Angeles
INVESTMENT ADVISORS

Commentary
Fourth Quarter 2009

Apology

Scuola di Atene, Raphael, 1510; Apostolic Palace, Vatican

It was a time of political tensions, when the resilience, even the very existence, of democratic society was being severely tested, by external threats and internal dissentions. As democracy had flourished, the state and its citizens prospered: the arts thrived, great public buildings were erected, but jealousies festered and the state was attacked, first by a mortal outside enemy, and then by internal factions. The democracy was overthrown, but briefly, and the citizens quickly rallied to restore the old order. A general amnesty was declared, to heal old wounds, but the sustenance of democratic rule was by no means certain.

The most respected voice among the *populi* was that of a venerable philosopher, who had taught many of society's leaders. Widely acknowledged as the wisest man alive, his incessant quest for truth often rankled those he queried, as he doggedly exposed the ignorant and the imposters. In times of peace and prosperity, his irritable nature was tolerated, even admired, for he brought wisdom and knowledge to the people, but in these troubled times he was seen more as an instigator of unrest, even a threat to democracy.

All acknowledged his brilliance, and his wisdom had been confirmed by the highest authority, a revelation by the Oracle. But he did not embrace their form of democracy for he believed the people lacked virtue, and were thus unworthy to rule themselves. Enlightened philosophers who had obtained knowledge were the only proper leaders of the people, a view, given the precariousness of the democracy, that was interpreted as seditious. This cantankerous, irritating, exasperating old man may be a wise philosopher, but he was a growing annoyance and a perceived threat to public order. And so, he was put on trial.

His was no ordinary trial; not only is it the oldest recorded trial in history, it is the most famous trial of all time. Its myriad lessons have been studied and debated for over two millennia, generating reams of legal and philosophical scholarship. But there's one lesson, at the root of the charges levied against this great and dif-

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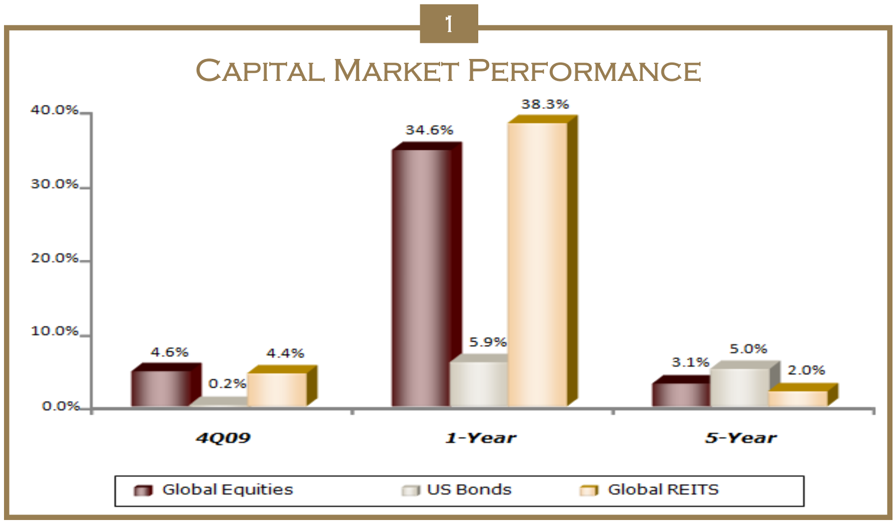
ficult man, with particular meaning for us today.

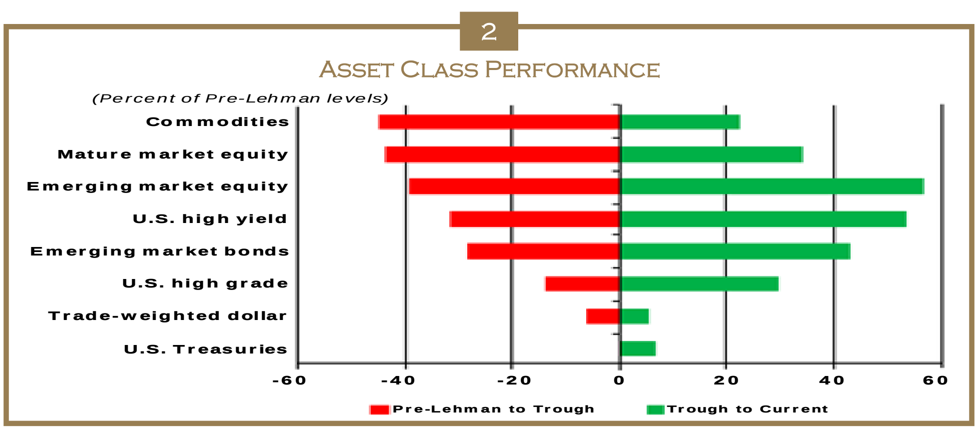


Quarter-end marked also the turning of a year as well as the closure of a decade. It was quite a year and quite a decade, for quite different reasons. It was a good quarter, and despite the horrid start, a phenomenal year for equities and most risk-oriented assets. Global equities were up more than 4% in the past three months, and nearly 35% in 2009. Greece was the big loser among equity markets in the quarter, plunging 23%, although it still managed a 20% gain for the year. The big winners in 2009 were in the emerged (neé emerging) world: Brazil and Indonesia rose 120% while Russia and India doubled. The year's grand winner, with a 184% jump was…Sri Lanka (you probably knew that). There were some losers to be found last year, surprisingly among commodity producers: Nigeria and Ghana dropped a quarter of their value and Bahrain lost more than a third.

"...it capped the close of an awful decade, worse, even, than the 1930s in nominal terms...."

Surprising, because commodities generally had a great year, driven by China restocking its inventories. Energy and precious metals gained about 25%, and industrial metals nearly doubled, led by copper, lead and zinc. There must be plenty of wheat and hogs, though, as those prices fell by a quarter last year. Commodity investors may not have fully participated in the overall gains, however. The spot prices of the underlying commodities in the S&P/GSCI index jumped 50% last year, but the total return to financial investors was slashed to 13%. The discrepancy was due to "negative roll" in futures contracts, a technical term that often dominates the returns to commodity investors.

The brightest star in 2009 was the credit market, and the lower the credit the higher the return. AA-rated bonds rose a respectable 9% last year, but BB-rated bonds, the highest in the non-investment grade universe, gained



Sources: Bank of America Merrill Lynch; Bloomberg L.P.; and IMF staff estimates

46%. All child's play, though, as CC- and D-rated bonds (companies in or near default) soared 136%. As you might expect, 2009 was by far the best year on record for the credit market (*n.b.*: 2008 was, by far, the worst year on record). Indeed, the record declines in 2008 were followed by record gains last year across many asset classes (see Chart 2, page 2).

While 2009 was a richly rewarding year for equity investors, it capped the close of an awful decade, worse, even, than the 1930s in nominal terms, and worse than the 1970s in real terms (see Table 1).

TABLE 1

ANNUALIZED MONTHLY TOTAL RETURNS BY ASSET CLASS AND DECADE

Decade	S&P 500	Small Cap	Govt Bonds	Corp Bonds	Cash	Copper	Real Estate	US CPI
1930's	-0.1	1.4	4.9	6.9	0.6	-3.6	-1.2	-2.0
1940's	9.2	20.7	3.2	2.7	0.4	4.1	8.1	5.4
1950's	19.4	16.9	-0.1	1.0	1.9	6.0	3.0	2.2
1960's	7.8	15.5	1.4	1.7	3.9	4.7	1.8	2.5
1970's	5.9	11.5	5.5	6.2	6.3	7.1	8.0	7.4
1980's	17.5	15.8	12.6	13.0	8.9	0.4	6.6	5.1
1990's	18.2	15.1	8.8	8.4	4.9	-2.8	2.5	2.9
2000's	-1.0	5.2	7.7	7.5	2.8	13.7	4.3	2.6

Source: Bloomberg; Ibbotson; BofAML Investment Strategy
Notes: Real Estate based on Case Hiller annual data 1930-1999, monthly data thereafter (updated as of October 2009); CPI data as of November 2009; Corporate bonds are high grade

A closer look reveals that the decade was "lost" only for investors in developed market equities. There were gains to be had elsewhere in the world and among other asset classes. Every emerging country equity market rose in the past decade (Taiwan was the lone exception), led by Colombia and Peru, each up more than 20% *annually* for the past ten years. As a group, emerging market equities rose 10% per annum over this span.

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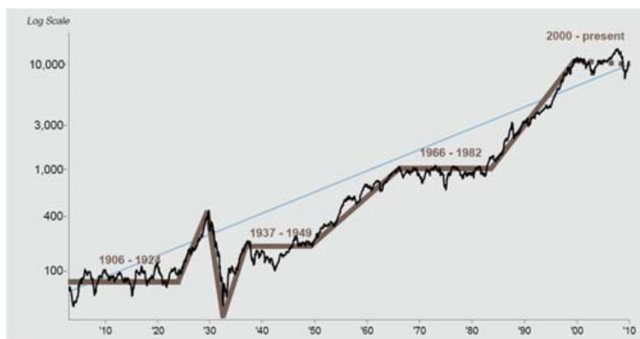
DOW JONES INDUSTRIAL INDEX PRICE RETURN (SINCE 1900)



Source: IDC, FactSet, J.P. Morgan Asset Management
Data shown in log scale to best illustrate long-term index patterns. Data are as of 12/31/09.

Interest rates generally declined throughout the decade, leading to strong returns for bonds. Inflation was moderate, lower than the previous decade, which perhaps explains the good results for fixed income. But commodities, seen as inflation-sensitive, had stellar gains as well in this low inflation decade. We can surmise that it was not inflationary pressures that pushed commodity prices higher, but the simple forces of supply and demand. Years (decades) of underinvestment on the supply side (when was the last oil refinery built, or a new copper mine opened?) met the full force of three billion people entering the world economy and demanding a rising share of goods and products.

"Lost" decades are an integral part of the market's history. Indeed, the past century contained three such periods of zero nominal gains lasting, on average, more than 15 years (see Chart 3). Of course, this is in nominal terms; in real (inflation-adjusted) terms, "lost" decades can last much longer than a decade. It may be some time, perhaps another decade, before the old highs are broken in real terms.

We do enter the new year with some positive economic momentum. Corporate profits bottomed a year ago and are rising strongly. Broad economic output troughed in the middle of 2009, with real GDP rising a robust 5.7% in 4Q. Housing prices have corrected and the employment data seem to be stabilizing, and job gains, finally, are expected in 2010.

Housing affordability, defined as the ratio of home prices to wages, is as attractive as it has been in over thirty years, and the inventory of homes on the market has fallen below seven months, in-line with historical averages. But the data may mask underlying stress. There has been an enormous government effort to forestall the foreclosure process, keeping additional homes off of the market. More than 10% of loans are in serious (>60 days) delinquency, translating to about 5.6 million borrowers. At the current pace, more than two million are entering serious delinquency annually. These delinquent homes do not (yet) show up in the inventory data. But approximately 30% of home sales, about 1.7 million, are distressed sales, so the rate of distressed sales is a little less than the rate at which borrowers are entering delinquency. Despite the recent (modest) rise in national home prices, this potential overhang of distressed homes may weigh on housing prices for some time.

"And we had never had (post-war) more than three million people unemployed for longer than six months; today there are more than six million."

Even if supply and demand were in rough balance, the housing sector has stabilized at very low levels. Housing starts have fallen to around 500,000 units annualized, well below the long-term average of 1.5 million, and the lowest in at least forty years (see Chart 4).

The housing bust is one aspect that characterizes the recent downturn as different from previous ones and may help to explain why the recovery is likely to be tepid. Historically, housing busts are associated with high excess capacity in the economy that takes years to redress. This keeps pressure on interest rates for some time; the average trough in rates occurred four years after the bottom of economic output.

Perhaps the most troubling aspect of our current economy is the condition of employment. In some respects, it was a lost decade economically as well.

The unemployment rate seems to have stabilized (for now) around 10%, a bit lower than the post-war peak of 10.8% in 1982,

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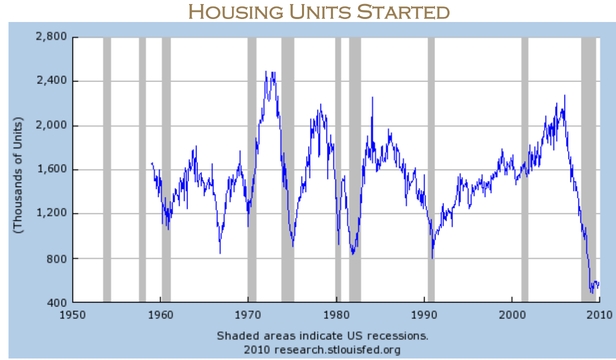
HOUSING STARTS: TOTAL: NEW PRIVATELY OWNED HOUSING UNITS STARTED



Source: U.S. Department of Commerce: Census Bureau

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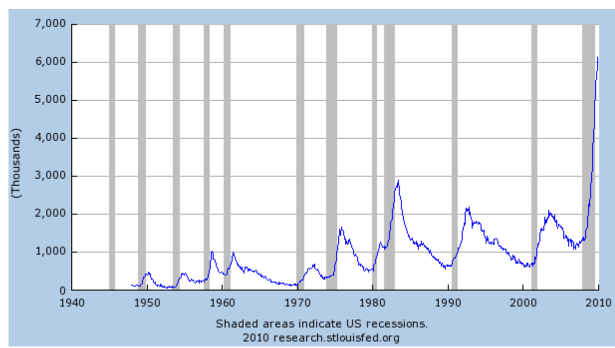
CIVILIANS UNEMPLOYED FOR 27 WEEKS AND OVER



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

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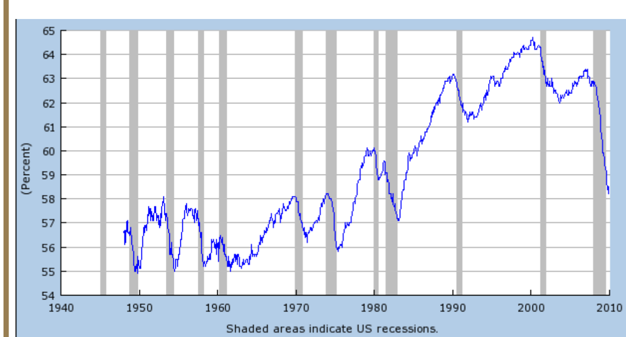
CIVILIAN EMPLOYMENT-POPULATION RATIO



Source: U.S. Department of Labor: Bureau of Labor Statistics but when we include those who are discouraged from looking for work as well as those working part-time, this broader measure of unemployment rises to 17.3%, easily a record high. Equally disturbing has been the increase in the duration of unemployment. The previous record high in the median duration of unemployment was 12 weeks; today it is greater than 20 weeks. And we had never had (post-war) more than three million people unemployed for longer than six months; today there are more than six million (see Chart 5, page 4).

Most distressing is the unprecedented decline in our productive capacity from the drop in the labor pool. Approximately 131 million people are employed (down from a peak of more than 146 million less than two years ago), which is about the same as ten years ago, despite an increase in the labor pool of 13 million people. The employment-to-population ratio has fallen to 58% from more than 64% in the past two years (see Chart 6, page 4), the fastest decline on record and back to levels in the early 1980s when women began entering the workforce in numbers.

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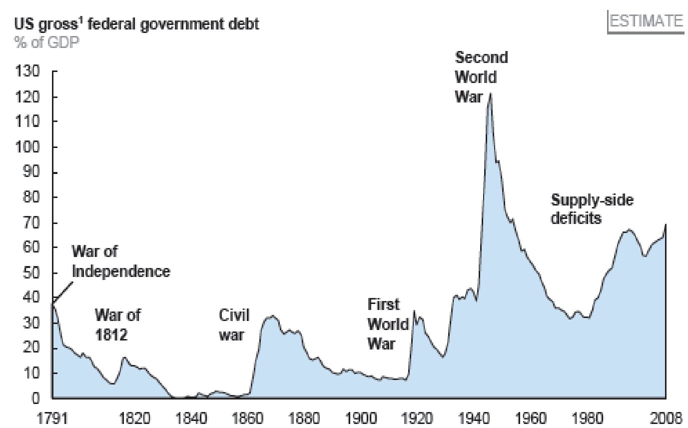
US GROSS[1] FEDERAL GOVERNMENT DEBT



[1] To Construct this long-term time series, we use US gross federal debt which includes debt held by the public as well as intra-government holdings; this methodology differs from the methodology we use to construct the medium-term time series across 14 countries (mainly that the long-term time series includes debt owed to social security funds, but excludes state debt); see Appendix A: Technical Notes for more details.
Source: US Treasury Department; McKinsey Global Institute

If this were a cyclical downturn in employment, we could envision a return to full employment in a few years. But the sheer number of un- and underemployed, and the length out of the labor force, augers for a sustained period of high unemployment, and a significant drag on the growth potential of the economy. This is a significant structural challenge.

"The employment-to-population ratio has fallen to 58% from more than 64% in the past two years..."

Underlying our economic challenges is the accumulation of debt. Total debt in the US is more than three times GDP, above the previous high seen in 1933. Federal government debt peaked at 120% of GDP in World War Two, fell to near 30% in 1980 and has been growing ever since (see Chart 7, which is shown only through 2008). This past year, federal debt rose to 84% of GDP, and government estimates (never especially accurate or conservative) show our debt-to-GDP ratio rising above 110% in the next few years.

Recent work by Kenneth Rogoff and Carmen Reinhart highlight the dangers of excessive debt[1]. Looking at 44 countries over 200 years they found that a debt-to-GDP ratio under 90% had no discernable impact on either infla-

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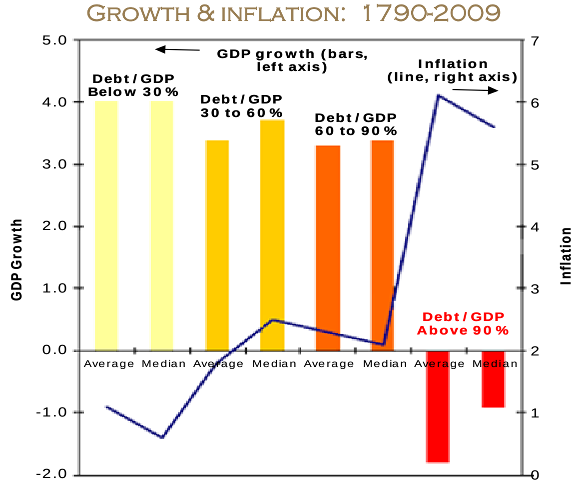
U.S. CENTRAL (FEDERAL) GOVERNMENT DEBT, GROWTH & INFLATION: 1790-2009



Notes: Central government debt is gross debt. The number of observations for the four debt groups are: 129 for debt/GDP below 30%; 59 for debt/GDP 30 to 60%; 23 observations for debt/GDP 60 to 90%; and 5 for debt/GDP above 90%, for a total of 216 observations.
Sources: International Monetary Fund, World Economic Outlook, OECD, World Bank, Global Development Finance, US Treasury Direct, Reinhart and Rogoff (2009) and sources cited therein.

[1] Rogoff, Kenneth S. and Carmen M. Reinhart, *Growth in a Time of Debt*, January 2010.

tion or economic growth. But once the debt ratio rises above this level, there is a clear decline in output and a rise in inflation. In the US over the past two centuries, high levels of debt have reduced GDP growth by 1-2% and more than doubled the rate of inflation (see Chart 8, page 5).

The nature of debt accumulation is important as well. Debts acquired during war are "less problematic for future growth and inflation than debts that are accumulated in peace time." This is due to the twin factors that post war there is a natural decline in government spending, and growth tends to be higher as resources are redirected to the civilian (productive) economy. Peace-time debt accumulation often reflects unstable underlying dynamics that can persist for a long time.

Private debt, unlike public debt, declines rapidly for an extended period following a financial crisis. These periods of deleveraging result in much slower economic growth and much higher levels of unemployment (see Chart 9).

It's not clear why there are thresholds in debt, or what is magical about a 90% debt-to-GDP ratio. There may simply be a "tipping point," beyond which investors demand increasing risk premia, forcing governments to reduce spending to retain some credibility.

Rising risk premia is occurring. The cost of insuring against borrower default is already less for many corporations than it is for sovereign countries. In the US, the CDS spreads (cost of default insurance) for companies such as Microsoft, IBM, H-P, 3M, Baxter, General Dynamics is less than 30 basis points, below that of the United States government. Put differently, the market assigns a (modestly) higher probability of the U.S. Treasury defaulting on its debt than those of

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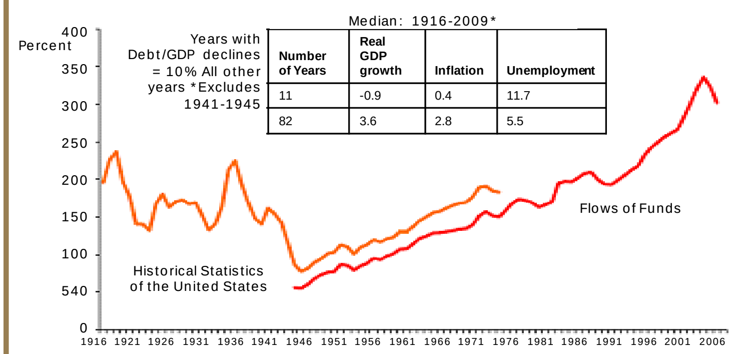
US: PRIVATE DEBT OUTSTANDING, 1916-2009
(END OF PERIOD STOCK OF DEBT AS A % OF GDP)



Note: Data for 2009 is end-of-June. The years with private debt/GDP annual declines greater than or equal to 10 percent are: 2008 and 2009.
Sources: Historical Statistics of the United States, Flow of Funds, Board of Governors of the Federal Reserve International Monetary Fund, World Economic Outlook, OECD, World Bank, Global Development Finance and Reinhard and Rogoff (2009b) and sources cited

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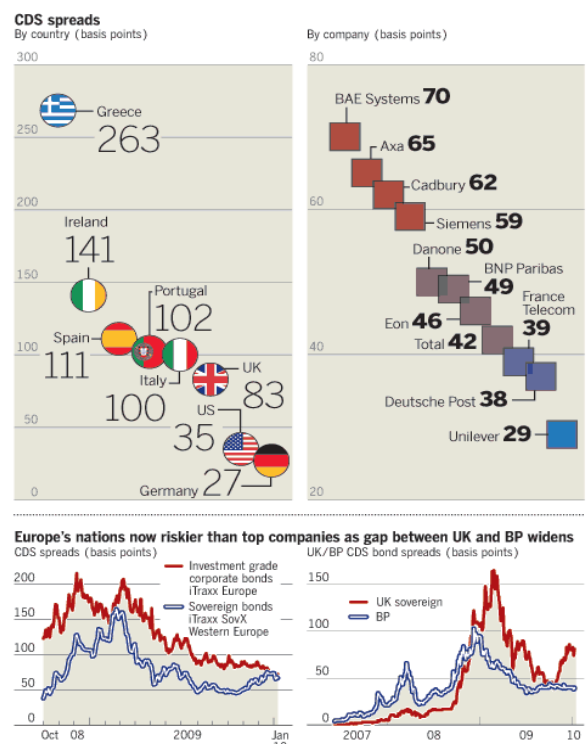
SOVEREIGN RISK FEARS TRUMP CORPORATE JITTERS



Source: Markit *Courtesy: Financial Times.*

TABLE 2

WE HAVE OBSERVED 4 ARCHETYPES OF THE DELEVERAGING PROCESS

	Archetype	Number of episodes after a crisis (total[1])	Description	Examples	Years
1	**"Belt-tightening"** *Most common deleveraging path*	**16** (23)	▪ Episodes where the rate of debt growth is slower than nominal GDP growth, or the nominal stock of debt declines	▪ Finland ▪ Malaysia ▪ US ▪ S. Korea	91-98 98-08 33-37 98-00
2	**"High inflation"** *Absence of strong central banks, often in emerging markets*	**8** (12)	▪ Periods of high inflation mechanically increase nominal GDP growth, thus reducing debt/GDP ratios	▪ Spain ▪ Italy ▪ Chile	76-80 75-87 84-91
3	**"Massive default"** *Often after a currency crisis*	**7** (7)	▪ Stock of debt decreases due to massive private and public sector defaults	▪ US ▪ Argentina ▪ Mexico	29-33 02-08 82-92
4	**"Growing out of debt"** *Often after an oil or war boom*	**1** (3)	▪ Economies experience rapid (and off-trend) real GDP growth and debt/GDP decreases	▪ US ▪ Nigeria ▪ Egypt	38-43 01-05 75-79

1 Includes 13 deleveraging episodes that were not preceded by a financial crisis.
Source: McKinsey Global Institute

these companies. The story is similar in Europe where, with the exception of Germany, a number of leading companies are seen as less likely to default than their sovereign counterparts (see Chart 10, page 6).

Price clears a market. Countries have already increased their borrowings (the supply of US Treasuries increased 36% last year), and will borrow even more in the upcoming year. Unless there is a commensurate rise in investor demand, prices will have to fall.

Historically, countries don't often grow their way out of a debt crisis. Most of the time growth is much slower than normal. High inflation and wholesale defaults are the other (less common) paths out of a debt crisis (see Table 2). Let's hope that a prolonged period of slow growth is our fate.

Five hundred men were selected by lots to serve as jurors for the trial, as stipulated by law. They gathered in the morning to hear the charges read by a herald: impiety and corrupting the youth. The accusers were given three hours to assert their case, and no record of their comments survives. The accused then rose, slowly, for he was a frail 70 years old, to present his defense, his apology. Not a sound was heard in the agora, the center of the city where the trial was heard, as all strained to hear the words of the greatest philosopher they had known, surely among the greatest in all of recorded history, Socrates.

Historians remain perplexed, 2,400 years later, how a free and democratic society could put on trial a 70-year old philosopher for his teachings over a lifetime. Some speculate it was politically motivated, others see a personal grudge, but the trouble probably started years before on a visit to the Oracle at Delphi. Socrates' friend, Chaerephon, decided to ask the Oracle whether there was any man wiser than Socrates. The Oracle answered no; no man is wiser than Socrates.

"Historians remain perplexed, 2,400 years later, how a free and democratic society could put on trial a 70-year old philosopher for his teachings over a lifetime."

Now, everyone knew that the Delphic Oracle sometimes spoke in cryptic terms, and Socrates could not believe the revelation was true. He ventured forth to determine the meaning of the Oracle's words by questioning people he thought may be wise, hoping to refute the prophesy with proof of a wiser man. He started with a politician that many thought very wise, but discovered that he really was not wise at all, pointed this out to the politician and incurred his inevitable wrath. As he left, Socrates thought to himself that neither one of them really knew anything, but that he had a slight advantage in that Socrates knew he didn't know anything but the other man did not know his own ignorance. This process of inquisition continued, with poets and artisans and men of wealth, with Socrates never finding a man wiser than himself. He did not endear himself to the citizens of Athens.

By a vote of 280-220, the jury found Socrates guilty, and arguments for his sentencing ensued. The accusers had demanded death, and Socrates had the chance to speak again on his behalf to propose an alternative punishment. Had Socrates offered exile as his sentence it would certainly have been granted. Instead, he proposed that he should live out his years in the Prytaneum, the lodging reserved for Olympian heroes, with free room and board. The jury was not amused, and voted 360-140 to condemn him to death, as Socrates surely knew they would.

In the audience taking notes was his 24-year old pupil named Plato. The account of this trial, in fact, all we know of Socrates, came from Plato, for Socrates himself left no written record. Plato ascribed all of his thoughts to Socrates, and it remains in dispute how much of Plato's writings reflect Plato and how much reproduce Socrates' ideas. We will never truly know the answer, but it is clear that the source of the wisdom of Plato, and of his pupil, Aristotle, was Socrates.

The Death of Socrates, Jacques-Louis David, 1787; Metropolitan Museum of Art, New York

We may perform our duties well, or we may fall short, but every day we are humbled by the challenges we face and humbled by the trust others put in us. Socrates knew he possessed no wisdom, so he spent his life in its pursuit. He chose to interpret the Oracle's words, "No man is wiser than Socrates," to mean that no man is wise. Indeed.

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

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