Angeles
INVESTMENT ADVISORS

Market Commentary
Third Quarter 2008

Retreat

Michael Barclay de Tolly was neither French nor English, although his family traced its roots to the Barclay clan of Scotland. He was born in Lithuania, then part of the Russian Empire, to nobility, and as expected, joined the Tsar's army when he came of age. His career advanced methodically until the winter of 1809, as Russia and Sweden were fighting for control of Finland. Barclay de Tolly, at the head of a division, marched across the frozen Gulf of Bothnia, separating Finland from Sweden, captured the Swedish town of Umea, forcing Sweden to cede Finland to Russia a few months later. For his exploits, Barclay de Tolly was named Governor of Finland and then Minister of War in the Tsar's cabinet. When Napoleon crossed the River Neman on 24 June 1812 with over 600,000 troops, entering Russian territory, Tsar Alexander I turned to his Minister of War, and national hero, to drive the invaders back.

Speed was Napoleon's hallmark, as he had consistently surprised and outmaneuvered a succession of European armies. But speed carries the risk that a rapidly advancing army will outrun its logistics supply. In central Europe, densely populated and fertile, *la Grande Armée* could live off the land, and stretching its supply line was feasible. But the northeastern steppes of the European continent are sparse and stark, and as Napoleon advanced, Barclay de Tolly retreated, certain that the French would slowly starve. But his lack of aggression and concession of hundreds of miles of territory invited harsh critics. Following his retreat from the city of Smolensk, Tsar Alexander lost patience with his Minister of War, and turned to his father's favorite general, the 67-year old Mikhail Kutuzov, to assume command of the Army, bring the fight to Napoleon, and drive the French out of Russia. Barclay de Tolly, still Minister of War, was given a partial field command, reporting to Kutuzov.

Kutusov arrived at the village of Borodino in early September 1812, where Barclay de Tolly had established a defensive position outside Moscow. Here, Napoleon attacked, and 7 September became the bloodiest day in European history, with over 70,000 casualties.

The Battle of Borodino is often cited as the pivotal point of the Napoleonic Wars, but we'll argue that the turning point came later, and Borodino offers us few lessons. More relevant for investors today is Napoleon's broader strategy in Russia, and even more importantly, Russia's strategy in defense. The Russian bear gained strength, even in retreat, before

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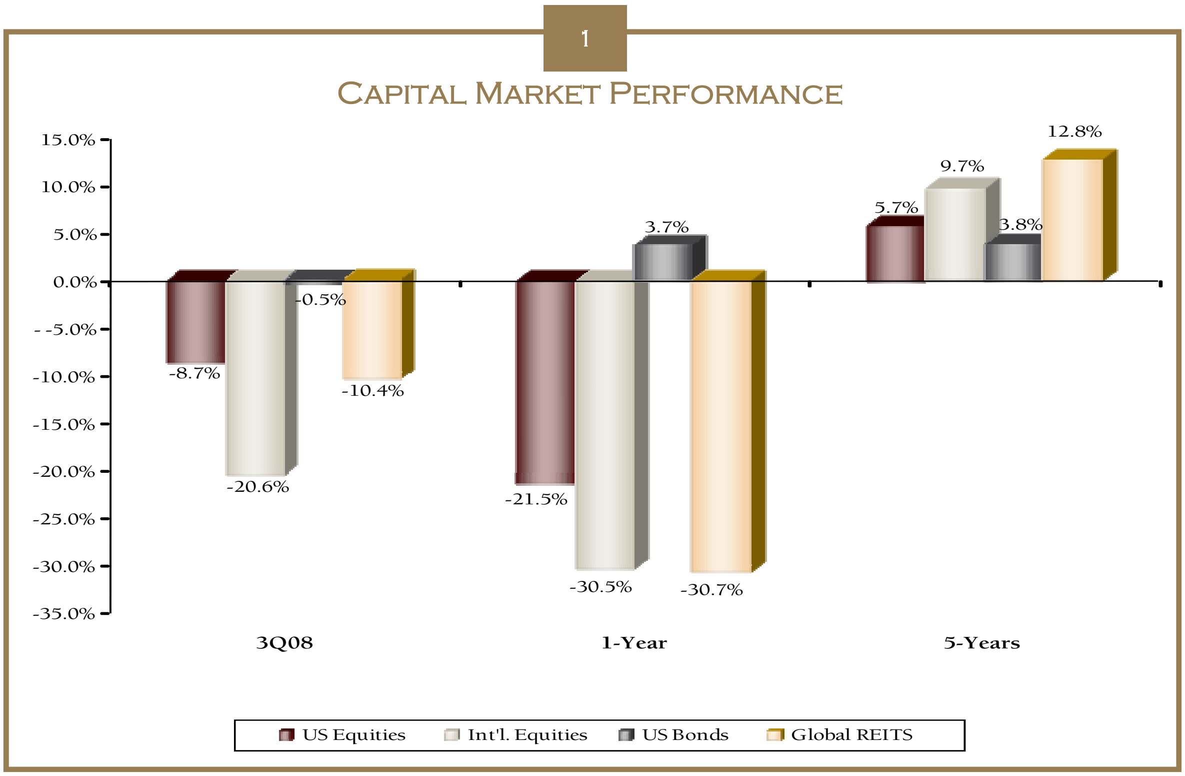

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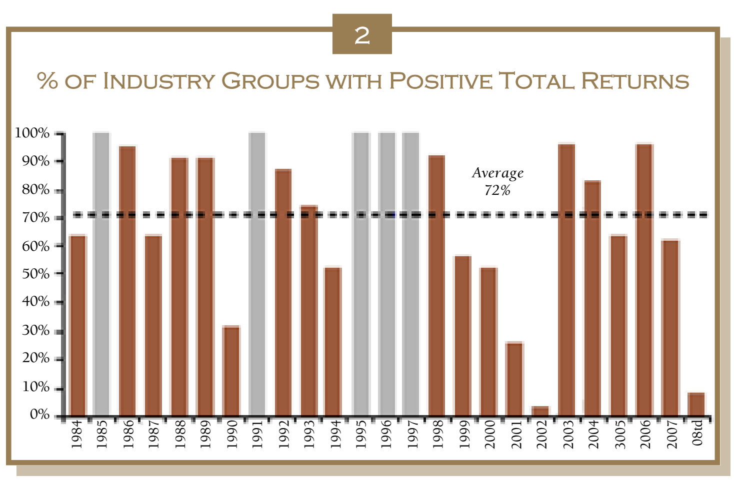
unleashing her fury, much as our bear market gathered strength last quarter, prelude to the coming disaster.

All major asset classes, globally, declined in the past quarter: equities, bonds, real estate, commodities, were all down. For US stocks, it was the fourth consecutive quarter of losses, the first such streak in thirty years. Outside of canned goods, no industry has been spared this year (see Chart 2). And excepting but three countries (Philippines, Tunisia and Vietnam, which inexplicitly jumped 33%), every developed and emerging equity market in the world declined. Especially hit were countries of the former Soviet Union—Ukraine, Kazakhstan and Russia—each down around 50% in the quarter. Russia's invasion of Georgia may have had something to do with that.

The end of September, with US equities off 21% from a year ago, marked the beginning of a bear market (unofficially described as a 20% decline), but it was only the beginning, because the markets imploded in October, at one point off more than 25% in the month alone (equities ended down 17% for the month). And did volatility return! From 2003 to 2007, there was not a single day in



Courtesy: Morgan Stanley

which US equities moved more than 4%; there were nine such days in October (besting the record of 8 set back in September 1932), making October the most volatile month in the 80-year history of the S&P 500 index. Volatility isn't unidirectional, and indeed, two of the biggest days up in history occurred in October. Take little comfort in that, as most of the other such days of dramatic gains took place between 1929 and 1933 (see Table 1), a rather unfavorable period for investors.

Equities may make the headlines, but they were tame compared to commodities and the credit markets.

There has been a massive, multi-year price boom across all commodities (see Chart 3), driven by the combination of strong demand, especially from emerging economies, low inventories and supply constraints. The current slowing of global demand and the beginning of supply responses have caused prices to tumble (oil fell 33% in October, its largest monthly drop on record), but inventories generally remain low and growth is still robust in many emerging economies. Higher volatility, for sure, but it may be premature to bet that prices will now be permanently depressed.

TABLE 1

LARGEST DAILY GAINS IN S&P 500

	Date	Pct.
1	30 Oct 1929	12.5
2	6 Oct 1931	12.4
3	5 Sep 1939	11.9
4	21 Sep 1932	11.8
5	13 Oct 2008	11.6
6	28 Oct 2008	10.8
7	22 Jun 1931	10.5
8	21 Oct 1987	9.1
9	14 Nov 1929	8.9
10	24 Jul 1933	8.8
11	8 Oct 1931	8.6
12	18 Dec 1931	8.3

Source: Bloomberg

For those who (still) believe in normally distributed capital market returns, the October decline in equities was a 4-standard deviation (sigma) event. That's rare enough (less than 0.1% of the time); the 16% declines in high yield bonds and bank loans were nearly 8- and 9-sigma events, respectively (see Chart 4, pg 4). These moments should occur once in approximately never.

"Equities may make the headlines, but they were tame compared to commodities and the credit makrets."

High yield bonds are priced for 25% default rates and 20% recovery rates, both more than twice as draconian as anything seen since the

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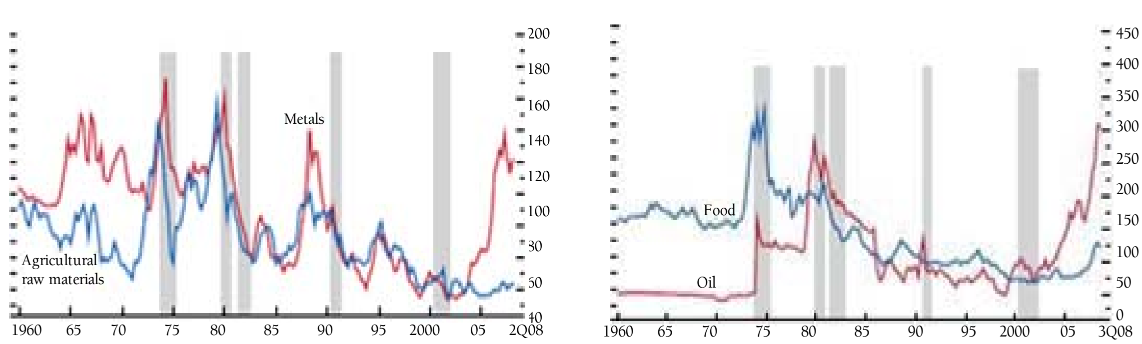
METAL AND AGRICULTURAL

FOOD AND OIL PRICES



Source: IMF Staff Calculations
1 Deflated by US Consumer Price Index (CPI).
2 Shading denotes periods of global recession (identified by a monthly index of global industrial production).

1930s. Investment grade credit had its worst month in its history (see Chart 5), and spreads are at levels last seen at the nadir of the Great Depression (see Chart 6).

It is arguable that the credit markets have priced in a worst-case scenario (although the bar for "worst-case" seems to shift frequently). But there is real economic pain behind these moves, borne principally by consumers.

> *"The housing market shows little indication of stabilizing and no sign of improvement."*

The housing market shows little indication of stabilizing and no sign of improvement. New home sales are off by a third over the past year while prices (Case-Schiller) are 17% lower. Delinquencies are at record highs, as are vacancy rates (see Chart 7, pg 5).

The asset side of the consumer's balance sheet has been slashed, as approximately $4 trillion of housing value has been erased in the last two years, and the 40% decline in equity prices add another $8 trillion of losses to households. The liability side is equally stressed with the massive, multi-year accumulation of debt (see Chart 8, pg. 5). It's no wonder that consumer confidence is at its lowest level since records were kept over forty years ago.

The US economy contracted modestly in the third quarter (-0.3% at first estimate), but the recession is likely to be severe and prolonged. Job losses are accelerating, hours worked fell to a record low and the unemployment rate has moved above 6%. Look for unemployment to move higher: 7, 8 or even 9% as the recession deepens. Business conditions are weakening too, with production and

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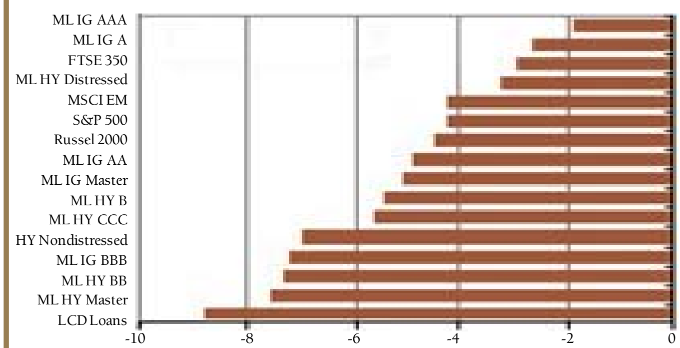
Oct 08' Sigmas



Source: Merrill Lynch

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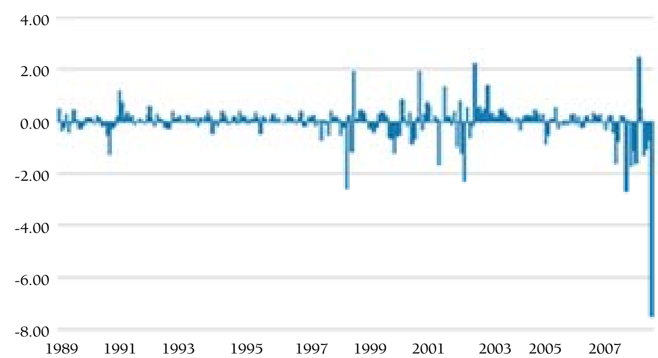
Monthly Investment Grade Excess Returns



Courtesy: Morgan Stanley; Source: Yield Book

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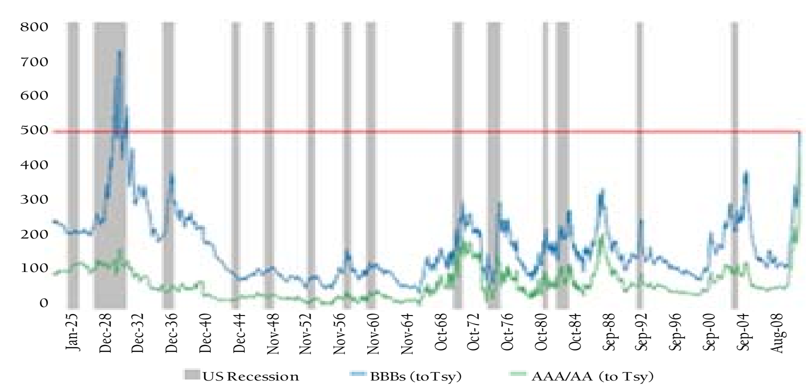
Credit Spreads, 1925-2008



Source: Morgan Stanley; Bloomberg, Moody's the Yield Book, the Federal Reserve

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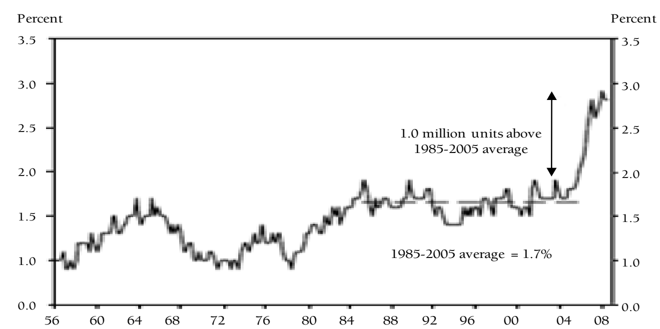
Homeowner Vacancy Rate



Source: Department of Commerce; Graph Courtesy : Goldman Sachs

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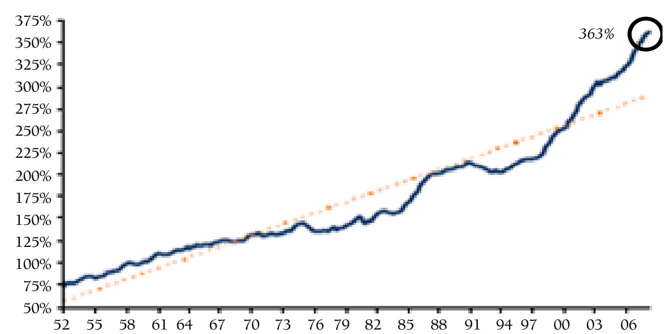
Private Sector Debt to Private Sector GDP



Source: Bloomberg L.P.

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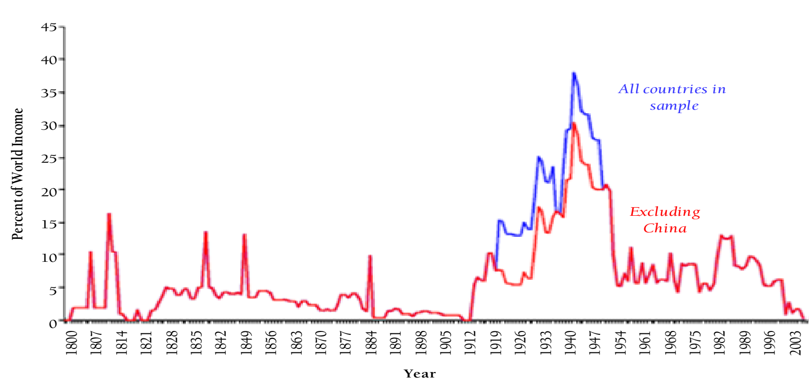
Sovereign External Debt: 1800-2006

Countries in Defaults Weighted by Their Share of World Income



Source: Carmen M. Reinhart and Kenneth S. Rogoff, This Time is Different: A Panoramic View of Eight Centuries of Financial Crises, *March 2008*

capacity use heading lower and corporate profits falling from record levels. Manufacturing is contracting at the fastest rate since 1982, and exports, recently the sole engine keeping the economy aloft, are slipping as the global economy slows. Europe and Japan have already been contracting for a few months, and growth everywhere is being revised lower.

Financial crises were found in small countries run by autocrats or in the history books. A 200-year perspective suggests this is largely accurate: there were defaults among a handful of autocratic countries in the 1980s and 1990s, a more widespread problem in the 1930s, and punctuated episodes throughout the 19th century, but entirely mitigated in recent years (see Chart 9).

The shock of the Asian Crisis of 1997-98, beginning with Thailand and culminating with Russia's default, taught the lesson that emerging countries need to accumulate foreign reserves, and their export-led economic development brought in huge amounts of reserves over the subsequent decade. Between 2000 and 2007, foreign currency reserves grew more than $5.2 trillion, representing about three-quarters of all the reserves accumulated in world history. These reserves were in amounts well above what could be absorbed in their domestic economies, and to prevent escalating domestic inflation, capital was recycled back to the safest, most liquid market in the world, US Treasuries. Of course, some money went into corporate debt and into equities, and not just in the US. This helped push interest rates lower,

"Look for unemployment to move higher: 7, 8 or even 9% as the recession deepens."

encouraging consumers to take on additional debt (see Chart 8 again, pg. 5).

This developed into a virtuous cycle, where rising reserves were recycled, encouraging consumption and debt, which fed back to accumulated wealth. An important aspect of this cycle was the lubrication supplied by Wall Street wizardry. Banks sliced, packaged and securitized (seemingly) everything, from home mortgages to credit card receivables to natural disaster insurance (and much more), and created new instruments derived from these various underlying securities. A decade ago, the notional value of all derivatives contracts was $75 trillion, about 2 ½ times world GDP; by the end of 2007 over $600 trillion of contracts were outstanding, about eleven times global output. But growth was strong and interest rates low for many years, and the extreme current account imbalances that transpired were believed sustainable, indeed necessary, to maintain the system's balance. It was a Minsky Moment.

"Hyman Minsky, an American economist who died in 1996, argued that financial stability was an illusion ."

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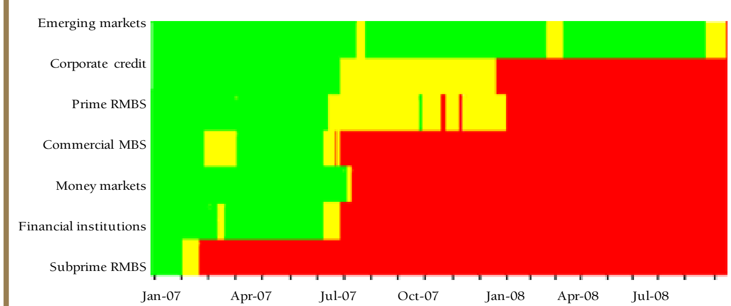
HEAT MAP: SPREADING SYSTEMIC RISK



Note: The heat map measures both the level and 1-month volatility of the spreads, prices, and total returns of each asset class relative to the average during 2004-05 (i.e., wider spreads, lower prices and total returns, and higher volatility). The deviation is expressed in terms of standard deviations. Green signifies a standard deviation under 1. yellow signifies 1-4 standard deviation, red signifies greater than 4 standard deviations.
MBS-mortgage-backed security; RMBS- residential mortgage-backed security.
Source: IMF

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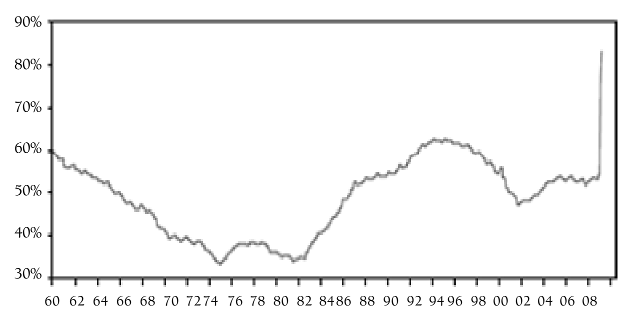
GOVERNMENT + FEDERAL RESERVE LIABILITIES AS % GDP



Courtesy: Bridgewater Associates

Hyman Minsky, an American economist who died in 1996, argued that financial stability was an illusion, that the very conditions of stability would inevitably lead to accumulated risks that would ultimately cause a collapse of the system. Cracks, in the form of rising delinquencies in subprime residential housing appeared in early 2007, and spread over the course of the following 18 months to other markets and around the world (see Chart 10). In a two-week period in early September, the US government nationalized Fannie Mae and Freddie Mac, guaranteeing more than $5 trillion of mortgages, nationalized (effectively) AIG, the world's largest insurance company and its trillion-dollar balance sheet, took equity stakes in the remaining largest banks in the country, extended deposit insurance to $3.4 trillion of money market funds and raised the FDIC deposit-guarantee at all banks, pledged $700 billion to buy busted mortgage assets, is now lending directly to corporations in the commercial paper market, and is considering multi-billion bailouts of what is left of the US auto industry, the airline industry, and every other group that has failed to compete effectively in the global markets. As a result, government liabilities have nearly doubled in the past two months (see Chart 11), and the Treasury will need to borrow over a trillion dollars in the coming year.

Borodino was a pyrrhic victory for Napoleon. The Russians suffered many more casualties but the French lost one-third of its army, and they could not be replaced. Recognizing that he could not defeat Napoleon in battle, Kutusov adopted the strategy of his predecessor, and still superior, Michael Barclay de Tolly. He ordered his army to withdraw, and the 270,000 residents of Moscow to abandon the city. A week after the battle of Borodino, on 14 September 1812, Napoleon entered Moscow, but far from triumphantly. No delegation received him, the Tsar did not offer his surrender (he was safely ensconced in St. Petersburg), and the city was empty of people and supplies. The next day, two-thirds of the city burned to the ground.

Leo Tolstoy, writing of the battle of Borodino in *War and Peace*, discredited Napoleon's genius: "it was not Napoleon who directed the course of the battle, for none of his orders was carried out and during the battle he did not know what was going on….It only seemed to Napoleon that it all took place by his will." (Napoleon) "did nothing harmful to the progress of the battle…but with his great tact and military experience carried out his role of appearing to command, calmly and with dignity". *La Grande Armée* was being devoured with each advance into the lair of the Russian bear.

Napoleon sat in the Kremlin as conqueror of Moscow, but he had achieved nothing. A month later, in the midst of the brutal Russian winter, he marched out of Moscow with his army. Along his retreat, the Russians attacked at his weakest points. All of his horses died or were eaten, so all canon and heavy artillery had to be abandoned, and by mid-December, the French were stepped out of Russian territory. In perhaps the greatest statistical graph ever drawn, Charles Minard plots the size of

"Napoloen sat in the Kremlin as conqueror of Moscow, but he achieved nothing ."

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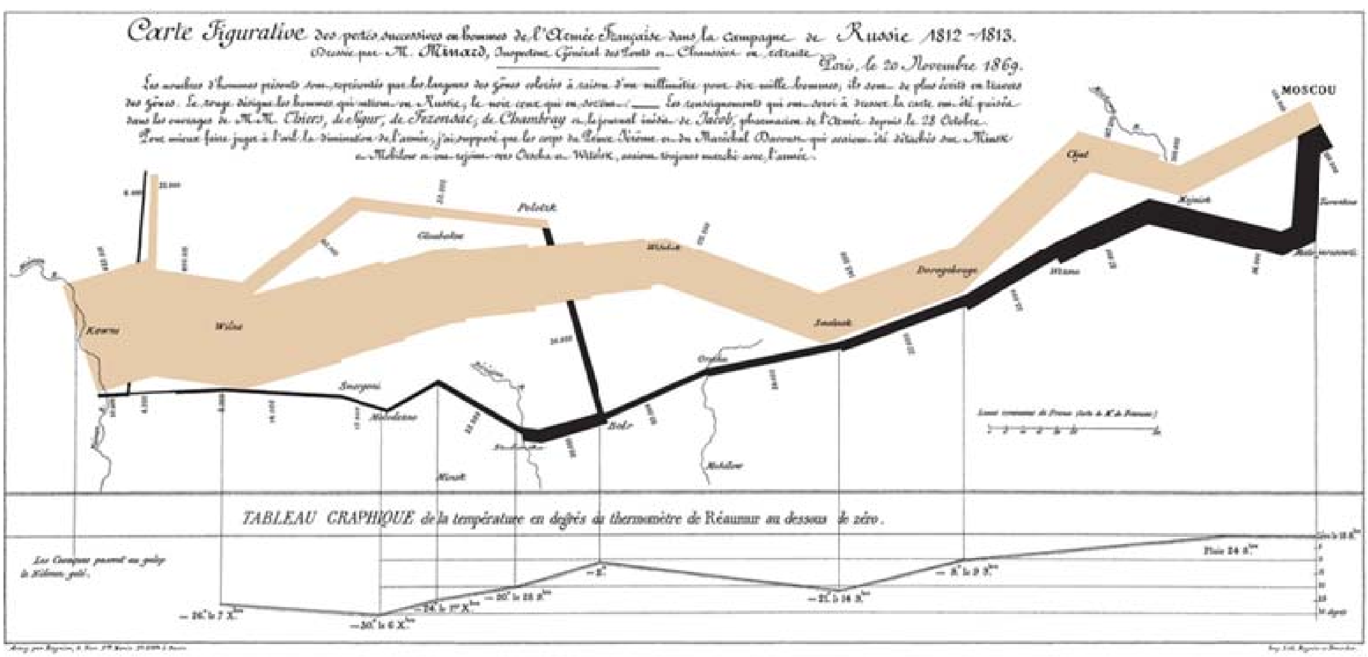
CARTE FIGURATIVE
DES PERTES SUCCESSIVES EN HOMMES DE L'ARMÉE FRANÇAISE DANS LA CAMPAGNE DE RUSSIE 1812-1813



Napoleon's *Grande Armée* as it entered and departed Russia versus time, geography and temperature (see Chart 12). He shows 422,000 troops crossing the River Neman into Russia, just 100,000 leaving Moscow, and only 10,000 making it back to France as the temperature plunged to -38°.

Barclay de Tolly's strategy of delay, retreat and scorched-earth played directly to the strengths of Russia and to the weaknesses of Napoleon. The nearly infinite reserves of Russian troops and the immense vastness of the country meant that with each step forward to Moscow, Napoleon was actually taking a step away from victory, allowing the Russian army to remain intact even in retreat. The turning point in the war, indeed the pivotal moment in European history, was when Napoleon entered Moscow, for he sealed his eventual fate. Napoleon was weakest at that point of victory, Russia strongest at that moment of defeat. When it was time, Russia gathered its reserves, eviscerating the French army as it retreated.

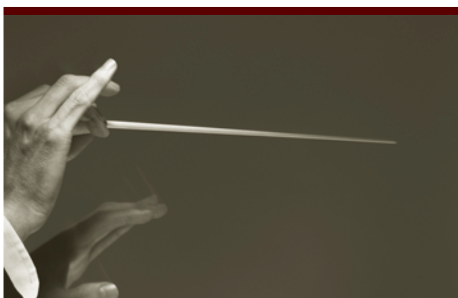
"In the face of market turmoil and dysfunction, nimble investors can retreat, build reserves, and wait."

Investors need to understand their own strengths, but that's not enough. We must also be aware of the nature of the investment environment. In the face of market turmoil and dysfunction, nimble investors can retreat, build reserves, and wait. When the moment is most bleak, when markets have priced assets for calamity without recovery, smart investors will advance, picking off the opportunities as they are encountered, whether that is credit at spreads not seen in 80 years, or distressed mortgages at pennies on the dollar, or equities or real estate or commodities.

The Tsar soon realized the strategic genius of his Minister of War, and restored him to command of the army. In April 1814, Michael Barclay de Tolly rode up the Champs-Élysées to the Arc de Triomphe, erected by Napoleon to commemorate his victory at Austerlitz, and announced the overthrow of the Emperor. The following year, Barclay de Tolly fought his last battle, leading the Russian invasion of France once again, this time deposing Napoleon for good. The Tsar made him a prince.

Barclay de Tolly understood his enemy and he understood his own resources. He saw that retreat would bring eventual victory, and knew when it was time to advance. We are building reserves; we are waiting to advance.

Founded in 2001, Angeles Investment Advisors LLC provides investment advice to select institutions and high net worth families and individuals.



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