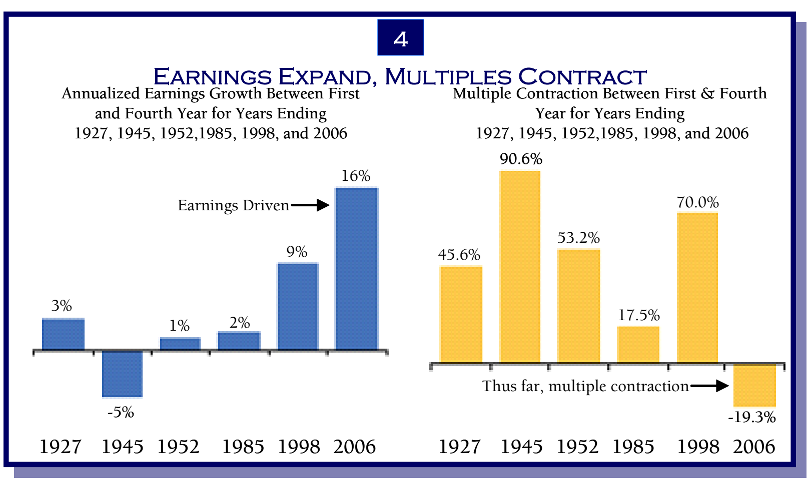
Courtesy: Merrill Lynch

Equities were strong nearly everywhere around the globe in 2006, with China leading the way, gaining 138%. Right behind was Namibia, up 126%, although we're not entirely sure why. Venezuela nearly doubled (+99%), despite avowing to adopt the Cuban model of economic development. Oil probably had something to do with its results, although oil didn't help Saudi Arabia, the big loser in the world last year, off more than 50%.



Despite the "collapse" of the housing markets across the English-speaking world, real estate posted its fourth straight year of double-digit returns as the supply/demand balance in commercial markets remained tight and investors embraced the favorable characteristics of the asset class. Bonds, alas, failed to earn their coupon in the US, but at least showed a positive return, unlike most commodity prices, which posted their largest declines in 30 years (Graph 2, pg 2).

For US stocks, 2006 was the fourth consecutive year of gains, but it's been an unusual bull market.



Source: Thomson Financial, S&P, Robert Shiller, Factset, Morgan Stanley Research

Returns have been modest for this four-year period, averaging 12.7% annually, but earnings growth has been the strongest on record (Graph 3). Earnings alone, and then some, have propelled this bull market because, uniquely, the rise has been accompanied by lower valuations (Graph 4).

Resilient certainly characterizes the US economy, although remarkable might be more apt. In the past few years, we've seen the worst bear market since the 1930s, terrorist attacks on our soil, the largest and longest engagement of US troops since Vietnam, a trebling of the price of oil, the largest trade deficit in over a century and a "collapse" in residential housing. Yet unemployment is near record lows, inflation seems well-contained

Note: Obese is defined as a Body Mass Index (IBM) greater than or equal to 30
Source: Center for Disease Control, Bureau of Economic Analysis
Graph Courtesy: Goldman Sachs

and the economy continues to hum along. After moderating to a 2% growth rate in 3Q06, the economy grew at a 3.5% annual rate last quarter. Still, the imbalances are striking and, to our theme, interrelated. Let's consider the two sides of the same coin: savings and debt.

The nation's savings rate is negative (we spend more than we earn), and has been heading lower for 25 years. So, to finance our consumption, we borrow. Household debt exceeds 130% of disposable income, twice the level of 20 years ago, and 14.5% of that income goes toward servicing that debt. For some this has taken on moral overtones, indicative of our profligacy and decadence (our favorite Graph (5) this quarter tracks this moral decline, showcasing the close, inverse relationship between our savings

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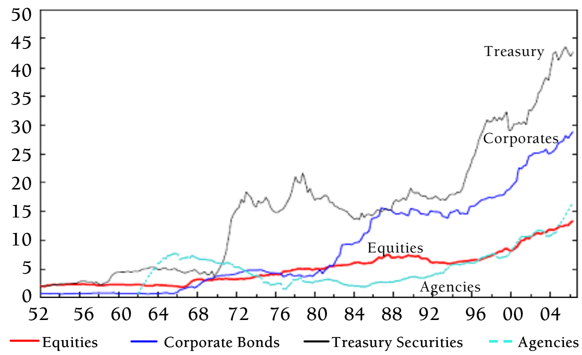
FOREIGN OWNERSHIP % OF TOTAL US OUTSTANDING SECURITIES



Graph Courtesy: Citigroup

rate and the percentage of obesity among adult Americans).

But for every borrower there is a lender, and for us, the lenders are foreign central banks. We're fortunate, because these are the best lenders we could ever imagine. They have deep (really, limitless) pockets, and their urgency to lend more and more has meant ample supply of credit available to us. They are banks with no requirement (or interest) in earning a profit, so an ample supply of credit is available at almost any price. We may be accumulating debt, but they are amassing pieces of paper (Graph 6).

Foreign central bankers may not be profit maximizers, but they have good reasons for hoarding dollars (in other words, they may be crazy but they're not stupid). A simple example will illustrate (Graph 7). Step 1 is a US importer sending dollars to a Chinese manufacturer for goods. The Chinese manufacturer converts those dollars to renminbi with the local bank in Step 2. The bank has two sources of renminbi: it can print more currency (which is inflationary) and/or it can borrow by selling bonds (Step 3). As it happens, the Chinese central bank (the People's Bank of China—PBOC) has mostly borrowed renminbi by issuing bonds, but the magnitude of this borrowing has become enormous. The PBOC's balance sheet is now over 60% of China's GDP (by contrast, the Fed's balance sheet equals about 7% of US GDP). Of course, the central bank is still holding dollars, and in the final step (4), sends those dollars back to the US in exchange for IOUs (bonds, stocks, etc.), which is how China has amassed more than $1 trillion of reserves. The same process is played out in similar form with most of our trade partners.

These actions of central bankers are logical, even reasonable, but the magnitude of these capital flows has some worried that these trends are unsustainable, and when they reverse, we will see some serious economic dislocations in the form of a collapse in the value of the dollar, a significant rise in US interest rates, and a precipitous drop in valuations of all assets. The late 1960s/early 1970s period is instructive. Then, the emerging markets were Germany and Japan, exporting furiously to the United States and recycling those export earnings into US Treasury debt in order to maintain the fixed exchange rates of the Bretton Woods system. When they chose to sell their bond holdings, the Fed opted to print money in order to offset the resulting rise in interest rates. This is the very definition of inflation, which caused foreign investors to accelerate their sales of dollar-denominated debt, putting additional pressure on both interest rates (upward) and the value of the dollar (downward). The pressure built until 1971 when President Nixon unilaterally withdrew from the system, and allowed the dollar to collapse.

Such a scenario is unlikely to be repeated, but the magnitude of these flows has many worried. Perhaps more confounding to economists and strategists is that many of these variables

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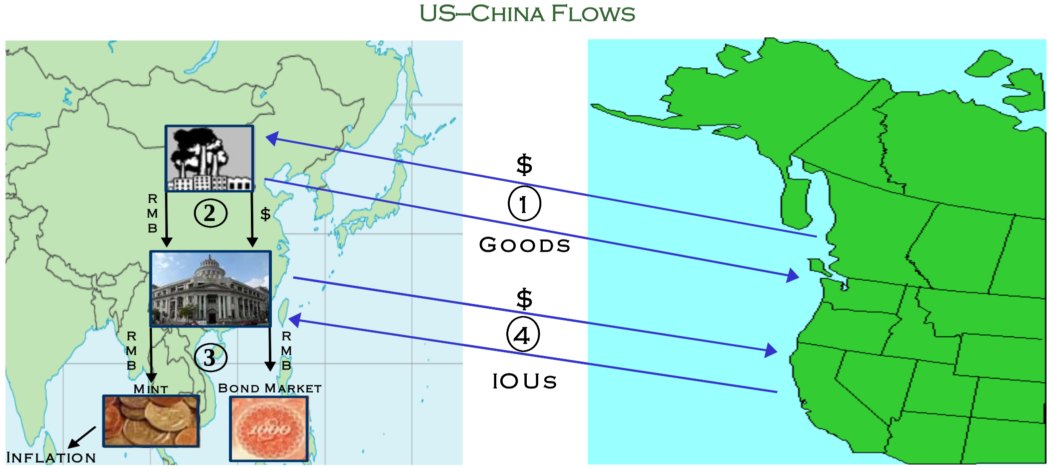
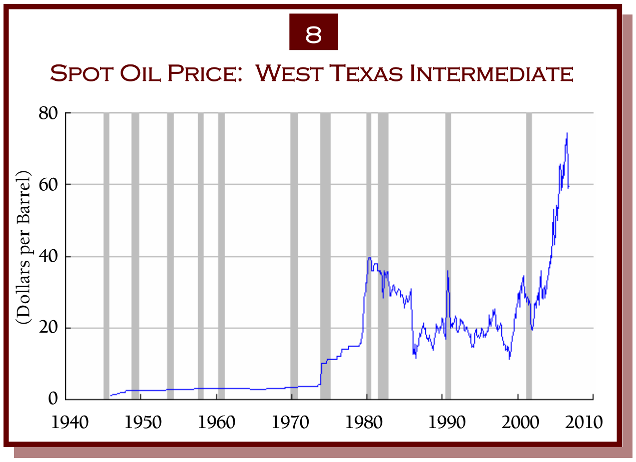
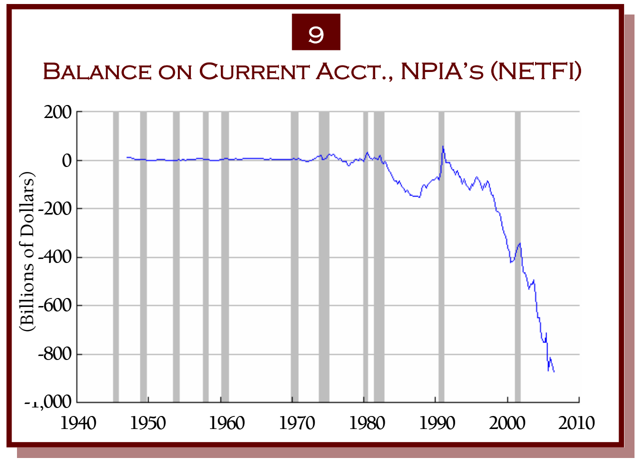
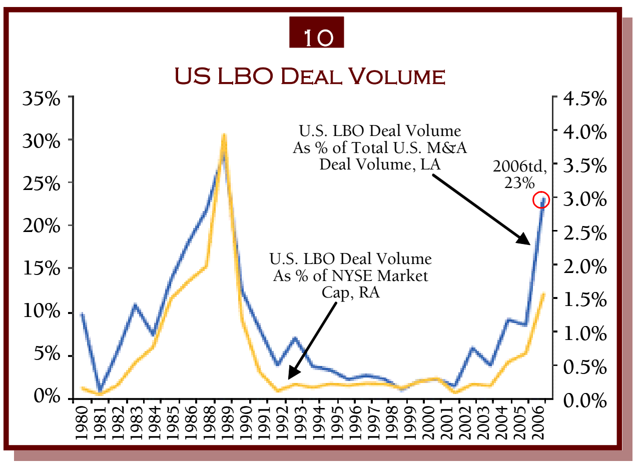
US–CHINA FLOWS

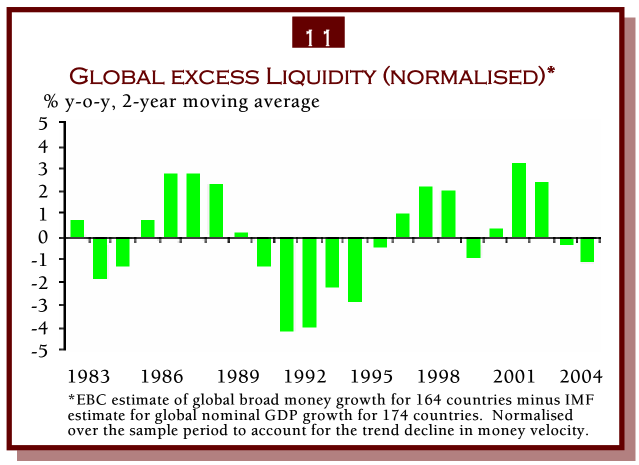








Source: Thomson Financial, Haver, Morgan Stanley Research



Graph Courtesy: Lehman Brothers

appear contradictory, deviating from past relationships, and they struggle to understand why.

For example, the inverted yield curve has presaged every recession since 1950, yet a recession seems remote today. Likewise, we've never seen housing starts fall by this magnitude or oil spike by this amount (Graph 8) without a recession following. The record current account deficit (Graph 9) ought to lead to a decline in the value of the dollar, a rise in inflation and higher interest rates, but none of these has occurred. Interest rates, both nominal and real, have remained well below GDP growth for years, and the return on capital has persistently been much higher than the cost of capital, contrary to economic theory, hence the record low spreads on risky assets and the surge in leveraged-buyout activity (Graph 10).

Numerous explanations have been offered for each of these apparently contradictory observations. Excess liquidity, seen in rising asset prices, particularly in riskier assets, is often cited as a cause of these imbalances, but the evidence for this is scant (Graph 11). Excess savings in the world, an explanation offered by Ben Bernanke (pre-Fed), doesn't quite mesh with the high level of economic growth. A recent proposition from Kenneth Rogoff of Harvard suggests that lower macroeconomic volatility justifies higher valuations for riskier assets.

All three of these explanations are plausible, and may have some validity to some extent, but we think there is something bigger, something special going on. We are in the midst of an explosion of wealth creation, unprecedented in scope and profound in its implications, emanating from the integration of previously disparate (and large) parts of the world into a (almost) truly global economy.

Michael Spence of Stanford (and a Nobel Laureate) has shown that wealth creation is characterized

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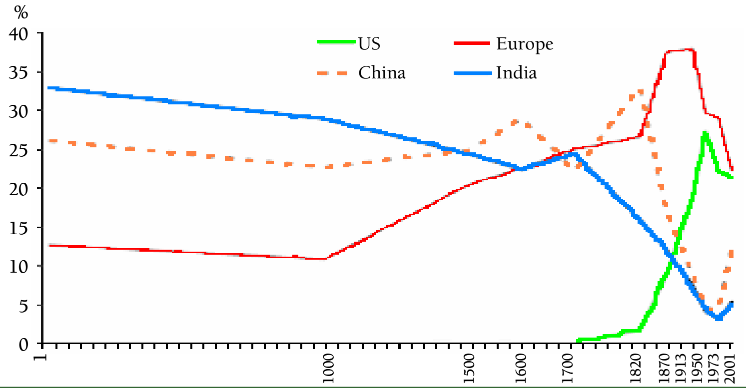
SHARE OF WORLD GDP



Source: Angus Maddison, The World Economy: Historical Statistics, OECD 2003
Graph Courtesy: Goldman Sachs

TABLE 1
SHARE OF WORLD GDP, REAL, PPP ADJUSTED

	0	1000	1500	1600	1700	1820	1870	1913	1950	1973	1998	2006
US	0.0	0.0	0.3	0.2	0.1	1.8	8.9	19.1	27.3	22.0	21.9	19.9
Western Europe	10.8	8.7	17.9	19.9	22.5	23.6	33.6	33.5	26.3	25.7	20.6	17.8
China	26.2	22.7	25.0	29.2	22.3	32.9	17.2	8.9	4.5	4.6	11.5	16.4
Other Asia	16.1	16.0	12.7	11.2	10.9	7.3	6.6	5.4	6.8	8.7	13.0	13.7
Latin America	2.2	3.9	2.9	1.1.	1.7	2.0	2.5	4.5	7.9	8.7	8.7	7.9
Japan	1.2	2.7	3.1	2.9	4.1	3.0	2.3	2.6	3.0	7.7	7.7	6.3
India	32.9	28.9	24.5	22.6	24.4	16.0	12.2	7.6	4.2	3.1	5.0	6.0
Former USSR	1.5	2.4	3.4	3.5	4.4	5.4	7.6	8.6	9.6	9.4	3.4	3.9
Africa	6.8	11.8	7.4	6.7	6.6	4.5	3.6	2.7	3.6	3.3	3.1	2.9
Canada/Australia	0.0	0.0	0.1	0.1	0.1	0.1	1.3	2.5	3.4	3.2	3.1	2.8
Eastern Europe	1.9	2.2	2.5	2.7	2.9	3.3	4.1	4.5	3.5	3.4	2.0	2.4

Courtesy: Bridgewater Associates

by high levels of investment, the application of technology or knowledge, a functioning market economy including price signals and legal protection of property, and an increase in the population that is productively employed. These are the factors we see present in China, to a large degree, and in other emerging economies. In China, which we'll use as the most prominent example of these phenomena, savings and investment are at very high levels, both around 50% of GDP. As the government has created a more attractive investment environment, China has been able to import the newest technologies, so that its manufacturing base is now the most efficient in the world. And labor mobility is present, allowing a more productive and growing work force. In 1980, more than 80% of China's population was rural; today it is less than 60%, and falling. Approximately 1% of the population, about 13 million people, migrates to cities each year.

Integrating into the global economy is critically important for developing countries. Integration allows countries to leverage demand, which may be constrained by the size or level of development of a country, and to leverage technology, which is otherwise unavailable domestically. The reduction in trade barriers and the improvements in transportation and communication technology over the past few decades have accelerated global integration, permitting a sustained period of wealth creation not seen for centuries.

China and India account for 40% of the world's population. When large, labor-intensive, high-saving, commodity-scarce economies join the global economy, economic theory predicts that the prices of labor-intensive goods will decline, the returns on capital will rise while labor's share of the profits decline, real interest rates will fall with the rise in savings, causing current account surpluses in these countries (and offsetting deficits in other countries), and higher productivity rates for the global economy as resources are more efficiently allocated. All of these factors are evident in the world economy today, all interconnected by the process of global integration.

This shift in wealth may cause angst in some but, barring some colossal leap of political stupidity (a non-zero probability, alas), is both inexorable and not without precedent. We are fond of very long-term data, and the accompanying Graph 12 and Table 1 show the allocation of the world economy over the past 2,000 years. The message we take from these is that a bet for a static allocation of global wealth is a foolish one. A

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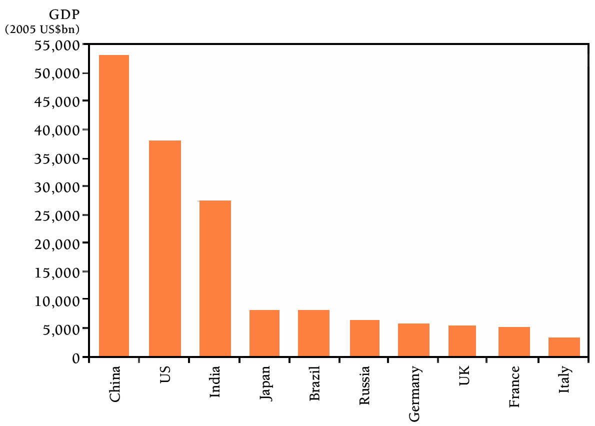
THE WORLD IN 2050



Source: Goldman Sachs

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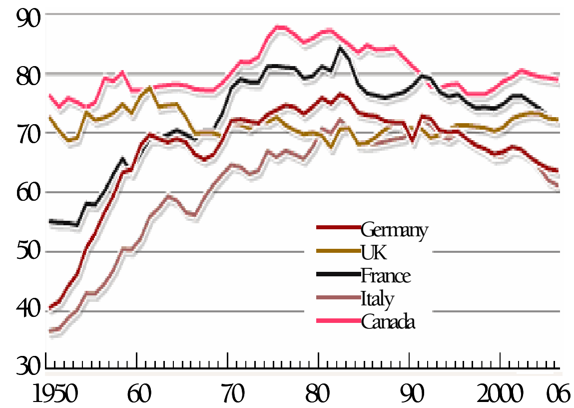
REAL GDP PER CAPITA AS A % OF US LEVEL



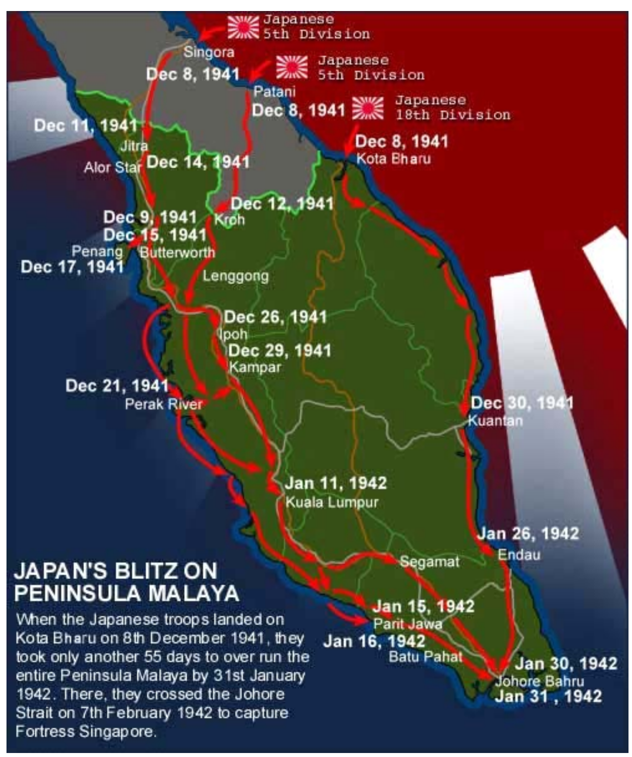
Graph Courtesy:: Financial Times

reasonable guess of what the near future will look like is found in Graph 13, from the crack economists at Goldman Sachs.

China, India, and others are playing catch-up. Starting from a low base, a modicum of application of these capitalist principles should (and has) resulted in rapid growth, and this will continue to play out. But as these economies develop, sustaining this pace becomes more difficult. Western Europe is instructive. In 1950, real GDP per capita in Germany and Italy was less than half that of the US. Within a generation, most of that gap had been narrowed, but then it stalled and has been declining over the past 25 years (Graph 14).

Ned Phelps of Columbia used his Nobel lecture last year to explain this convergence of wealth and its subsequent relapse. He distinguishes between capitalism and corporatism, where the former is marked by a high degree of market dynamism, openness to market signals and toleration, even embrace, of Schumpeter's forces of creative destruction. In his view, Europe chose to protect its economies from the dynamics of free enterprise while the US was more accepting of its effects. And so, there is a lesson for today's economic stars: rapid economic growth is more easily attained than sustained.

British reaction to the Japanese invasion of Malaysia was disbelief followed by inaction. No orders were given to engage the enemy, so the Japanese landed unopposed. Two days later, the entire RAF fleet was destroyed on the ground in Singapore. The Admiralty ordered its only two capital ships in Singapore, the *Prince of Wales* and the *Repulse*, to interdict the landing troops, but on 10 December 1941, both were sunk within 50 minutes of each other by Zero fighter planes. With the remnants of the American Pacific fleet limping back to California, the Imperial Navy had uncontested control of the Indian and Pacific Oceans. Meanwhile, the 65,000 Japanese troops in Malaysia, led by General Yamashita, had no artillery support and no mechanized transportation; incredibly, they walked or rode bicycles down the 550 miles of jungle and mangrove swamps.



Lieutenant General Arthur Percival, commander of the 90,000 British troops in Singapore, was a WW1 veteran and career officer, but this was his first command of an entire army corps. He did not do well. In keeping with longstanding strategy, he prepared defenses against a sea assault. He refused to fortify the north shore of Singapore Island, even as the Japanese advanced down the peninsula. And when the Japanese landed across the Johore Strait on the western part of the island, his troops were stationed to the south and east. Percival made some poor decisions, but lacked Napoleon's essential ingredient for success in a general: luck.

Singapore fell on 15 February 1942. It was, in Churchill's words, "the worst disaster and largest capitulation in British history." 100,000 were taken prisoner, and an estimated 50,000 civilians were slaughtered in the subsequent years. Percival spent the war in a POW camp in Manchuria.

The British made many tactical mistakes, but their biggest errors were strategic: their inability to see a threat, and their insistence that an attack could only occur from the sea. The least of the consequences of these errors was the end of the British Empire. The war in the Pacific was prolonged, resulting in the deaths of millions more combatants and civilians, and most of Asia was reduced to abject poverty at the end of the war.

Of course, Singapore is transformed today. Early decisions to establish property rights, to react to market signals, to join the global economy all served to take this tiny city-state from poverty on a par with the worst of African nations to one of the highest per capita incomes in the world today.

We love the idea of Sunday brunch at the Raffles Hotel on a warm, sunny morning. But one's place in the world is never permanent. Sometimes the threats are in front of us, and sometimes they are behind us. But they are never not there.

MICHAEL A. ROSEN
PRINCIPAL & CHIEF INVESTMENT OFFICER
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