Angeles Investment Advisors

Commentary
First Quarter 2010

One

Near Granada, capital of Andalucía in southern Spain, sits the Alhambra, literally, "red palace," one of the most extraordinary edifices in the world. It is a paramount exemplar of the superlative design and decoration of Moorish architecture, and a fitting symbol of the wealth and power of its Arab rulers. But barely a century after its completion, the Catholic army of Castile had advanced to its walls, and centuries of Arab domination of the Iberian peninsula was about to end. In 1491, the then-current (and last Arab) occupant of the palace, Emir Mohammed XII, signed the Treaty of Granada, formally ceding the region to Castile, but protecting the religious rights of Muslims and Jews. Three months later, Queen Isabel of Castile and King Ferdinand of Aragon entered the palace and issued the Alhambra decree, revoking the religious rights of Jews and ordering their conversion or exile. Many, perhaps more than half, found safety in Portugal, until the Inquisition was established there in 1536. Many Jews did convert (the so-called *conversos*), but many only converted publicly and were suspected of secretly practicing their religion. Among these *marranos* was the Espinosa family that settled near the town of Vidigueira.

The pressures of the Portuguese Inquisition mounted, and sometime in the early 17th century the family escaped to Nantes in France. They were expelled in 1615 and found refuge in Amsterdam, where they were able to practice their religion openly. The family became successful merchants, wealthy and respected in their community, and in 1632, a son was born and named Baruch, meaning blessed, as indeed they were.

The boy began a traditional religious education, studying the holy texts and commentaries, and developed a reputation as an exceptionally bright student. When he was six years old, his mother died, and just as he came of age, his father died too and the family business collapsed. To make ends meet, Baruch turned to grinding glass into lenses. The rest of his life would be spent in study and lens grinding.

This placid appearance of quiet study and sim-

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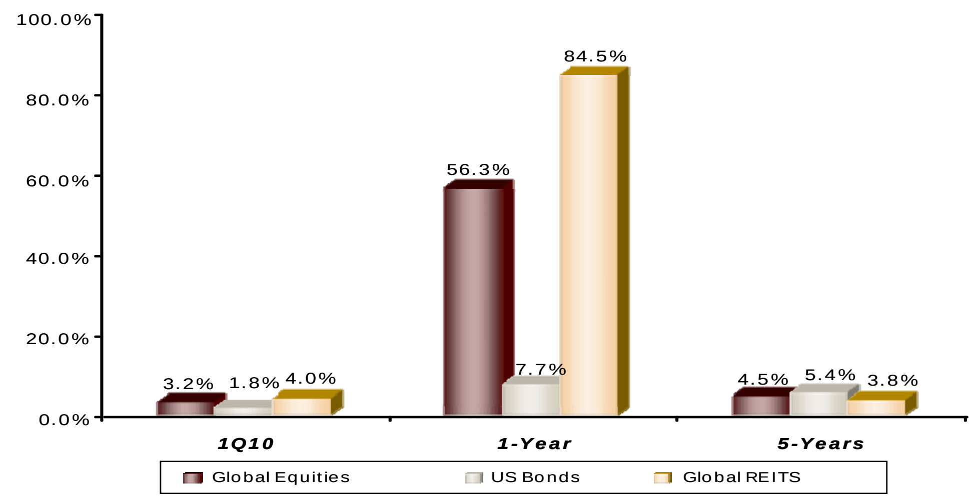
ple work and his outwardly tranquil demeanor belied the turbulence provoked by his unsettling ideas. Ostracized by the community for his controversial, heretical beliefs, he would be forced into exile, unable to publish his writings in his lifetime. Eventually his ideas would make it into print posthumously, and would come to form the basis of modern philosophy. His insights are more relevant today than they were 300 years ago, and they help us understand the complexities of our world by challenging our beliefs, just as he did in his time.

1

CAPITAL MARKET PERFORMANCE



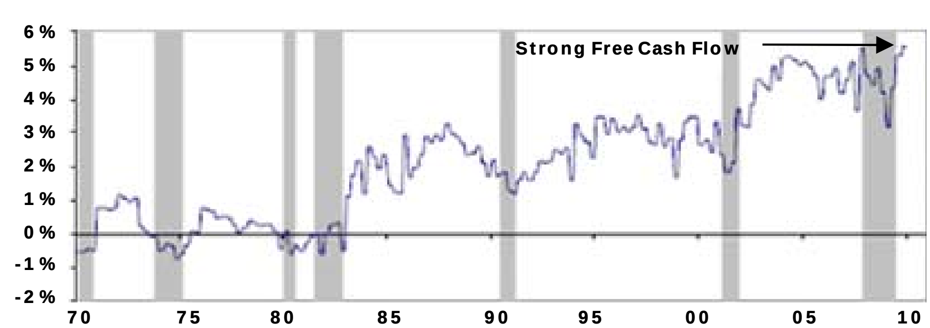
"the world economy is expanding...."

Calendar year 2010 began on a positive note, with all major asset classes posting gains. Of course, not every country sailed through the quarter: Greece and Spain saw their equity markets fall 13% and 16%, respectively, although both are still well above levels of a year ago. The fundamental backdrop for investors has been about as favorable as can be, with profits booming (see Chart 2), modest inflation and low interest rates. And there could be more to come, as even the 70% rise from trough back in March 2009 counts as about average among the 34 cyclical bull markets in the US since 1900.

The world economy is expanding, with real GDP growth in excess of 4% expected this year. Final demand is very strong in the developing world, while in the developed world growth has come from a pick-up in the inventory cycle and a moderation of some previous deteriorating trends, especially in employment. Still, US Real GDP grew at a solid annualized rate of 3.2% in the first quarter of this year, led by a surge in capital expenditures (+13.4%). The growth rate in the US economy may lag

2

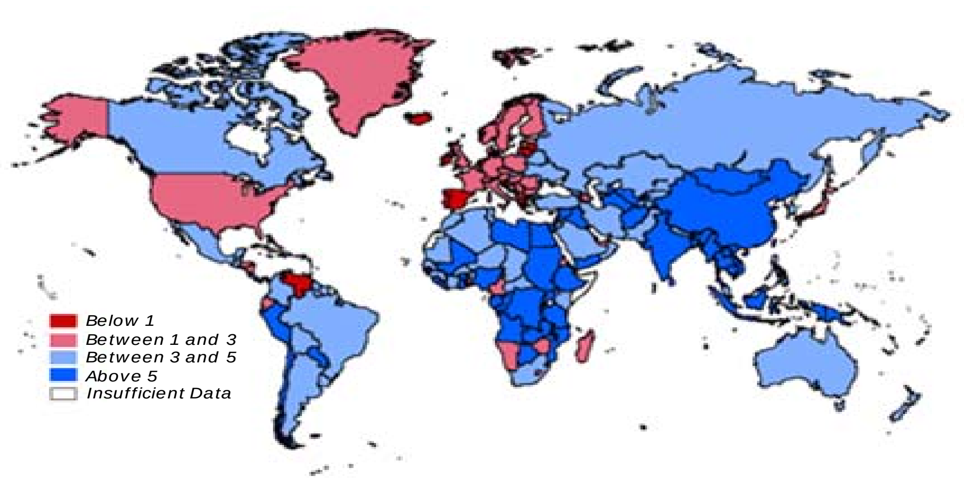
NON FINANCIAL CORPORATIONS: FREE CASH FLOW % POT GDP



Courtesy: Bridgewater Associates

3

AVERAGE REAL GDP GROWTH DURING 2010 - 11
(PERCENT)



Source: IMF staff estimates

the developing world, but is certainly far more robust than in Europe or Japan. Nine countries in the world are expected to see their economies contract this year, eight of which are in Europe[1]. A glance at Chart 3 highlights where growth is expected to be over the next two years.

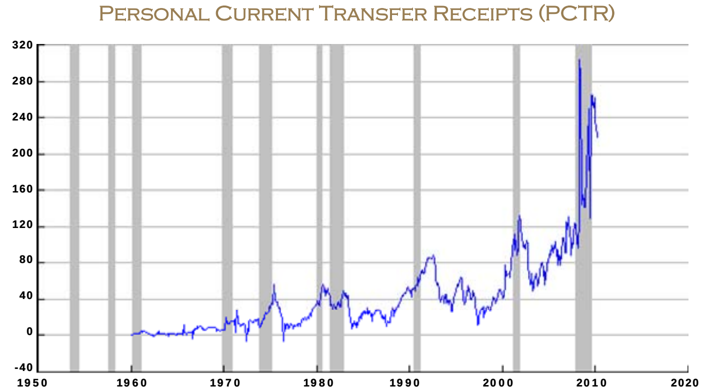
There may be more (or rather, less) than meets the eye in the current data. As mentioned, capex surged 13.4% in the quarter, but this only represents 6.5% of GDP. Commercial and residential construction fell at double-digit rates (-14% and -11%, respectively), and even state/local government spending fell 3.8%, the largest quarterly decline in 30 years, more than offsetting a modest rise in federal government spending. A full half of the 3.2% rise in GDP in the first quarter came from inventory additions, and these will not be sustained unless the final demand for goods and services strengthens.

Personal consumption was strong, up 3.6% in the quarter. But this surge is partly being driven by a decline in the savings rate (from 3.9% to 3.1%; meaning consumers are, again, spending more than they earn). More disconcerting is the growing dependence on government transfers (see Chart 4). Disposable personal income rose $305 billion over the past year, but $218 billion of that came from government transfers, not from earned income.

Housing has also been highly dependent on government support. Tax credits have stimulated demand for homes, as have low mortgage

4

PERSONAL CURRENT TRANSFER RECEIPTS (PCTR)



Source: U.S. Department of Commerce: Bureau of Economic Analysis
Shaded areas indicate US recessions. 2010 research.stlouisfed.org

[1] Spain, Greece, Ireland, Cyprus, Iceland, Hungary, Lithuania, Latvia (the weakest , at –4%), and Venezuela.

rates. The government now owns or guarantees approximately $6 trillion of mortgage assets. Supply has been reduced, helped by a decline in housing starts from more than 2 million units to about 600,000 units, and the combination of rising demand and less supply has helped prices turn up in recent months. But we may have reached the end of government-led demand stimulus, and the supply picture may not be as favorable as appears. Delinquencies have risen from 1% of mortgages in 2007 to 4% today, and foreclosures have tripled from ½ percent to 1.5%. As many as 4 million housing units, or more, could be added to the housing inventory via foreclosures, doubling the current supply, and threatening the prospects for further price appreciation.

"Growth is the elixir to the economy's woes..."

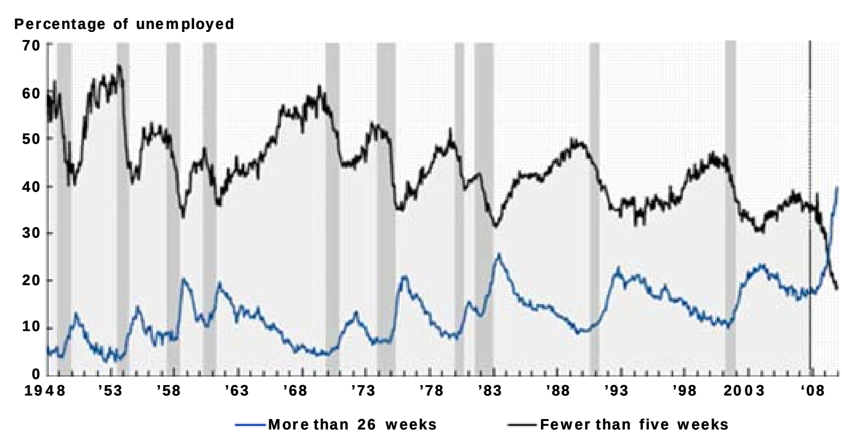
Recent employment data have been strong and broad, with 80% of sectors adding jobs last month. While certainly welcomed, there is reason to believe that the job market will remain weak for an extended period. The unemployment rate, currently at 9.9%, *understates* the severity of the employment picture as the size of the labor force has been flat over the past few years, despite a rise in the potential labor pool (those who have given up looking for work are no longer counted as unemployed, a definition from the pages of Joseph Heller). The number working in the US is the same as in 1999, again, despite an increase in the labor pool. We've discussed before the rise in long-term unemployment which, unfortunately, shows no signs of abating. The average duration of unemployment is above 30 weeks (the previous peak 30 years ago was 20 weeks), and a full 4% of the entire labor force (more than 40% of the unemployed) has been out of work more than six months (well above the prior high of 2.6% of the total labor force). For the first time, the long-term unemployed exceed the short-term unemployed, and by a growing margin (see Chart 5). This trend threatens to turn into a structural (semi-permanent) employment issue that becomes far more intractable over time.

Growth is the elixir to the economy's woes, and credit formation is a key ingredient. Unfortunately, credit is shrinking, the weakest showing in over 50 years. Of course, credit to a lender is the equivalent of debt to a borrower, and for credit to fuel growth both lenders and borrowers need to be in a position to support credit formation. Lenders are making progress in shoring up their books so they will be able to lend again. Globally, banks have realized $1.5 trillion of the estimated $2.3 trillion in cumulative loss provisions they are expected to take. Corporations have solidified their balance sheets by (generating and) retaining cash at record levels (13% of the market capitalization of the US nonfinancial sector is compromised of cash). But sovereign debt is moving the opposite way on a massive scale, reaching levels not seen in more than 60 years (see Chart 6, pg. 5).

Fiscal deficits will only add to the debt burden, and there is reason to fear that these deficits may be structural, i.e., will not shift to surpluses

5

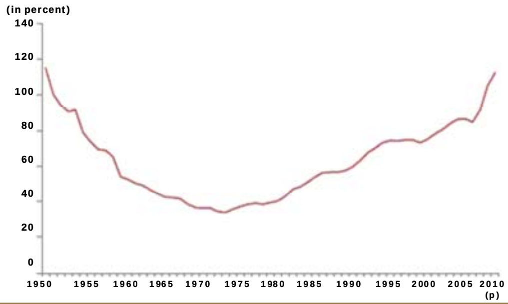
SHORT-TERM AND LONG-TERM SHARE OF UNEMPLOYMENT, 1948-2009



Note: The shaded areas indicate official periods of recession as identified by the National Bureau of Economic Research; the dashed vertical line indicates the most recent business cycle peak.
Source: U.S. Bureau of Labor Statistics, Current Population Survey, from Haver Analytics.

6

SOVEREIGN DEBT TO GDP IN THE G-7



Source: IMF, World Economics Outlook database
Note: Average using PPP GDP weights.

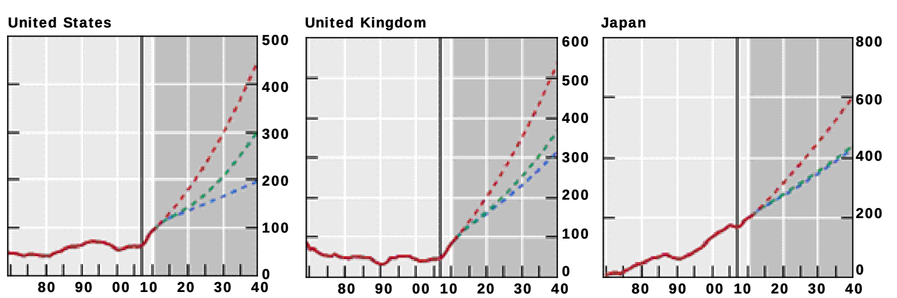
with a turn in the economic cycle. The Bank for International Settlements, the organization of the world's central banks, projects soaring debt levels even with improvements in fiscal deficits. In Chart 7, the top line plots the current debt trajectory, the middle line assumes a 1% p.a. deficit improvement over the next five years, and the bottom line combines gradual deficit improvement with a freezing of age-related spending relative to GDP. As we can see, under even optimistic assumptions, projected debt service burdens rise to assume an ever greater percentage of GDP (see Chart 8).

As noted, and despite the structural concerns just outlined, growth is accelerating for now, largely due to unprecedented government intervention in the economy in the form of both monetary and fiscal policies. These stimuli are receding, however. Money supply growth is diminishing and the quantitative easing that saw the Fed expand its balance sheet by trillions of dollars is ending, although the European Central Bank has just started its program of quantitative easing in response to the Greek debt crisis. Much of the fiscal spending at the US federal level has been offset by cuts by state and local governments, and ominously, tax rates are scheduled to rise next year and beyond for the fewer and fewer Americans who pay income tax (nearly half of Americans, 47%, do not pay income tax, up from 38% a few years ago).

"There is considerable evidence that raising taxes to redress fiscal deficits is misguided and self-defeating"

7

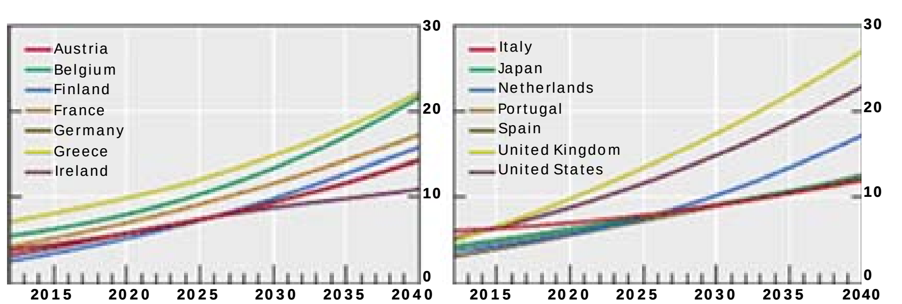
PUBLIC DEBT/GDP PROJECTIONS



Source: BIS Working Papers No. 300, March 2010

8

PROJECTED INTEREST PAYMENTS AS A FRACTION OF GDP

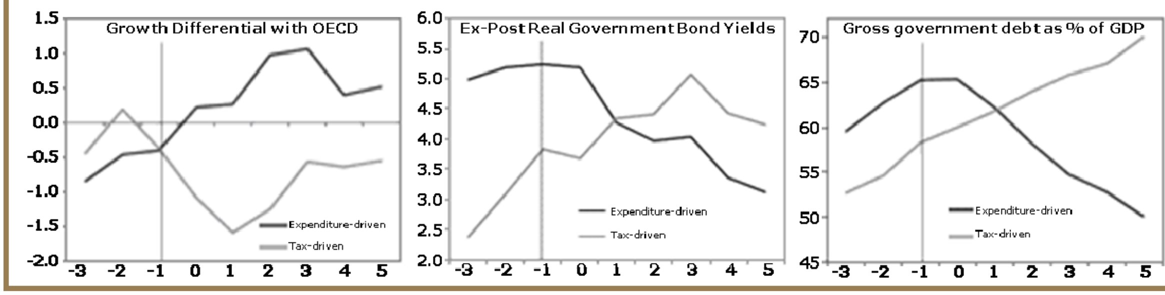


Source: BIS Working Papers No. 300, March 2010

There is considerable evidence that raising taxes to redress fiscal deficits is misguided and self-defeating. Compared to the alternative of decisively cutting government expenditures, raising taxes reduces economic growth, leads to higher interest

9

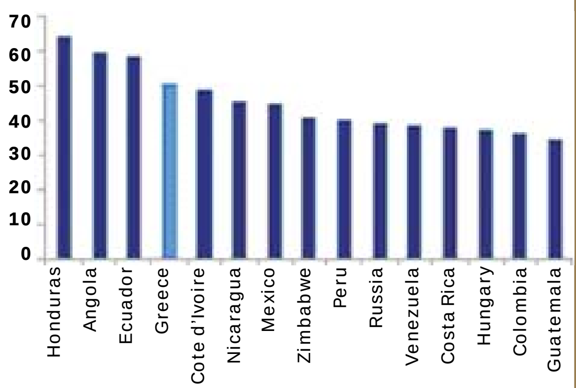
Impact of Deficit Reduction Policies on Growth, Rates and Debt



Source: OECD, Goldman Sachs Global ECS Research

10

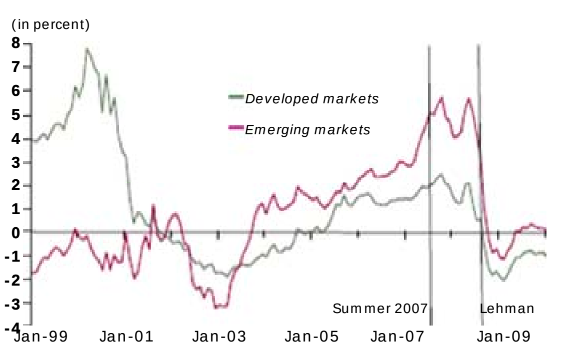
Share of Years in Default or Rescheduling Since Independence or 1800



Courtesy: Goldman Sachs

11

Emerging Market Returns Better on a Volatility-Adjusted Basis



Source: Bloomberg LP.;MSCI Barra; and IMF staff estimates.
Note: Volatility-adjusted returns = three-year rolling log returns/three-year historical standard

rates and *increases* the debt/GDP ratio (see Chart 9). These data have been confirmed in numerous studies over the past decade or so, but unfortunately, appear not to have made their way inside the Beltway.

Following a different path of low debt, high savings and low taxes is the group formerly known as developing countries. For investors, the standard view is to treat the emerging markets as peripheral investments, perhaps to be invested in-line with their capitalization weight (currently about 13% of the world equity benchmark). Perhaps investors are wary of the heightened risks, from greater volatility to expropriation of property, that have dogged these countries for centuries. Indeed, many of them have been in default on their debt more than they have been current (see Chart 10). But even accepting the greater risks of investing in many of these countries, investors may have missed not only better returns, but better risk-adjusted returns in emerging markets over the past decade (see Chart 11). If these advantageous conditions in many of these countries are structural, and therefore sustainable, then prospective returns—absolute, relative and risk-adjusted—should remain attractive.

While the economies of the developed and developing world may be on different paths, those paths are interconnected. Excess savings in the developing world have been invested largely in the markets of the developed world. The value of the dollar or the euro matters as much to China, as the world's largest holder of foreign reserves, as it does to the US and

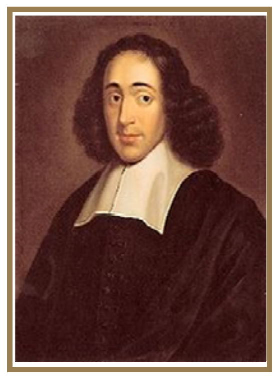
Europe. The health of the American consumer is as important to Germany and Korea as it is to US politicians. Chinese domestic demand affects directly the growth of the economies of Australia and Brazil. Countries can enact individual policies that may be harmful or helpful, but increasingly, our fates are joined in a single, global economy.

When not grinding lenses, Baruch had time to put his thoughts on paper. His *Theological-Political Treatise* was published anonymously in 1670. In it he argued that society is advanced by freedom of thought and inhibited by the fears and superstitions of people preyed upon by the clergy. His solution was to strip the clergy of all political power. We can understand why he chose to publish this anonymously. His *Treatise* created a firestorm of criticism, causing his Jewish community to renounce him, as much for fear of retribution by the Christian government as for his heretical views against the traditional teachings of Maimonides. He was thus banished from the Jewish community in Amsterdam, and lived out his years in the Dutch countryside.

His *magnus opus*, *Ethica* (Ethics), was published after his death. Even then it was banned from publication in the Netherlands. Controversially among theologians, it rejected the anthropomorphic, personal and interventionist God of tradition, and broke with Descartes' separation of God with our world. Instead, it makes no distinction between God and Nature; they are the same, the only substance there is, the one perfect reality. Good and evil are only relative to our perceptions, and the imperfections we perceive arise only from our inability to understand God. We find happiness only by recognizing our place in Nature and accepting it.

Baruch Spinoza was (and remains) simultaneously one of the most controversial and influential philosophers in history. Many see him as a denier of the nobility of Man created in God's image. But for others, Spinoza is the beginning of enlightened modern thought. When asked if he believed in God, Albert Einstein replied, "I believe in Spinoza's God who reveals himself in the orderly harmony of what exists, not in a God who concerns himself with the fates and actions of human beings."

Spinoza saw everything as connected, a unity of God/Nature/Man. Differences, imperfections do not exist, except only as we perceive them. All of our lives are intertwined: with each others', with the world, with God. Reaching this enlightenment would not be easy, as he concluded his *Ethica*: "If the way I have shown to lead to these things now seems very hard, still, it can be found…. all things excellent are as difficult as they are rare."



"…all things excellent are as difficult as they are rare."

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

MICHAEL A. ROSEN
PRINCIPAL & CHIEF INVESTMENT OFFICER
MAY 2010

If you would like to receive a copy of our Form ADV Part II free of charge, please email Steve Smetana at ssmetana@angelesadvisors.com, or call Mr. Smetana at our main number: (310) 393-6300.