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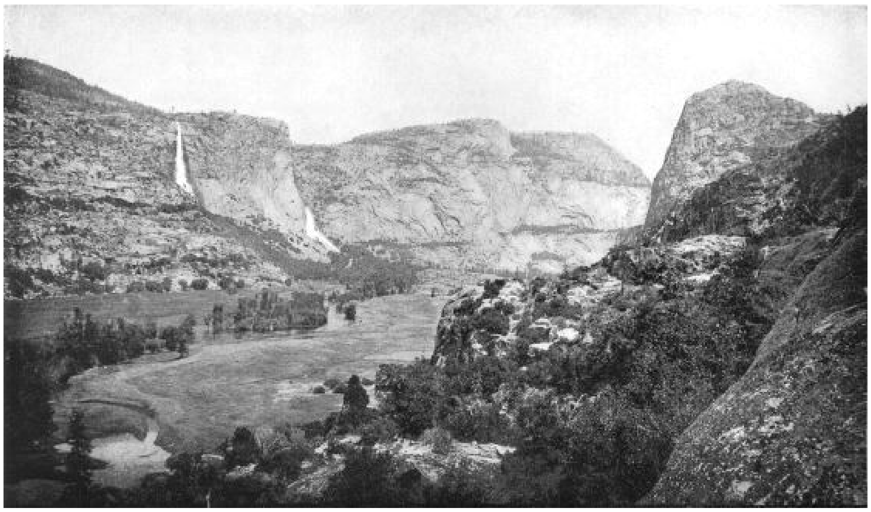


American mythology is filled with epic stories of heroic men (and women) who forged a great nation through sheer determination: adventurers and tinkerers, who tamed and then shaped a wild and virgin continent, and in the process, created the wealthiest, most powerful civilization in history. Remarkable for not being feared so much as being admired, drawing and embracing millions to its shores from all corners of the globe.

Unlike the mythologies of ancient civilizations (we think), the American mythology is rooted in truth, and its heroes are celebrated in stories and schoolbooks. Adventurers spread out across a continent, from the founding Pilgrims of Massachusetts Bay to the homesteaders who followed Meriwether Lewis and William Clark and settled the vast prairies. Tinkerers, from Thomas Edison to two brothers in their Dayton bicycle repair shop, invented machines that would shape the world. Industrial titans, from John D. Rockefeller to Henry Ford, harnessed the untapped powers of the nation's infinite resources to create immense wealth, for themselves, but also enriching the entire country.

Just over a century ago, another strain developed in this narrative from those who questioned the costs of unfettered growth and sought a balance between the aesthetic and the material; economic progress, but not at the cost of despoiling our great natural beauty.

These strains may seem at odds, but they coexist, at times separate and competing, but more often as simultaneous cognitions. It is not surprising, then, that the man who gave voice to this movement, the inspiration of every person or group anywhere in the world that seeks to preserve our natural resources, was himself an immigrant, an inventor, a scientist, a friend of Presidents yet happiest alone in the mountains. His contribution to our world is as profound as any of our heroes, and his life serves to remind us of our inherent duality: to prosper, yet preserve; to advance, yet conserve; to create anew, yet nurture.

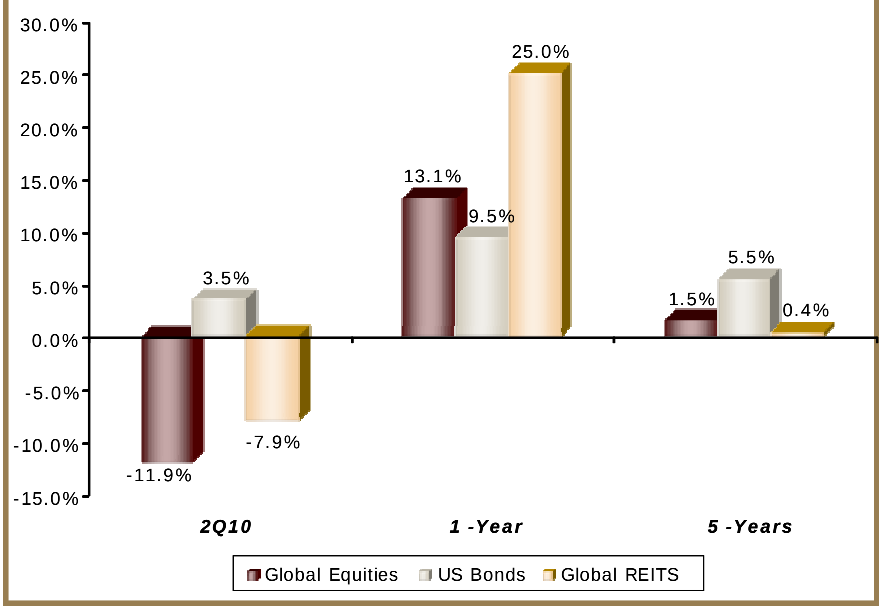
European turmoil was the principal theme of the quarter, with a Greek bailout occurring just days before a likely default. Sovereign credit spreads blew out, equities tanked and Treasuries were the safe haven of choice, with 30-year yields falling nearly a full percent. No surprise that Greece was the worst performing market in the quarter, dropping 41%, but most equity markets were down. Only 11 (of 73) markets posted gains, led by Sri Lanka at almost 14%.

Sovereign risks garnered the headlines, but global economic growth is moderating, adding to investors' worries. US GDP grew at a 2.4% annualized pace in the second quarter, down from a 3.7% rate in the first quarter and 5.0% at the end of 2009. But nearly half the growth came from inventory adjustments, so the "true" underlying growth rate is just over 1%, weak enough, and trending lower, and not sufficient to generate any meaningful employment growth.

"...the US economy is not creating permanent jobs..."

1

CAPITAL MARKET PERFORMANCE

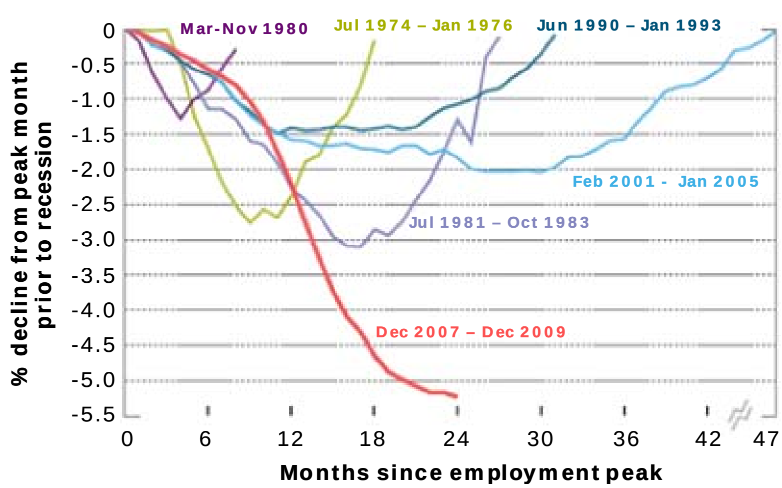


The unemployment rate stands at 9.5% at the end of June, but if not for the decline in the participation rate (to 64.7%), the official unemployment rate would be much higher. As we've noted in previous letters, most disconcerting is the rise in long-term unemployment. 45.5% of the unemployed have been out of work for over half a year, and the median duration of unemployment is now 25.5 weeks, both record highs. Temporary employment and the average workweek are up slightly, but the US economy is not creating permanent jobs, in stark contrast to previous recession/recovery periods (see Graph 2).

Weakness in the employment market is not limited to this current cycle. In the decade of the 1990s, the US gained 21.7 million jobs. In the decade just past, December 1999-December 2009, the economy *lost* 944,000 jobs. The recession at the end of the decade skews these

2

US EMPLOYMENT DURING RECESSIONS[1]



[1] Total nonfarm employment, seasonally adjusted.

Courtesy: McKinsey *Source: US Bureau of Labor Statistics* numbers, but when the economy was creating jobs, job growth was less than half the pace of the previous decade: 16 million jobs were created in the first eight years of the 1990s versus 7.5 million jobs in 2000-2007.

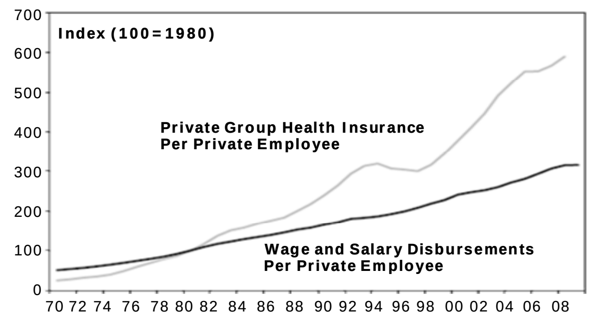
There is no definitive explanation for the poor job growth over the past decade, but one likely culprit is healthcare costs. Benefits are generally fixed costs, that is, they don't vary with hours worked, and they have been rising at a much faster rate than salaries, 6.9% annually versus 4.5% in the ten years ending 2008 (see Graph 3). Healthcare insurance accounts for 8% of total compensation, although that share is likely to be higher for private employers.

The failure of the economy to create new jobs, not just in the current economic cycle but over a period of many years, has led to our current structural employment condition which, if not ameliorated soon, and there is no sign of that, will diminish the economy's long-term capacity and productivity.

Historically, one of the relief mechanisms in weak employment markets has been labor mobility, the ability and willingness to move to where the jobs are. The bleak housing market is an impediment to labor mobility, exacerbating the weakness in structural unemployment. For many, their homes are worth less than the mortgage (see Graph 4), making it difficult to move. Home prices have bounced following a precipitous drop, but there remains a significant supply/demand imbalance, with 4 million existing homes for sale and possibly a similar amount in the pipeline due to rising delinquencies. Even the recent moderation in the foreclosure rate is misleading (see Graph 5), due more to lender forbearance than improving economic conditions: the foreclosure process has not begun on one-third of the loans that have not

3

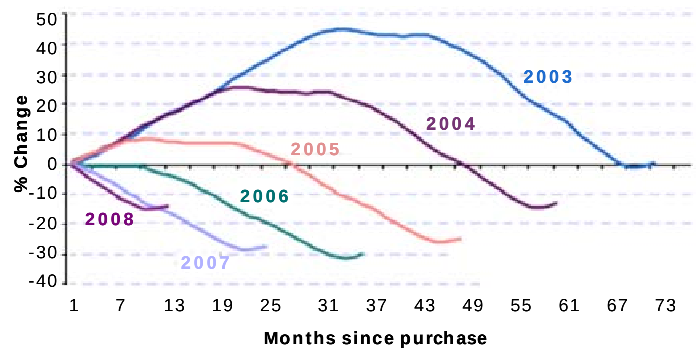
Benefit & Wages, 1970-2009



Source: Bureau of Economic Statistics *Courtesy: Morgan Stanley*

4

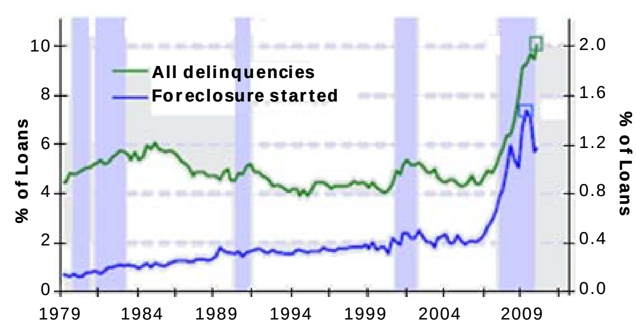
Cumulative House Price Change, by Purchase Vintage



Based on Case Shiller Index. Assumes average mortgage in given year set at average house price for that year.
Source: S&P/Case-Shiller, Morgan Stanley Research

5

Mortgage Delinquencies and Foreclosures*



**All delinquencies NBER recession shaded*
Source: MBA, NBER, Morgan Stanley Research

seen a payment for more than six months, or even on the one-quarter that have not made a payment in more than a year. With fewer delinquents being foreclosed, the "true" inventory of unsold homes, officially around 8 months, is likely closer to two years.

The federal government has thrown a lot of resources at stabilizing the housing market. Its agencies have increased the number of loans it makes and has subsidized mortgage rates through purchasing trillions of dollars of securities. It (we) has paid people to buy a house (through a tax credit), paid people to stay in their homes (through HAMP—Home Affordable Modification Program which modifies interest payments), and paid people to sell their homes (HAFA—Home Affordable Foreclosure Alternatives).

"These interventionist programs may have tempered the severity of the housing downturn, but they will likely expand its duration."

These interventionist programs may have tempered the severity of the housing downturn, but they will likely expand its duration. The foreclosure process has already been extended, as we noted, and borrowers may be perversely incented to default in order to take advantage of these programs. We can forestall the natural market process of aligning supply with demand, but eventually, these houses will come to market, and prices will have to fall.

Not all the recent news has been gloomy. Prices of industrial metals and oil are higher, as is the price of renting a shipping container: to send a 40-foot container from Hong Kong to Los Angeles costs $2,600, triple the price from a year ago. International air traffic, both passenger and freight, have surpassed their previous peaks, and more than 70% of companies are beating earnings estimates, a record high, and more than half are also exceeding revenue estimates.

If this were a normal recovery from a normal economic contraction, we could be very encouraged about these data (well, we are encouraged; we just have other worries). As we've described in previous letters, every downturn experienced in the US in the past 70 years has followed a similar pattern of monetary tightening in the face of rising inflation pressures, eventually causing output to decline as the cost of credit became too high. Every downturn, that is, except this one. The current environment has much more in common with contractions that followed debt-induced asset deflation. We don't have many examples in recent history (thankfully), but the world economy in the 1930s and the Japanese experience since 1990 are reasonable examples.

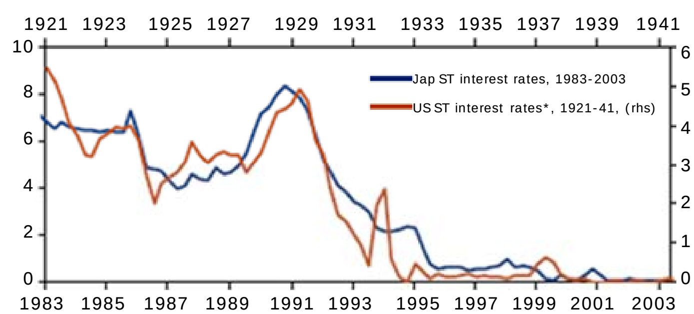
We won't repeat the analyses of the economic parallels (you can find our previous letters on our website). But we will highlight the very different investment implications of these contrasting economic environments.

If this were a typical economic cycle, we would expect to see a strong response to the massive monetary stimulus: businesses and consumers would borrow at these low rates in order to build new capacity and consume new goods to relieve pent-up demand from the downturn. But we are seeing real demand growing at 1-1½%, not the 5-6% we would expect to see. Normally, this policy response would be very favorable for equities: with low valuations and strong economic tailwinds, equities perform best in this environment while bonds would lag as inflation rebuilds.

In contrast, following a debt-induced asset collapse, as we experienced in the 1930s and in Japan in the 1990s (and beyond), interest rates can remain very low for a very long period of time, and bond returns, while not spectacular,

6

LOW RATES FOR A LONG TIME
US (1921-41), JAPAN (1983-2003)



Source: BofA Merrill Lynch Global Research

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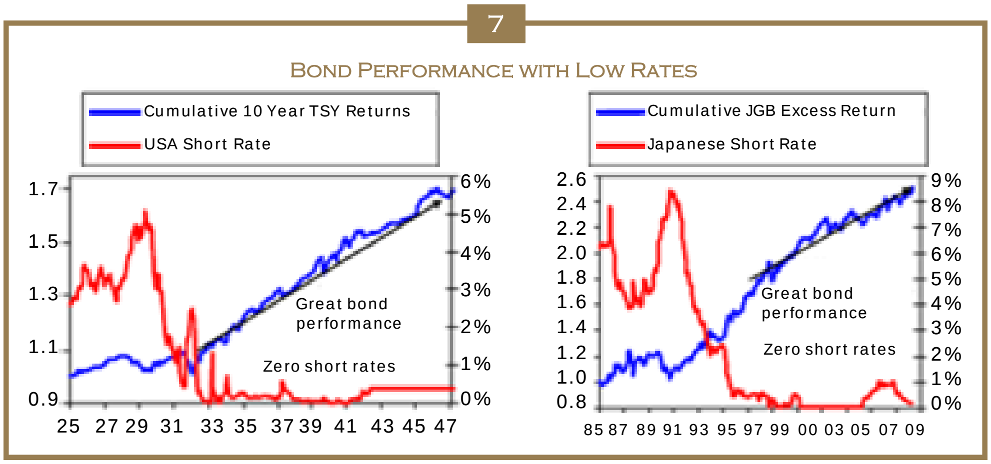

Bond Performance with Low Rates

Courtesy: Bridgewater Associates

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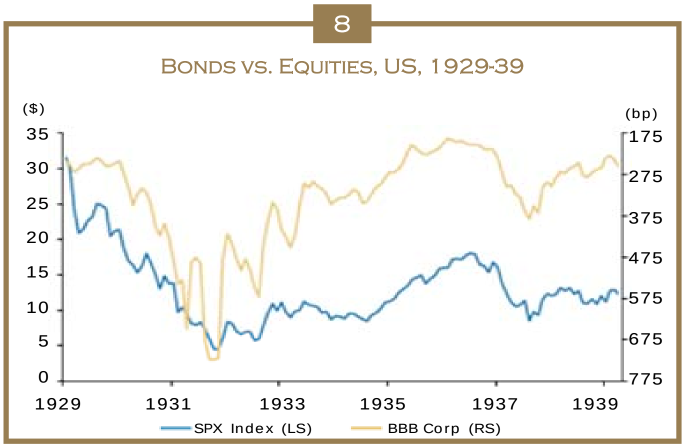

Bonds vs. Equities, US, 1929-39

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

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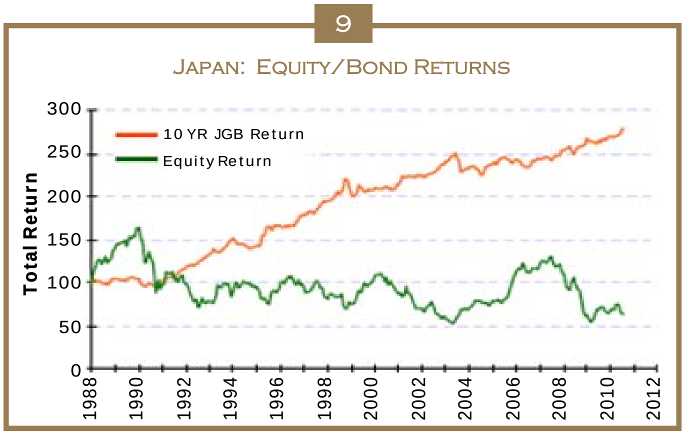


Japan: Equity/Bond Returns

Source: MSCI, DataStream, Morgan Stanley Research

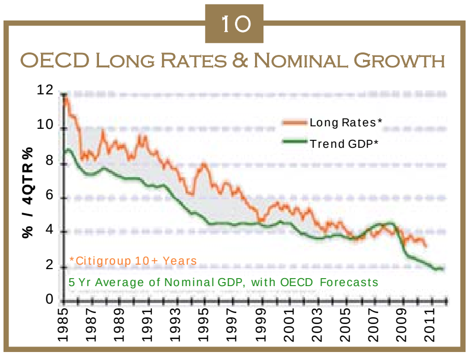
can be positive and better than equities. The accompanying Graphs illustrate these points. Graph 6 (on page 4) compares US rates in the 1920s and 30s and Japan's in the 1980s and 90s: in both cases, when rates hit zero (or close to it), they can stay there for many years. Bond returns in both periods were positive, despite short rates anchored at zero (see Graph 7). And bonds outperformed equities in both the 1930s (Graph 8) and in Japan for the past 20 years (Graph 9).

No historical experience is identical to another one, and one can argue that Japan's recent experience is due as much to the extreme overvaluation of equities and real estate in 1989 (by most measures many times the overvaluation in the US), but these are reasonable economic parallels that bear consideration.

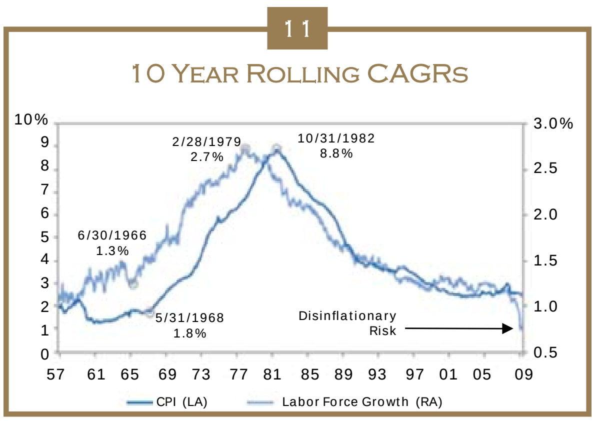
There are longer-term data too that suggest yields can remain low. In the developed world, nominal GDP growth has been trending lower over two decades, and yields have followed (see Graph 10, on page 6). Of course, correlation does not equal causation, but looking a bit longer, over 50 years, we see a relationship between labor force growth and inflation (and by extension, bond yields—See Graph 11, page 6). Demographics play out over very long periods, but to a certain extent, demographics are our destiny.

"… demographics are our destiny."

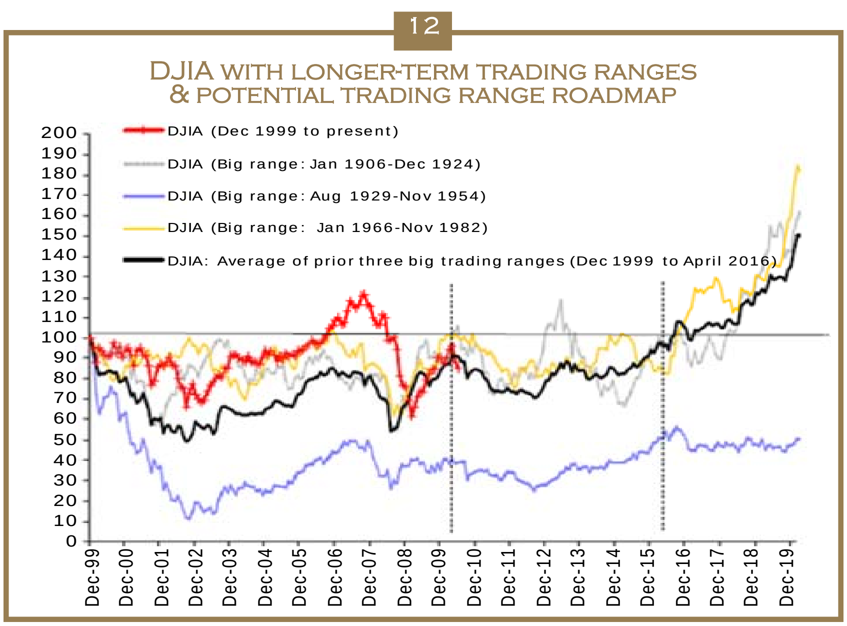
If bond yields can remain stable for some time, so too can equity prices. Over the past century, there have been three periods (other than the past dec-



Source: OECD, Citigroup, Morgan Stanley Research



Data from 1/31/58 to 4/30/10. CAGR = Compound Annual Growth Rate.
Source: Bureau of Labor Statistics and MSIM



Source: BofA Merrill Lynch Global Research, Bloomberg.

ade) in which stock prices widely fluctuated with little net result, accounting for more than half of all the years. In other words, while equity prices have risen substantially over the past 100 years, for most of that period, nominal returns were generally flat. If prices follow previous patterns (see Graph 12), we could expect a few more years of purgatory.

Prescient leadership is required to navigate the challenging terrain, and we are reminded that it was policy mistakes that derailed similar recoveries in the past. In 1937, the Fed tightened and Congress raised taxes, only to see the economy contract again and the unemployment rate soar from 10% to 20%. Likewise, after seeing years of 3-4% real GDP growth in the mid-1990s, Japan imposed a 5% consumption tax in 1997, only to see GDP decline 2% in the following year.

Tax rates in the US will rise next year as the tax cuts from a decade ago expire. Additional taxes are planned in 2013 to pay for the recent healthcare legislation. Simultaneously, we are expanding the growth of government (and have been for a decade—see Graph 13, page 7). The federal budget deficit is estimated by the White House to be a record $1.47 trillion this year, and we are borrowing 41 cents of every dollar we spend. Put another way, we're spending more than $4 billion per day of borrowed money. It's hard to see how continuing on this policy path is constructive.

Monetary policy is likewise challenged. The tripling of the monetary base in 2008-2009 helped avert systemic financial failure by providing liquidity to banks, but it has failed to stimulate credit or economic growth. Money supply grew just 1.7% in the past year (see Graph 14), the second slowest in 50 years and a third of the average rate over the past century.

John Taylor of Stanford, perhaps the most distinguished monetary economist in the country, has been sharply critical of Fed policy, arguing that a "Great Deviation" in policy brought an end to the "Great Moderation" of the 1980s and 90s, by causing the "Great Recession" of 2008. He criticizes the Fed for holding rates way too low in 2003-2005, fueling the housing boom that ended in the greatest housing disaster in our history. He thinks the Fed misdiagnosed the banks' solvency problems as a liquidity challenge, and is highly critical of the capricious rescues/failures of some financial institutions. Finally (well, not finally, as his list of policy errors goes on for considerable length), fiscal spending programs are doomed to fail to stimulate the economy as people do not respond to temporary boosts in income: the cash-for-clunkers program, as an example, raised auto production for one month last year, which then settled back to its previous level, while consumers added another $11 billion of debt they could ill afford as they traded up. The combined legacy of these policies is unsustainable debt and monetary overhang. The greatest monetary economist, Milton Friedman, warned of the perils of mere mortals (even economists) tinkering with forces beyond their control. In a 1958 address to Congress, he said, "There are serious limitations to the possibility of a discretionary monetary policy and much danger that such a policy may make matters worse rather than better…. The attempt to do more than we can will itself be a disturbance that may increase rather than reduce instability."

"The combined legacy of these policies is unsustainable debt and monetary overhang."

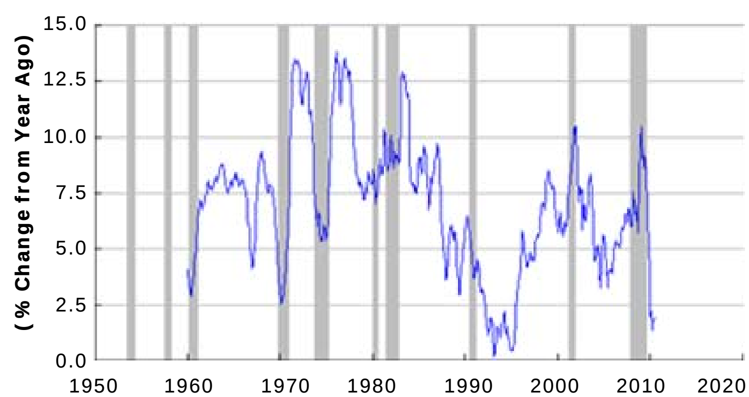
13

Federal Expenditures as % of GDP

Courtesy: Laffer Associates
Source: BEA

14

M2 Money Stock (M2NS)



Shaded areas indicate US recessions 2010 research.stlouisfed.org
Source: Board of Governors of the Federal Reserve System.

At the 1860 Wisconsin State Fair in Madison, the hit exhibit was an "early rising machine:" a bed connected to a clock that would dump its occupant at a set time. Its inventor was a self-taught 22-year old Scottish immigrant named John Muir.

For the next 40 years, Muir wandered around the country, working as an engineer, a botanist, a rancher, a writer. Mostly, he was unemployed, but managed to live off the land in a remote corner of California's Sierra Nevada mountains known as the Yosemite Valley. Muir came to see Yosemite as nature's cathedral, a sacred place to be cherished and preserved.

The country's first national park, Yellowstone, was so designated in 1872, but then it was only much later, in 1890, that the next national parks were chosen (Sequoia, Kings Canyon and Yosemite, all in California). The conservation movement really began around this time with the Sierra Club, formed by Muir and others in 1892. But there soon developed a theological split among conservationists. One faction, led by Gifford Pinchot, the first head of the US Forest Service (and later governor of Pennsylvania), favored "wise use" of the land to benefit the greatest number of people. The other side was led by John Muir, who believed in preserving the land in its natural state, unspoiled by human activity.

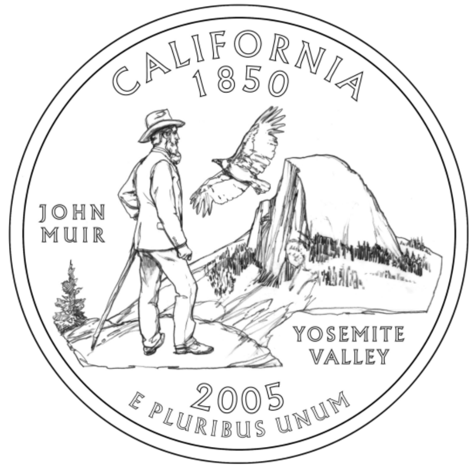
Muir had an eager student in the President of the United States, Theodore Roosevelt, himself an avid outdoorsman. When Roosevelt visited Yosemite in 1903, Muir persuaded him to ditch his secret service detail and spend a few nights in Muir's cabin. Roosevelt did, and must have been persuaded by Muir's vision of conservation, because in his remaining term in office, Roosevelt established 148 million acres of national forest, five new national parks and 23 national monuments. Roosevelt's image today as our greatest conservationist president can be traced to that meeting with Muir in the Yosemite Valley.

There is a particular corner of the Yosemite Park that Muir considered the most beautiful. It was called Hetch Hetchy, after a kind of grass that grows there. It was here that the battle was fought between those that wanted to use the land for the benefit of people and the preservationists. In this case, Pinchot argued that the best use of the Hetch Hetchy Valley was to dam the Tuolumne River in order to provide drinking water for the residents of San Francisco, 150 miles away. Muir's reaction was strong: "Dam Hetch Hetchy! As well dam for water-tanks the people's cathedrals and churches, for no holier temple has ever been consecrated by the heart of man."

Muir had the ear of Roosevelt, and his successor, Taft, and every attempt at passing a bill in Congress to allow the damming of Hetch Hetchy failed. But Pinchot had the ear of the next President, and after 12 years of fighting in 1913, Woodrow Wilson signed the bill authorizing the dam. The Hetch Hetchy valley was destroyed, and Muir died, broken, the following year.

But Muir may have had the last laugh. The damming of Hetch Hetchy galvanized the conservation movement. Hundreds of new conservation groups appeared over the following decades, and the next time there was a proposal for a dam in a national park, in 1954 in Dinosaur National Monument, public pressure forced its abandonment.

Of course, it's really a false choice. Those who alter nature often do so with the best intentions: to provide some good or benefit for people. It may be electricity or water, or it may be supporting banks that would otherwise fail or helping people stay in their homes. But John Muir taught us that when we alter nature's landscape, it is often irreversible, and we will have lost something of great value for eternity. The wilderness can be a means, wrote Wallace Stegner, "of reassuring ourselves of our sanity as creatures, a part of the geography of hope."



Of all the possible symbols of California, from the Golden Gate Bridge to the Hollywood sign, from the snow-capped mountains to Death Valley to the famous beaches, when it came time to choose a design for a state quarter to be minted, California chose to honor John Muir and place him in Yosemite. It is certainly a fitting honor, and a reminder of the balance in nature that we disturb at our peril.

"...reassuring ourselves of our sanity as creatures, a part of the geography of hope.."

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
AUGUST 2010