Angeles
INVESTMENT ADVISORS

Commentary
Third Quarter 2010

Chosin

Staring into the abyss, facing total collapse. A bold, even reckless, action to avoid disaster. An advance, and apparent victory. But a sudden turn of events, a wall of opposition, the recovery is halted. And then reversed. The challenges mount, the outlook grows bleaker, jeopardizing not only the recent gains we have made, but threatening to diminish our stature in the world and our way of life.

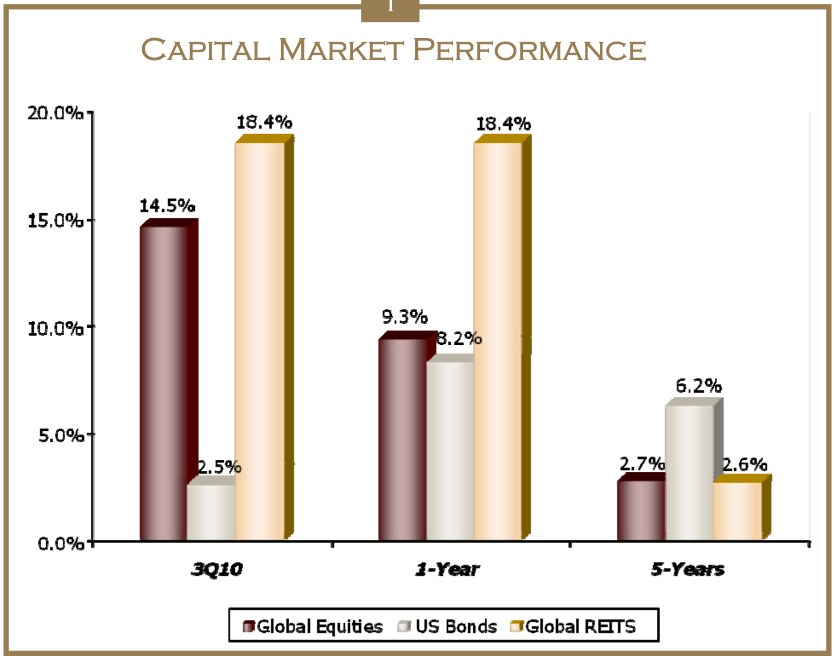
If this narrative is familiar, it is because we are living through it today. Two years ago, major banks failed, bringing the world financial markets to near-collapse. Controversial efforts to support the banking system, government takeovers of major multinational corporations (AIG, GM, et.al.) and expansions of the balance sheets of both the Federal Reserve and the US Treasury at unprecedented pace and magnitude, seemed to have averted total economic collapse. There has been growth in the economy, but we are encountering stiffer headwinds, and the prospects of additional government stimuli grow dimmer as our deficits grow larger. The optimism we dared to hold in the spring has given way to discontent and despair.

But this narrative also comes from a different context, exactly sixty years ago. Then, as now, there was no savior on a white horse to lead us to victory, for there was no victory, there was only defeat. But that defeat on a frozen wasteland in a far corner of the globe, among the most ignominious in the glorious history of the United States military, was, in fact, one of the greatest accomplishments in the annals of military history. It was achieved, not by a magical weapon, strategic insight or tactical brilliance, but by the individual acts of heroism under extraordinary hardship by thousands of men who, collectively, and alone, saved the Army, and their country. Their narrative, regrettably and inexcusably widely forgotten, provides lessons for us today.

It has been a see-saw year, with one month up, the next one down. That is, until that crisp, August morning in Jackson, Wyoming when Federal Reserve chairman Ben Bernanke hinted (as Fed chairmen are prohibited from speaking directly) that the US central bank would likely begin another round of quantitative easing. The markets took this sig-

nal as it was intended, as a promise that the Fed would supply all the funds necessary to support speculative activity, thus setting off a huge rally across financial assets. US equities jumped 11% in the quarter, nearly all of it in September, but even this strong gain paled beside Asia's (ex-Japan) and Europe's 20% advance. Poland led all with a 35% jump. We could find only one "real" market that lost ground in the quarter: Ireland, off 4% amid trying to rescue its insolvent banking system (Vietnam and Nigeria fell 10%, but it's unclear how real those markets are). In the first nine months of the year, Sri Lanka has been the stand-out, more than doubling in value, whereas Greece brings up (or rather, down) the rear, falling 40%.

1



"Shrinking supply and greater demand explain the bond rally."

Bonds, too, rallied in the quarter. With each tick lower in yield, bonds continue to confound the critics (none of whom are Japanese) who cry that yields cannot possibly go lower. They have, because market prices are set by supply and demand, and both trends have been highly supportive. The $2.2 trillion increase in federal debt in the period 4Q2008 to 2Q2010 has received all the attention, but nongovernment debt actually fell by $3 trillion in this period, thus shrinking overall supply. Corporations are hording cash, and commercial lending has been falling at a record pace. Even households are reducing their debt, for the first time since records began 60 years ago (see Chart 2). Investors have channeled record amounts into bonds, drawn by the strong recent returns, memories of a turbulent past and fears of future economic prospects. Shrinking supply and greater demand explain the bond rally.

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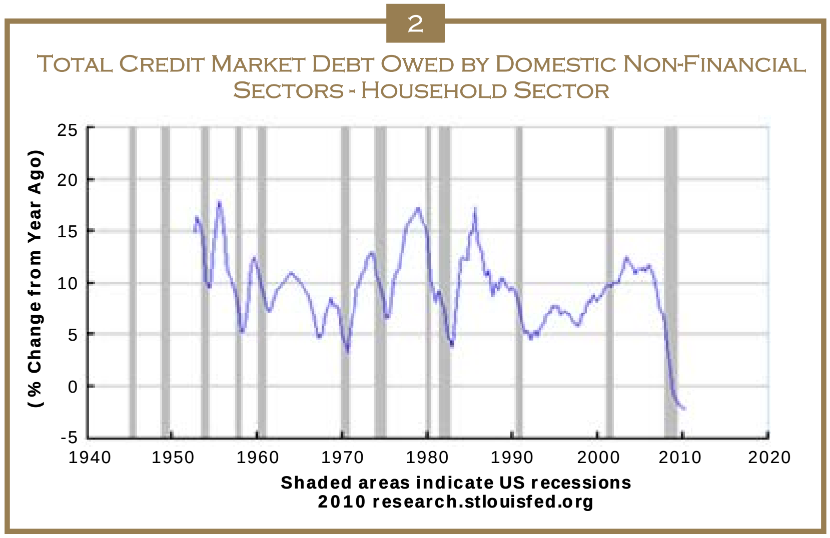
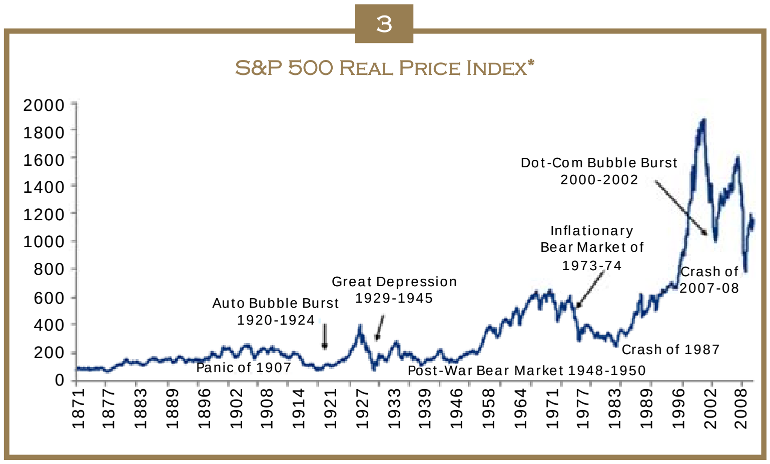


Source: Board of Governors of the Federal Reserve System

Taking advantage of the environment, and perhaps emblematic of how much has (appeared to have) changed, the United Mexican States issued a 100-year bond last quarter, paying around 6%. Coincidently, exactly a hundred years ago the long dictatorship of Porfirio Díaz ended with the beginning of the decade-long Mexican Revolution. In the interim, Mexico nationalized the oil companies (1938), defaulted on its debt (1982) and had to be bailed out to avoid another default (1994). Last month's bond, which matures in 2110, was oversubscribed.



*U.S. large company stock market returns, monthly average price return
Source: BofA Merrill Lynch Global Equity Strategy; Robert Shiller; Ibbotson

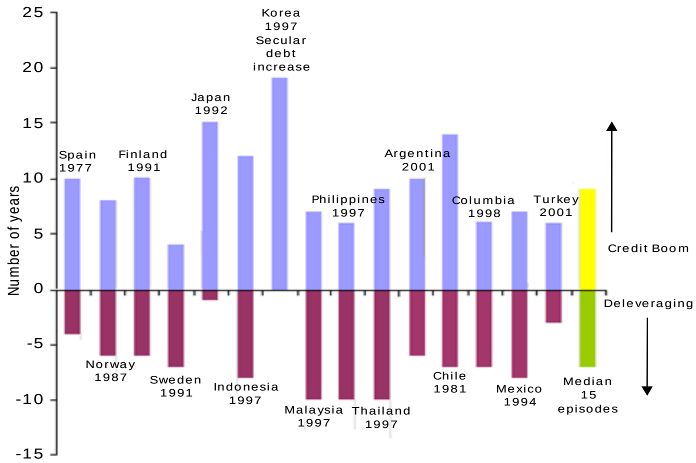
There's no disputing that the recent past has been very good for bond investors and disappointing for equities. US equities have provided zero nominal return over the past decade while bond investors have enjoyed nearly 6½% annual compounded gains. But long periods of little or no return in equities are not uncommon. A glance at long-term, real returns for equities over the past 140 years (see Chart 3) leads to a number of observations, but we'll make just two: stock prices, in real terms, have shown only two sustained periods of advance, 1947-1966 and 1982-2000 and, secondly, following these periods, inflation-adjusted prices have fallen (while flat in nominal terms) for many years (1966-1982 in the first instance, 2000-? in the second).

It may be that a sustained period of price appreciation requires not only attractive valuations, but a catalyst, or theme. Post-war reconstruction and productivity growth were the themes of the 1950s and into the 1960s, derailed by massive government spending on a war and social programs and then compounded by a series of horrific policy errors in the 1970s. The advance of the 1980s and 1990s were supported first by economic deregulation and favorable supply-side reforms and then by productivity-enhancing capital investment, especially in technology. Another series of policy errors, principally government encouragement to consumers to (over)accumulate (mainly mortgage) debt, led to our current quagmire. Equities may be reasonably priced, especially in relation to bonds, but the next long-term bull market will not begin with only reasonable valuations; it needs a catalyst and a theme.

In the developed world, it is hard to see when and where that catalyst will come. Perhaps from a technological breakthrough, maybe in medicine? We are reasonably confident that day will come, but the interim may be a difficult slog for some time. The deleveraging aftermath of credit booms takes about as long to unwind as they did to build, as Professors Reinhart have documented (see Chart 4): on average, around ten years.

4

DOMESTIC BANKING CREDIT/GDP TEN YEARS BEFORE AND TEN YEARS AFTER SEVERE FINANCIAL CRISIS: DURATION OF BOOM-BUST CREDIT CYCLES IN FIFTEEN POST WWII EPISODES



Carmen M. Reinhart and Vincent R. Reinhart, After the Fall, August 2010.

The duration of credit booms shown correspond to the difference (in years) between the maximum domestic bank credit-GDP ratio around the crisis and the pre-crisis low for the ratio during the 10-year window preceding the crisis. Similarly the duration of the deleveraging phase is calculated as the number of years between the year minimum credit/GDP ratio reached during the 10-year window after the crisis and the year maximum ratio reached around the crisis. The specific dates and magnitudes for each episode are listed in Table x. Shown in italics are the episodes where leveraging (Korea) or deleveraging process is ongoing according to the latest available data.

For Korea, there is a uninterrupted secular rise in domestic bank credit-to-GDP during 1987-2007 (the 10-year window around the crisis). Post-crisis deleveraging appears to be confined to external debts (see Reinhart, 2010).

> *"There are three main areas of the economy that remain under significant pressure and of great concern: housing, employment and debt."*

TABLE 1

HOME PRICES

S&P/CS Home Price Index	% change from peak	Lowest level since:	
Las Vegas	-57.5	Q3	1999
Phoenix	-53.0	Q2	2001
Miami	-47.5	Q1	2003
Detroit	-44.7	Q2	1995
Tampa	-43.0	Q1	2003
Los Angeles	-36.6	Q3	2003
San Francisco	-36.2	Q2	2002
San Diego	-35.8	Q2	2003
Minneapolis	-28.6	Q3	2001
Washington DC	-26.5	Q2	2004
Chicago	-26.5	Q3	2002
Seattle	-24.5	Q1	2005
Portland	-21.6	Q2	2005
Atlanta	-21.2	Q1	2001
New York	-19.4	Q2	2004
Cleveland	-15.4	Q4	2000
Charlotte	-14.4	Q4	2004
Boston	-13.7	Q3	2003
Denver	-10.3	Q3	2002
Dallas	-6.9	Q4	2004
Composite 20	-28.8	Q3	2003

Source: S&P/Case-Shiller, BofA Merrill Lynch Global Research

There are three main areas of the economy that remain under significant pressure and of great concern: housing, employment and debt. Home prices seem to have stabilized (for now), but remain well below recent peaks. In not one of the 20 largest metropolitan areas have prices fully recovered, still off on average 28% from the highs to approximately 2003 levels. Of course, this national average masks wide differences: Dallas is only 7% below its peak value, but Las Vegas has fallen by more than half, wiping out 12 years of appreciation (see Table 1). Nearly one-in-four (23%) mortgages are worth more than the home equity, but that rises to one-in-three in California and two-in-three in Nevada. It should be no surprise that 6.5 million loans are in (or about to be in) foreclosure, assuming the banks can work through the mess of failing to follow proper legal procedures.

There is stress, too, in commercial mortgages, as delinquency rates rose above 9% for the first time, up from 6.5% at the beginning of the year, and only 1.2% at the end of 2008 and 0.38% at the end of 2007. Reported vacancy rates are elevated, but there is also an unusual amount of "shadow" space available. Nationally, the official office vacancy rate is around 16%, but shadow space raises the effective rate by a third to 24% (with wide variation among cities).

Job growth remains elusive. The official unemployment rate has been above 9.5% for 14 consecutive months, breaking the previous record in 1982-83. Adding those with less than full-time employment and those that have given up looking for work, this broader measure of underemployment rises to over 17%.

The US population grows about 1% per year, and we need to create around 100,000 new jobs each month to absorb this new labor pool. But that's only enough to maintain the level of unemployment, assuming no change in the participation rate. To bring the unemployment rate down to 8% in the next two years, for example, a level that would have been considered unacceptably high for most of our history, we would have to create between 200,000 and 300,000 new jobs each month (depending on assumptions). Consider that during the last expansion job growth averaged 142,000 per month, it seems unlikely we will see much improvement in the unemployment rate anytime soon, especially with overall growth weak. GDP is growing at a 1.5-2% annual pace, although it's closer to 1% when stripped of inventory adjustments. It's not a perfect correlation, but we need GDP growth above 3% to move the unemployment rate lower (see Chart 5), and that is not in most forecasts.

An inconvenient truth is that the rate of job growth has been declining for thirty years, and the level of private employment today is the same as ten years ago. A principal reason for this decline in the rate of job growth is the economy's structural shift from a manufacturing to a post-industrial basis with its much higher capital-to-labor ratio. The benefits of globalization and all economies have benefited from improved efficiencies due to globalization, have accrued primarily to capital, in the form of higher profits, rather than to labor.

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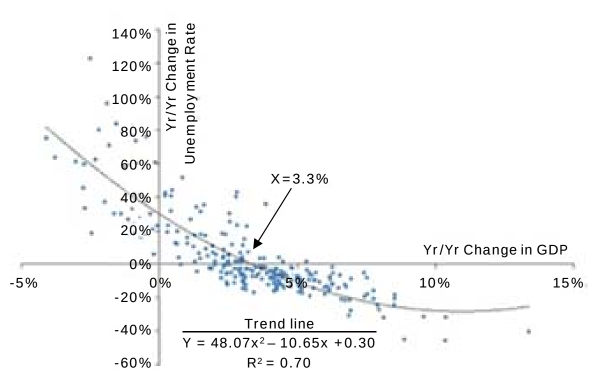
YR/YR CHANGE IN UNEMPLOYMENT RATE AS A FUNCTION OF THE YR/YR CHANGE IN REAL GDP (1Q 1949 - 2Q 2010)



Source: Gary Shilling

The US's structural employment challenge relates primarily to our broad failures in education. The consumption binge of the last decade temporarily created demand for low-skilled jobs, jobs that are not likely to return, and a highly educated work force is an essential condition for our future prosperity.

Taxes and regulations are cited by businesses as the principal obstacles to job creation, not access to or the cost of capital. Keynes, himself, envisioned government spending as a temporary response in a crisis, and certainly not as a permanent source of demand in the economy. Government policies that reduce taxes and regulations and bolster our education system are likely to be more effective at stimulating long-term job growth than additional borrowing and spending.

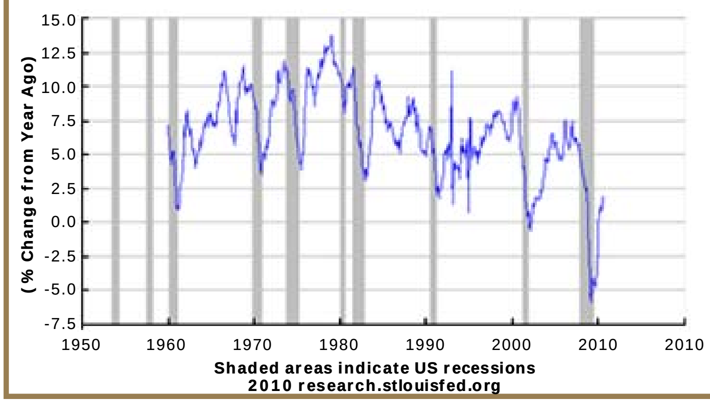
Which leads us to debt. Debt is not only the root of much of our current economic malaise, it has hidden from us the deterioration in important structural trends over the past three decades. Wage growth has been in decline for this period (see Chart 6). Debt can mask these structural shifts by turning a real wealth loss into an illusory nominal wealth gain. Indeed, we have become more reliant on debt to propel our economy. Beginning in 1980, debt has grown faster than GDP, and at an accelerating rate. In other words, we have used significantly more leverage (by a factor of four over the past thirty years) to generate a unit of GDP growth (see Table 2). Conversely, GDP growth would have been considerably lower had our debt levels only grown in-line with GDP. There is no law that sets the upper bound on debt, but we may have reached it.

Amidst the gloom and very serious long-term structural challenges we face are some encouraging developments. Corporate profits have been remarkably robust and balance sheets strengthened. The manufacturing sector has shown particular strength, among the best in the world (see Table 3). Auto sales are running around 12 million annually, below the 16-17 million previously, but up strongly from the 9 million rate a year ago. Future auto demand should rise as the median age of our cars is

"An inconvenient truth is that the rate of job growth has been declining for thirty years…"

6

WAGE AND SALARY DISBURSEMENTS



Source: U.S. Department of Commerce: Bureau of Economic Analysis

TABLE 2

DIMIN/SHING RETURNS
FROM DEBT-FINANCING BY DECADE
12/31/1949-3/31/2010

Date Range	Decade Change in Debt (billions $)	Decade Change in GDP (billions $)	Debt/GDP
12/31/1949-12/31/1959	337.6	248.0	1.36
12/31/1959-12/31/1969	752.1	491.3	1.53
12/31/1969-12/31/1979	2785.2	1654.9	1.68
12/31/1979-12/31/1989	8562.8	2922.3	2.93
12/31/1989-12/31/1999	12550.0	4026.0	3.12
12/31/1999-12/31/2009	26939.2	4669.6	5.77

Source: Ned Davis Research, Inc.

TABLE 3

MANUFACTURING PMIs (50+ = EXPANSION)

Country	October	September	MoM Change	
Australia	49.4	47.3	2.1	Contraction
Austria	56.0	56.1	-0.1	Expansion
Brazil	49.5	50.4	-0.9	Contraction
China	54.8	52.9	1.9	Expansion
Czech Republic	57.2	58.0	-0.8	Expansion
France	55.2	56.0	-0.8	Expansion
Germany	56.6	55.1	1.6	Expansion
Greece	43.6	44.7	-1.1	Contraction
India	57.2	55.1	2.1	Expansion
Ireland	50.9	48.4	2.5	Expansion
Italy	53.0	52.6	0.5	Expansion
Japan	47.2	49.5	-2.3	Contraction
Korea	46.7	48.8	-2.1	Contraction
Netherlands	55.4	52.9	2.5	Expansion
Norway	54.2	53.1	1.1	Expansion
Poland	55.6	54.7	0.8	Expansion
Russia	51.8	51.2	0.6	Expansion
Spain	51.2	49.6	1.6	Expansion
Sweden	61.8	63.3	-1.5	Expansion
Switzerland	59.2	59.7	-0.5	Expansion
Taiwan	48.6	49.0	-0.4	Contraction
Turkey	54.3	50.4	3.9	Expansion
UK	54.9	53.5	1.4	Expansion
US	56.9	54.4	2.5	Expansion

Source: Bloomberg, BofA Merrill Lynch Global Research

now nearly 9 years, and more cars were scrapped last year than were sold (see Chart 7).

Mortgage rates are the lowest in 50 years, dropping the after-tax mortgage payment-to-household income ratio below 16% (it was 28% in 1981 when rates were sky-high). The decline in home prices has lowered the median sales price to 3.4 times median income, versus 4.8 times in 2005. Savings rates are up (to about 6% of disposable income), and while overall household debt has declined only slightly, the decline in interest rates has reduced debt service significantly (back to 2000 levels—see Chart 8).

So, there are unmistakable signs of stability and even improvement in the economy, and the Fed is ready and willing to prime the pump. But the headwinds of housing, jobs and debt are stiff, and progress is likely to be measured in years, not months.

While we wait for the next catalyst to appear, there is a part of the world, indeed the majority of the world, where the themes of growth, reforms and productivity are firmly in place, to the great benefit of their inhabitants and to investors. Indeed, the single most significant development in the world these past few decades, and likely to remain the most important feature of the coming decades, has been (and is) the remarkable progress of lifting billions of people out of poverty and integrating them into the global economy.

Economic development in what used to be called the Third World has been nothing short of astonishing, with every indication of continuation for the foreseeable future. A few, admittedly selective, data serve to highlight both the progress and the opportunity.

In the US, there is one car for every registered driver. In India and in China, there is one car for every 25 registered drivers. Yet last year the

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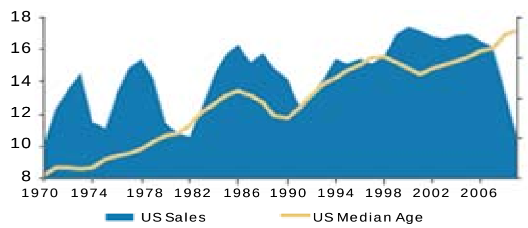
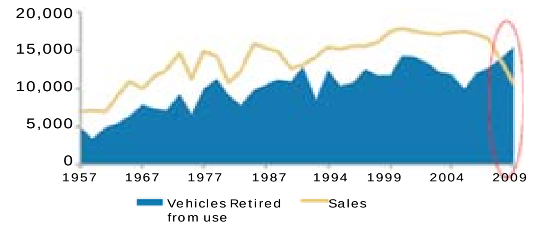
US VEHICLE AGE AT RECORD HIGHS
U.S. SALES (MM)



SCRAPPAGE EXCEEDED SALES IN 2008 AND 2009, LEADING TO DECLINES IN THE US FLEET FOR THE FIRST TIME EVER



*Source: Ward's, Morgan Stanley Research. *Weighted median age is MS estimate.*

Source: Ward's, Morgan Stanley Research.

number of automobiles sold in China exceeded that in the US. For the past century, the US has been the largest energy consumer in the world, until this year, when it was surpassed by China, despite China having per capita income less than one-tenth of the United States (approximately $4,000 versus $45,000). As a sign of things to come, China is about to surpass Japan as the largest patent filer behind the US; a decade ago, Japan's patent filings were four times greater than China's.

The global economy is therefore not balanced, although there is no reason it should be, as the developing economies of Asia, Latin America and elsewhere are experiencing strong growth and rising inflation in contrast to the developed world of sluggish growth and powerful deflationary pressures. This divergence in economic conditions requires different fiscal and monetary policies, ideally in coordination in recognition that ours is a global economy, not isolated local ones.

Unfortunately, that coordination is lacking, the pressures stemming from unbalanced growth are building, and a war of words (for now) has begun: "We're in the midst of an international currency war, a general weakening of currency. This threatens us because it takes away our competitiveness," Guido Mantega, Brazil's finance minister, warned last month.

"We're in the midst of an international currency war..."

The economic development of much of the emerging world the past few decades has been based on exports to the developed world. These exports earned foreign currency (mostly US dollars). In the alternate world of economic textbooks, this foreign currency would be converted back to the domestic currency, expanding the money supply, precipitating inflation, causing interest rates to rise and the currency to appreciate, thus slowing export (and therefore, overall) growth. Rather than permitting this adjustment mechanism to occur, exporters (principally China) chose to recycle their earnings into foreign reserves, thus avoiding the build-up of inflation pressures at home, and the need to raise interest rates and have the currency appreciate. The effect was to reduce the cost of capital in the developed world (principally the United States), facilitating the continued purchases of foreign goods.

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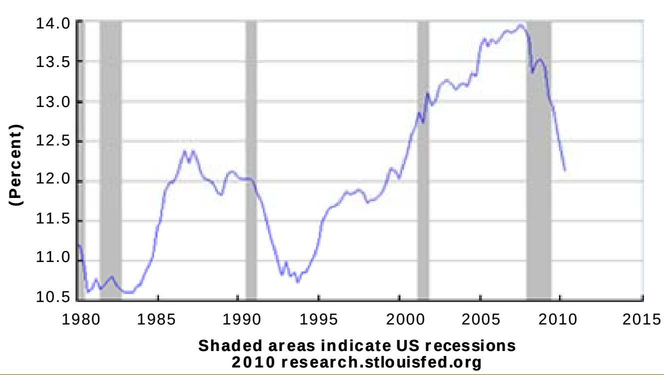
HOUSEHOLD DEBT SERVICE PAYMENTS AS A % OF DISPOSABLE PERSONAL INCOME



Source: Board of Governors of the Federal Reserve System

This happy cycle has been in place for much of the past decade, and it is similar to events in the 1960s when the principal developing (exporting) countries were Germany and Japan. But then, much of the world was on a gold standard, a system known as Bretton Woods (named for the pretty New Hampshire resort where the US told the rest of the world how the postwar monetary system would work). Germany and Japan recycled their earnings into US dollars, but the gold standard required the US to sell its gold and pursue tighter monetary policies. At some point (1971 actually), Germany and Japan decided they didn't want to own more dollars, with inflation rising in the US and the currency likely to depreciate, and the US decided it didn't want to keep selling its gold and raising interest rates. So the US unilaterally announced its abandonment, causing a massive devaluation in the dollar and a spike in inflation (which was addressed through wage and price controls—but that's another sad story).

Similar pressures are building today, with one big difference: the US is not required to sell its gold and raise its interest rates. Instead, it can redeem its debt in fiat money it can print without limitation. This is effectively the message from the Fed, and it is no surprise that some of our creditors have expressed their concern. Rationally, and they are all very smart and rational, creditors would stop lending us money because they know it will be repaid in devalued currency. But then they would be faced with the dilemma of what to do with their (continuing) accumulation of foreign currencies, because bringing those funds home would cause all the problems they wanted to avoid in the first place. A colossal Catch-22.

Ideally, there would be global coordination of policies, whereby countries with current account deficits would raise savings, lower consumption and see their currencies depreciate, and whereby countries with account surpluses would do the opposite. This might help reduce the imbalances and ease the pressures on currencies and trade. While it is probably in everyone's self-interest to make these concessions, the adjustments will be painful, and the path of least resistance is to continue on the current policies until a crisis occurs. It doesn't have to be that way.

On 25 June 1950, the North Korean army invaded the south and soon captured all but the southeast corner of the country around the city of Pusan. Douglas MacArthur, hero of the Second World War and Supreme Commander in Japan, was placed in charge of United Nations troops and devised one of the most daring and brilliant maneuvers in military history, a landing of forces at Inchon on 15 September 1950, attacking the enemy in the rear, forcing the North Koreans to fight on two fronts. Within weeks, the North Koreans had retreated across the 38th Parallel and were fleeing north. MacArthur pursued them to the Yalu River, the border with China. The war was nearly won.

But on 25 October, the People's Liberation Army of Communist China poured across the border, as Mao had vowed he would do if MacArthur crossed the 38th Parallel. Surprised and overwhelmed, UN forces retreated 200 miles and took heavy casualties as they fought through the Taebaek Mountains, some of the most rugged terrain in the world, as temperatures sank to -35 degrees. The greatest disaster of the war unfolded at the end of November, as 120,000 Chinese troops surrounded the 25,000 men of the 1st Marine Division around the Chosin Reservoir.

Ordered to retreat another 70 miles to the port of Hungnam, the Marines fought continuously in bitter conditions against overwhelming odds to escape. There was no single hero who led the way, no rescue from the air or reinforcement of troops. They were on their own and outnumbered five-to-one.

Chosin was a terrible defeat. The 1st Marine Division suffered nearly 1,000 killed, 3,500 wounded, and thousands more succumbing to frostbite. The two week fight back to Hungnam was the culmination of a 275-mile retreat, the longest in the 200-year history of the United States military.

Yet the 1st Marine Division was awarded the highest honor a group can receive in the United States military, the Presidential Unit Citation, for "…*The valiant fighting spirit, relentless perseverance and heroic fortitude of the officers and men of the First Marine Division, in battle against a vastly outnumbering enemy*…." Why?

Because the Marines inflicted more than 70,000 casualties on the Chinese army in their retreat. This halted their advance, depleted their forces, and by surviving largely intact, the 1st Marine Division was successfully evacuated and returned to fighting.

Facing complete annihilation, against insurmountable odds, the 1st Marine Division saved the war, and rescued the 50 million people today of South Korea from the monstrous fate of their 20 million or so brethren in the north condemned to the nightmare of Kim Il Sung and his misanthropic progeny. Their heroism is not only inspiring, it is instructional.

There are times when we cannot rely on our leaders for support or guidance; we have to rise and sacrifice individually and together to meet our challenges. The 1st Marines showed us how ordinary people in extraordinary circumstances can survive their ordeal and overcome their obstacles. Retreat was not defeat. In their honor is the inscription on the Korean War Memorial on the Mall in Washington, DC: Freedom Is Not Free. But it is worth the sacrifice.

"Freedom is not free."

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PRINCIPAL & CHIEF INVESTMENT OFFICER
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