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INVESTMENT ADVISORS

Commentary
Third Quarter 2009

Wilberforce

Britain's rise as the dominant world power for over four centuries was propelled by two foremost, and complementary factors: its mercantilist economic policies and the preeminence of the Royal Navy. It is moot as to cause-and-effect of these two forces, but it suffices to say that they were mutually reinforcing: the power of the Royal Navy enabled Britain to establish and expand its overseas empire (on which the sun never set), while the wealth of these colonies provided the financial support for the Royal Navy.

It was not the wealth, per se, of Britain's colonies that sustained the power of the Empire; Spain's possessions, for example, were arguably far wealthier. Rather, it was the mercantilist system that not only exploited the wealth of the Empire, but magnified it, thus allowing Britain to accrue enormous economic, political and military power. In its most simplistic form, mercantilism was based on the exchange of raw goods from the colonies for manufactured goods made in Britain. In practice, a triangular trade was at the core of the British mercantilist system: British manufactures, especially guns and ammunition, were sent to Africa for slaves, and slaves were shipped to the British West Indies and North America to work the plantations of sugar, tobacco and cotton, among other commodities, which were then sent back to Britain.

Thus did the British Empire rival, and in many ways surpass, the ancient Roman Empire for sheer breadth and world domination. Mercantilism was eventually discredited as an economic system by Adam Smith and David Ricardo, among others, for its inefficiencies, but it also came under attack (mainly by the Quakers) for moral reasons, since a key linchpin of the system was the slave trade. Unfortunately, evidence of the unimaginable abuses and arguments against the inhumanity and moral turpitude of this practice made little headway with politicians and the ruling class as long as the slave trade created enormous wealth.

We know that the slave trade was eventually abolished, but instead of exaltation, history has largely forgotten the man who, nearly alone for many years, championed its abolition. The patience, persistence, fortitude and determination of this exceptional man to persevere through enormous political obstacles over many years is inspiring, and holds lessons for us today.

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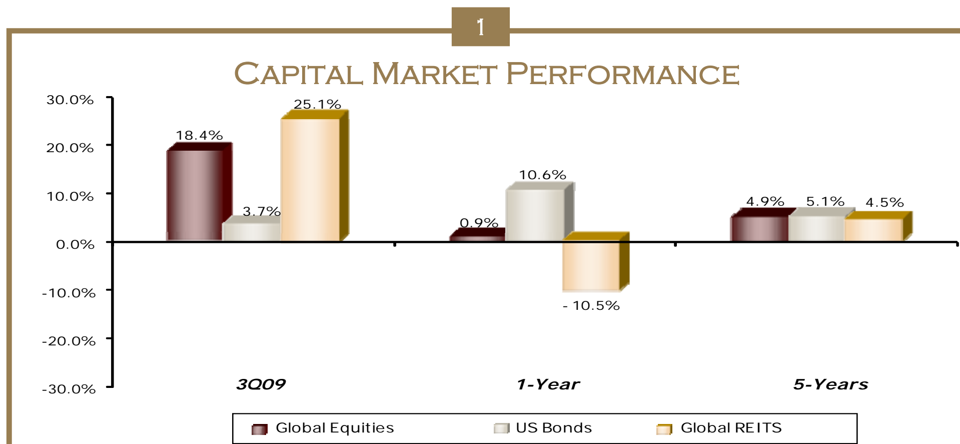
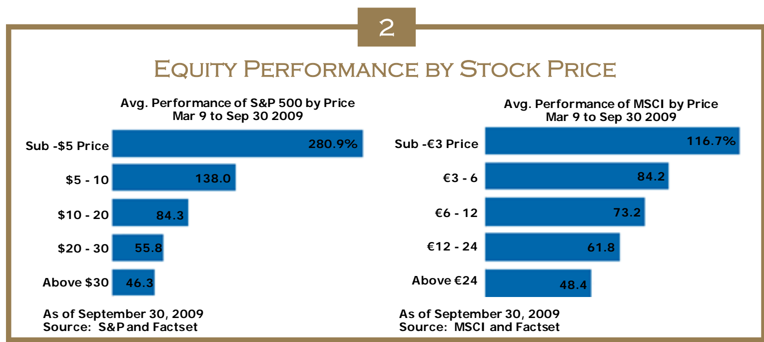
Appetite for risk was unslaked last quarter. Equities advanced in nearly every market, paced by Lithuania's 82% gain. Surprising laggards were oil-rich Nigeria and Bahrain, off more than 10% in the quarter and each down more than 20% for the year. In the first three quarters of 2009, Indonesia and Brazil have both doubled in value, but no market can touch Sri Lanka, up 152% in the first nine months of the year.



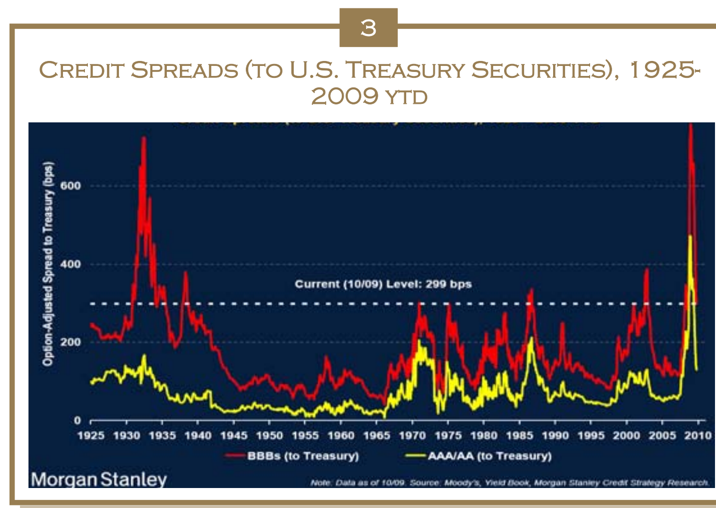
"Within the equity markets, risk has been amply rewarded."

Within the equity markets, risk has been amply rewarded. Companies that are most stressed, those with the lowest absolute share prices, have led this rally, more than doubling in Europe and nearly tripling in the US (see Chart 2).



Courtesy: Morgan Stanley

Risk was in the fore in other markets as well. Indeed, equities are plodding in comparison to the credit markets. High yield (née junk) bonds added 14% in the quarter, but the real juice was among securities in or near default; they surged 35%. Non-investment grade debt is having its best year in history, up 49% in 2009, but that masks the 105% gain in the lowest of the lowest credits. These phenomenal results must be seen in the context of the catastrophe of 2008. Spreads widened to apocalyptic levels, only to recover with remarkable speed (see Chart 3). It's as if the markets are determined to erase the memories of 2008 as an aberration; a nightmare to be sure, but

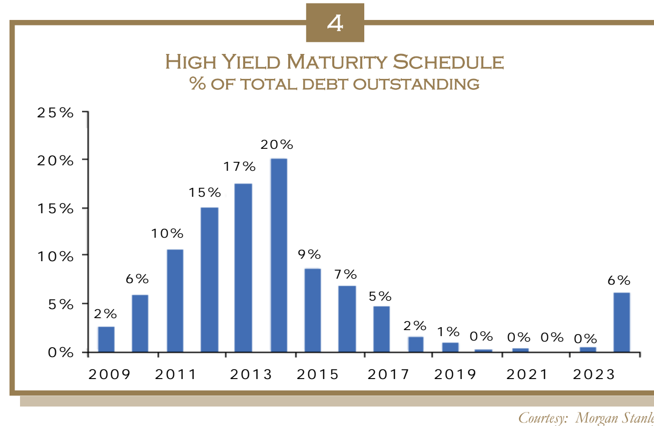


Sources Moody's, Yield Book, Courtesy: Morgan Stanley

transitory and blurry in the new light of day. The fact that 70% of outstanding high yield debt matures in the next five years is clearly a

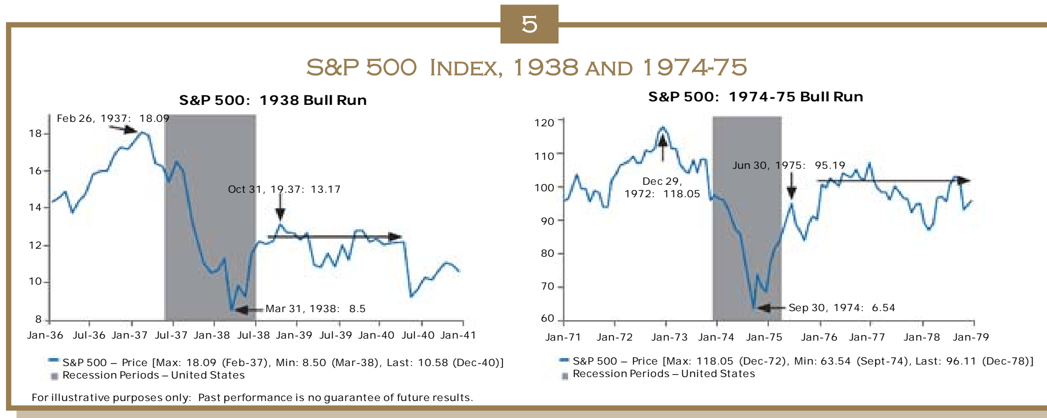
problem for another day (see Chart 4).

There are (thankfully) few historical examples of significant market declines amidst a troubling economic backdrop. But in the few we can find (1938 and 1974; see Chart 5), +50% rallies off the lows, as we've experienced this year, are expected. Subsequent performance, however, was less than stellar, for many years, and we may be advised to check our expectations.



Courtesy: Morgan Stanley

Avoidance of the apocalypse spurred this rally, but there have been positive economic data to

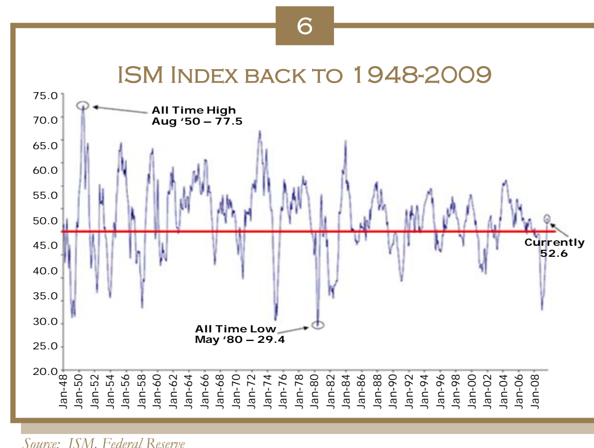


Source: FactSet Research Systems

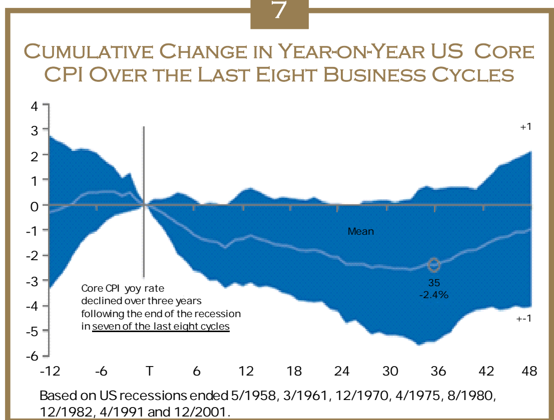
sustain it. Manufacturing is expanding, as signaled by the ISM diffusion index moving decidedly above 50 (the fulcrum between expansion and contraction – see Chart 6). Global semiconductor sales surged 8.2% in September, the seventh straight monthly gain, and the largest in over 23 years.

Productivity surged last quarter at a 9.5% annualized rate, helping sustain corporate profits, which have risen each quarter this year. Corporations have benefitted from falling wages and lower capital spending, and cash is building up as balance sheets strengthen.

Rising productivity is also favorable for inflation prospects, consistent with previous recovery periods (see Chart 7, pg. 4). Inflation typically falls, and productivity rises, as the economy rebounds as increased output is produced without requiring additional resources of capital or labor. Indeed, the economy is operating



Source: ISM, Federal Reserve



Source: NBER< Bureau of Labor Statistics, Goldman Sachs Research and MSIM

Table 1

Utilization Rates, Selected Data

Sector of economy	Current level (%)	Long-term avg. (%)	*Data since*	Excess capacity (std. deviations)
Goods sector				
Manufacturing capacity utilization	66.6	80.9	*1948*	2.9
ISM manufacturing operating rate	67.0	82.6	*1985*	3.7
Mining capacity utilization	82.2	87.3	*1967*	1.3
Service sector				
ISM non-mfg operating rate	80.1	86.1	*1998*	3.1
Hotel occupancy rate*	56.4	62.5	*1987*	2.7
Idle large commercial aircraft	8.4	5.4	*1975*	1.4
Utilities capacity utilization	78.7	87.7	*1967*	1.9
Housing/real estate sector				
Rental vacancy rate	10.6	7.2	*1956*	2.3
Owner-occupied vacancy rate	2.5	1.5	*1956*	2.5
Office vacancy rate	16.5	15.1	*1986*	0.4
Industrial vacancy rate	12.4	7.8	*1981*	2.1
Retail vacancy rate	17.6	13.9	*1982*	1.4
Labor market				
Unemployment rate	9.7	5.6	*1948*	2.7
Underemployment rate**	16.8	9.3	*1994*	4.1

* Seasonally adjusted by GS using Census X-12 procedure.
** Labor Department's "U-6" unemployment rate.
Source: Dept. of Labor, Dept. of the Census, Federal Reserve, Institute for Supply Mgmt, CB Richard Ellis, OAG Aviation, Property and Portfolio Research, Smith Travel Research.

Source: Goldman Sachs

> *"Among the most stable and broadest measures of economic health is found in power usage."*

well-below capacity, and it will likely be a number of years before we see more normal levels of employment and production. By some measures, spare productive capacity is the highest since the 1930s, at extreme levels in many industries (see Table 1).

All this spare capacity may alleviate near-term inflationary concerns, but it is a symptom of deeper economic stress, exemplified in the employment data (see Chart 8). The official unemployment rate spiked above 10% last month, for the first time since 1983, and in some ways, the picture is even worse. Hours worked are near record lows and the median duration of unemployment is at a record high (see Chart 9). Payrolls have declined more than 5%, the largest drop since records began in 1948. The broadest measure of un- and underemployment, counting people who have given up looking for jobs as well as those working part-time who would like to have full-time employment, is now at a record high 17.5% of the labor force. Employment follows economic recovery, but still, there are elements of the data that appear more structural than cyclical in nature. If so, expect elevated levels of unemployment for years to come.

Among the most stable and broadest measures of economic health is found in power usage. Power demand rarely contracts, even in recessions, yet 2009 will likely see the largest drop in

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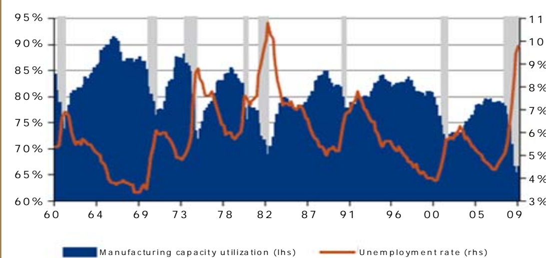
Mfg Capacity utilization & Unemployment Rate (%)



Sources: BEA and FRB

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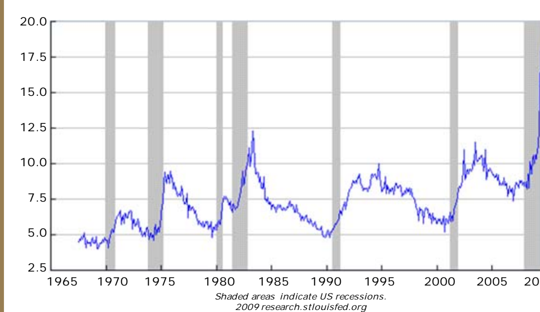
Median Duration of Unemployment



Source: U.S. Department of Labor: Bureau of Labor Statistics

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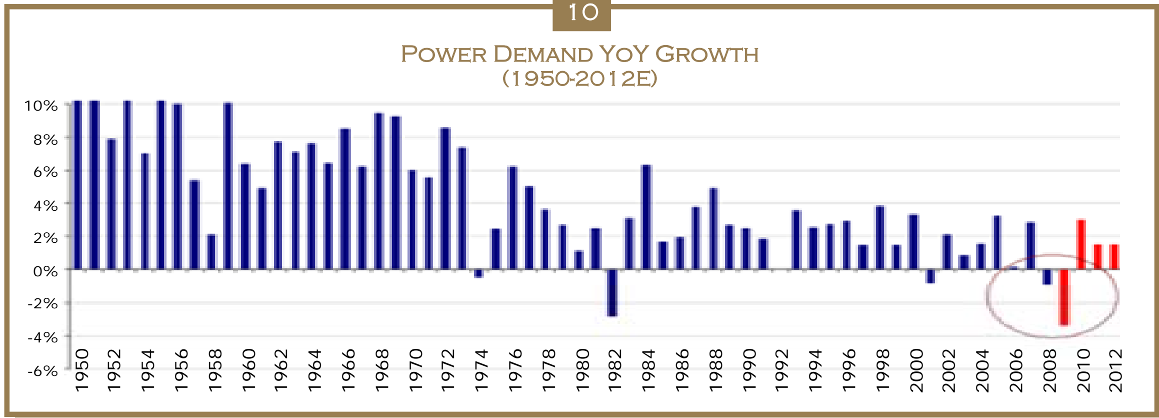

Source: Company data, Credit Suisse estimates, Bloomberg, Courtesy: Credit Suisse

demand in at least 60 years (see Chart 10).

Wealth was destroyed on a massive scale in the financial meltdown, and while some of it has been recovered, it will likely be years before former levels are attained. In 2008, every equity market in the world declined, as global equities lost nearly half their total value. Residential real estate values fell more than $5 trillion, and through mid-2009, nearly $30 trillion of household and investor wealth was erased. Some of that has been recovered with the rebound in equity markets, but the damage has been severe.

One of the drivers of global growth has been cross-border capital flows, which have exploded over the past two decades. These flows rose from $1 trillion in 1990 to more than $10 trillion in 2007, only to collapse last year (see Chart 11), and an important source of economic growth has yet to revive.

In addition to this loss of wealth, the financial crisis halted the three-decade expansion of global capital markets. For the first eight decades of the 20th century, financial assets grew in-line with GDP, with the exceptions of wars, when government debt surged. But from 1980-2007, world financial assets (equities, debt and bank deposits) grew four times as fast as the global economy. Liberalization and globalization of finance, and technological innovations such as derivatives and securitization, propelled this explosive growth in capital markets.

There are reasons to believe that the days of rapid growth of financial assets are over, at least in the developed world. Partly, this is political, as a tighter regulatory regime will im-

"One of the drivers of global growth has been cross-border capital flows, which has exploded over the past two decades."

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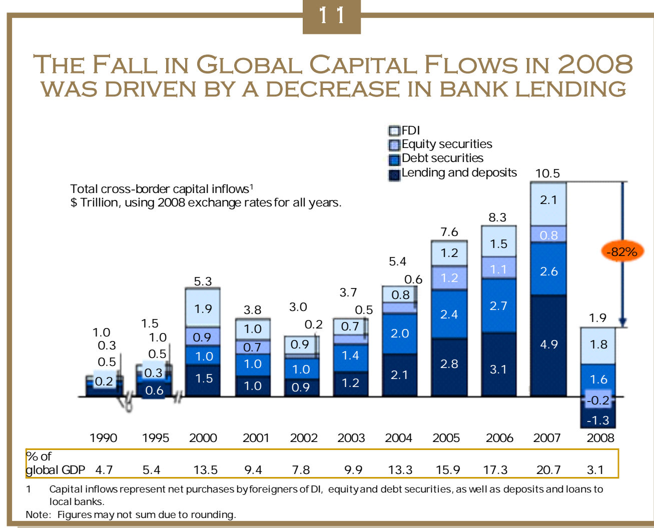

Sources: McKinsey Global Institute Cross-Border Capital Flows Database

pose limits on capital expansion. Mostly, it is the crushing burden of debt that will hinder growth.

Total US debt, as a percentage of US GDP, is now at a record high (see Chart 12). This is not a short-term phenomenon, a temporary spike due to one-off factors. Our debt ratio has been accelerating for 30 years. A positive aspect of leverage is that it magnifies growth; in other words, our growth rate has been higher than it otherwise would have been without the level of debt employed. Unfortunately, we've become very dependent (addicted?) on leverage, as we require an ever-increasing amount of debt to generate a unit of GDP. We are twice as dependent on debt for our growth as we were 30 years ago (see Chart 13).

Central banks responded to the financial crises with an unprecedented range of actions that averted a self-reinforcing spiral of deleveraging. Politicians then contributed massive fiscal spending programs of debatable value that ballooned fiscal deficits. US government debt is expected to expand from 63% of GDP in 2007 to 100% of GDP by the end of next year. Debt ratios are actually higher in Europe, and much higher in Japan, where a decade of fiscal stimulus programs has government debt already at 188% of GDP, going to 226% of GDP by next year. Government debt in the G-20 countries is projected to be 118% of GDP by 2014. Private sector debt has been swapped for public sector liabilities (see Chart 14), resulting in fiscal deficits of once-unthinkable magnitude for as far we can see.

The necessary deleveraging process was arrested in the midst of the crisis, but the day of reckoning can only be postponed, not eliminated. It seems axiomatic that debt needs to contract to a level that can be supported by income, a process that will be long and painful. The IMF estimates that banks globally have written off $1.3 trillion of assets, but will eventually have to realize total losses of $2.8 tril-

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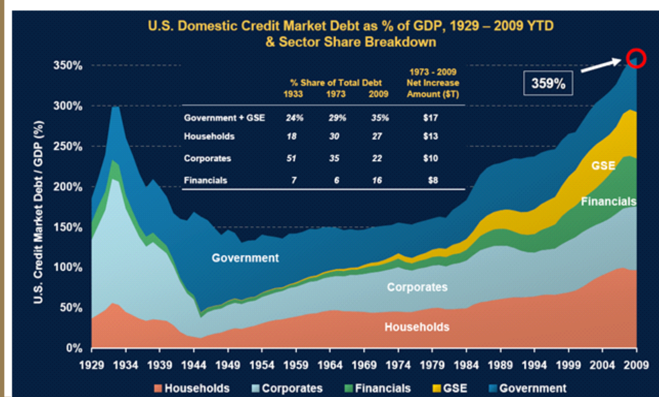
US Domestic Credit Market Debt as % of GDP, 1929-2009 YTD & Sector Share Breakdown



Note: 2009 YTD data as of CQ2; GSE (Government Sponsored Enterprises) debt includes various agency –backed mortgages;
Source: Federal Reserve, Ben Wattenberg, The Statistical History of the United States, From Colonial Time to the Present
Neil McLeish, Serena Tang, Morgan Stanley Research

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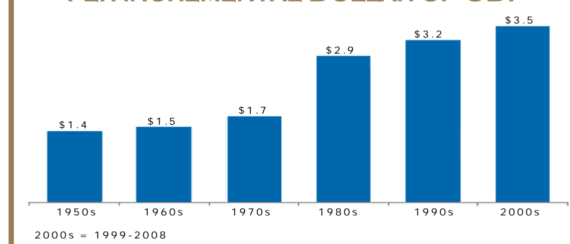
US Economy: Incremental Dollar of Debt per Incremental Dollar of GDP



Sources: Morgan Stanley Research, BEA, Federal Reserve and "The Statistical History of the United States" by Ben Wattenberg

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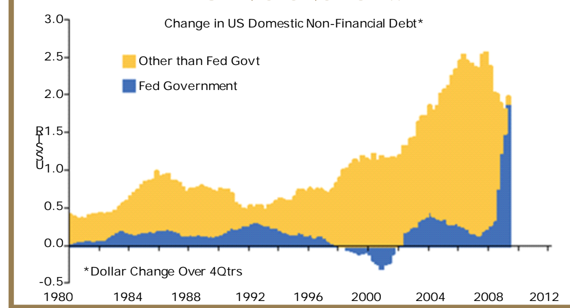
Debt Swapped from the Private to Public Sector..



Courtesy: Morgan Stanley

lion.

The fear in the developed world is the structural nature of these challenges: not just high unemployment, but longer unemployment; not just excess industrial capacity, but a permanent loss of production capacity; not a transitory spike in fiscal deficits, but a multigenerational debt burden.

Differentiation is not a feature of crises: a receding tide sinks all ships. Despite very different economic conditions and policies, all countries saw a sharp decline in output through 2008 to the beginning of this year, when paths then diverged. While the developed world hopes for signs of stabilization, emerging countries have rebounded sharply (see Chart 15). Fiscal surpluses, large international reserves and pro-growth policies apparently do matter.

US investors may have missed how much opportunity cost there has been in holding a preponderance of assets denominated in dollars. The growing current account deficit, requiring the US to attract an increasing amount of the world's savings, was funded by a combination of lower equity prices, higher interest rates and a weaker currency. For a decade now, US equity returns have fallen by 50% relative to non-US equities, in global currency terms, underperforming the average equity market by 10%

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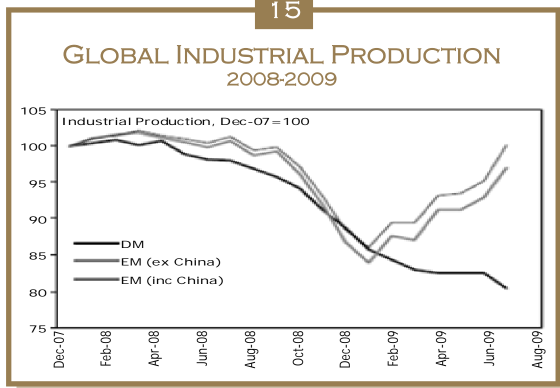
GLOBAL INDUSTRIAL PRODUCTION
2008-2009



Source: Goldman Sachs

per annum since 2002 (see Chart 16).

The "home bias," in which investors own a disproportionate amount of assets based in their home country, is prevalent for most investors, but there's an argument that investors' weight in emerging markets is far less than may be appropriate. Emerging markets represent 12% of the world equity capitalization index, but half of the world economic output, in currency-adjusted terms (see Chart 17, pg. 8). Perhaps the "natural" order of the world is where China and India alone account for half the global output (see Chart 18, pg. 8).

"Perhaps the "natural" order of the world is where China and India alone account for half the global output."

William Wilberforce[1] was born in Hull, county Yorkshire, in 1759, the only son of a wealthy merchant

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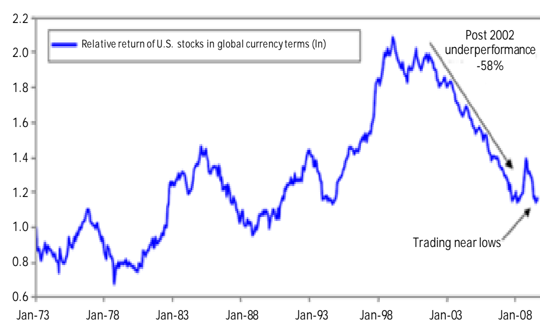
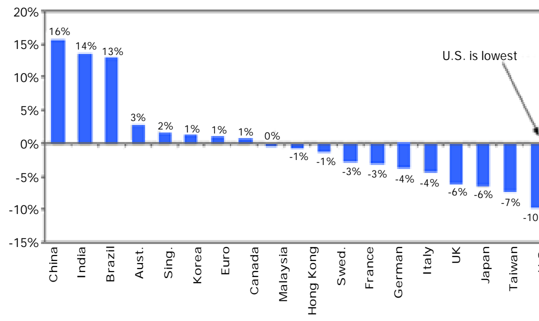
RELATIVE RETURN OF US AND NON-US EQUITIES, 1973-2009

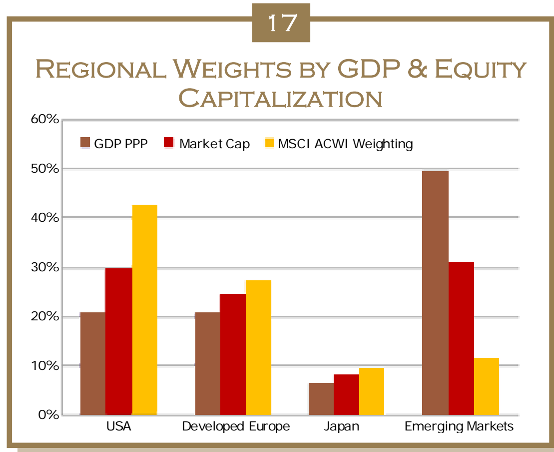


Courtesy: Bridgewater Associates

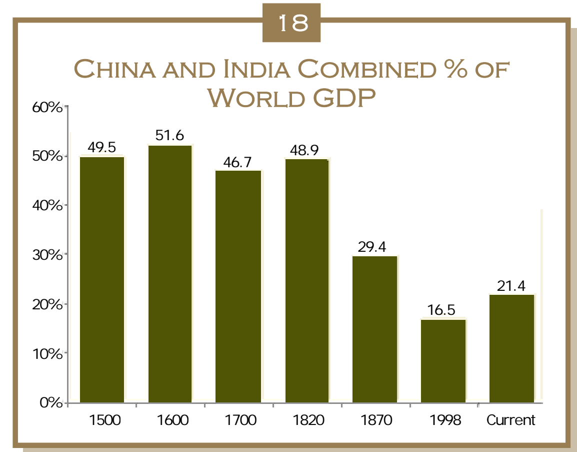
EQUITY RETURNS BY COUNTRY RELATIVE TO GLOBAL EQUITIES, 2002-2009



1 The name is likely derived from "wild boar forest."



Source: World Bank, Courtesy Everest Capital

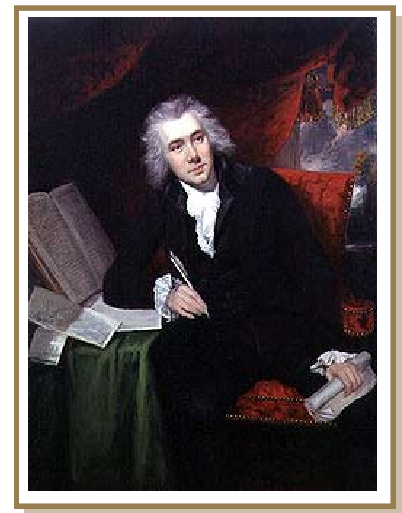


Source: Bloomberg, L.P., Courtesy: Gluskin Sheff

family. He entered Cambridge in 1776, where he met and befriended William Pitt, son of a former prime minister, and future prime minister himself. They would be lifelong friends and political allies. While still a student, Wilberforce was elected a member of parliament for Hull. By all accounts, he enjoyed the active social life of a young and wealthy up-and-coming politician.

As a boy, following the death of his father, he had been sent to live with relatives near London, relatives who were followers of the renowned evangelical Methodist minister, George Whitefield. His mother put an end to such shocking nonconformity by bringing him home, but the evangelical seed was planted, although it would lay dormant for many years. His religious conversion began on a trip to Europe in 1784, and he returned with an unshakeable religious conviction, harsh in self-criticism of his moral failings.

Under an oak tree at Pitt's home[2], Wilberforce first publicly expressed his misgivings about the slave trade to his friends Pitt and William Grenville, the current and future prime ministers. Pitt encouraged him to raise the issue in Parliament, but it took Wilberforce two years to muster the courage. In May 1789, Wilberforce rose to denounce the slave trade, presenting evidence of abuses and inhumane conditions. Opponents pressed to hear evidence



directly, and a vote was postponed. Again in 1790, Wilberforce raised the issue, and again Parliament delayed. The following year, Wilberforce introduced a bill to abolish the trade, but a conservative backlash following the terror of the French Revolution caused it to be easily defeated.

In each subsequent year, Wilberforce rose to denounce the slave trade and move its abolition, only to be voted down each time. In 1804, his bill passed the House of Commons, but too late in the session to be considered by the House of Lords. In 1805, it failed in the Commons. By 1807, Lord Grenville was prime minister, Pitt having died the year before at age

[2] The tree still stands at Pitt's estate in Kent, and is known today as the"Wilberforce Oaks."

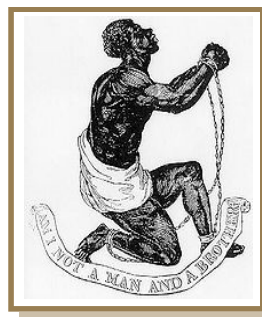
47. Grenville encouraged Wilberforce to rise again in opposition to the slave trade. Twenty years after his conversation with Pitt and Grenville, eighteen years after first raising his voice in Parliament, Wilberforce pleaded again for the abolition of the slave trade. As the vote was carried out, Wilberforce began to weep, as he saw the tide had finally turned: his bill had passed, 283-16 and the slave trade was officially abolished in the United Kingdom.

Despite the victory, and the hope that the end of the slave trade would lead to the end of slavery, the practice persisted, as few countries joined suit[3] and many British ships circumvented the law. Prohibiting the trade did not inhibit the institution, and so Wilberforce argued again each year in Parliament for the outright abolition of slavery. In 1833, Wilberforce contracted influenza. The 74-year old made a final public speech against slavery, and in July, the government honored Wilberforce by formally introducing in his name a bill for the abolition of slavery. Three days later, Wilberforce died, and the next month, Parliament passed the Slavery Abolition Act, freeing the British Empire of slavery. Wilberforce had asked to be buried with his family, but at the insistence of Parliament, Wilberforce was buried at Westminster Abbey, close to his friend, William Pitt.

It is worth quoting from his speech to Parliament in 1791, years after he decided to press for the end of slavery, but many, many years before he was to attain that goal:

Let us not despair; it is a blessed cause, and success, ere long, will crown our exertions. Already we have gained one victory; we have obtained, for these poor creatures, the recognition of their human nature, which, for a while was most shamefully denied. This is the first fruits of our efforts; let us persevere and our triumph will be complete. Never, never will we desist till we have wiped away this scandal from the Christian name, released ourselves from the load of guilt, under which we at present labour, and extinguished every trace of this bloody traffic, of which our posterity, looking back to the history of these enlightened times, will scarce believe that it has been suffered to exist so long a disgrace and dishonour to this country.

Wilberforce fought for twenty years to abolish the slave trade, and fought for another 26 years after that to see the end of slavery altogether. His persistence and perseverance strike us as extraordinary, even more than 200 years later. Our own economic challenges are not over; indeed they may only be beginning. William Wilberforce's example reminds us success can be achieved, if the cause is just, given sufficient determination and time.



3 The United States abolished the slave trade in 1808.

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MICHAEL A. ROSEN
PRINCIPAL & CHIEF INVESTMENT OFFICER
NOVEMBER 2009

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