Angeles
INVESTMENT ADVISORS

**Commentary**
**Second Quarter 2011**

# Good Name

Eddie was born in St. Louis in 1893 to first generation Irish-American parents. He married at the age of 19, and the first of his three children, Eddie, Jr., was born the following year. Working in his wife's family grocery store did not fill his boundless ambition, so at night, he attended college and then law school. Soon after passing the Missouri bar, Eddie had the good fortune to meet Owen P. Smith, head of the International Greyhound Racing Association, and inventor of the mechanical rabbit the dogs loved to chase. In the Roaring Twenties, dog racing was enormously popular, and through Smith, Eddie came to operate race tracks across the country. When Smith died, the mechanical rabbit patent went to Eddie (he claimed he bought it from Smith's widow, but more likely he stole it), making Eddie a wealthy man. His wealth enabled him to pursue his passion for flying, a passion he instilled in his son. He befriended a young pilot named Charles Lindbergh, often flying with Lindy on his mail routes.

Eddie soon sought bigger opportunities, and in 1927, divorced his wife and moved to Chicago. Now, anyone wanting to do business in 1927 Chicago had to go through the man who ran the city, Al Capone. Fortunately for Eddie, Capone was a huge dog racing fan (or, more accurately, a huge fan of betting on dog races), and the two soon became close friends and business partners, and Eddie's fortune grew. He was known as "Easy Eddie," and life was good.

Or was it? For reasons that may never be known, Eddie became concerned about how his life had developed: a business empire built on gambling, an ill-gotten patent, growing ties to the murderous Capone gang, and a family he had abandoned in St. Louis. His son was away at a military boarding school, but Eddie worried what kind of example he was setting.

Eddie's life is but a footnote in history. But his actions, and later his son's, changed American history, twice. As we will see, the story of their lives holds lessons for us today.

Economic worries weighed on markets in the second quarter. Equities made no progress, and interest rates fell as investors sought refuge from multiple storms. It was no surprise that Greece was the worst performing market in the world last quarter, off 18%, followed by Peru, down 16%, as a Chavez ally was elected president (not that Peruvians had much of a choice: the other candidate was the daughter of a former president convicted of corruption and crimes against humanity, running on the single platform of amnesty for her father). For those keeping track, the best market in the quarter was New Zealand, with an 11% gain (lamb prices must be rising).

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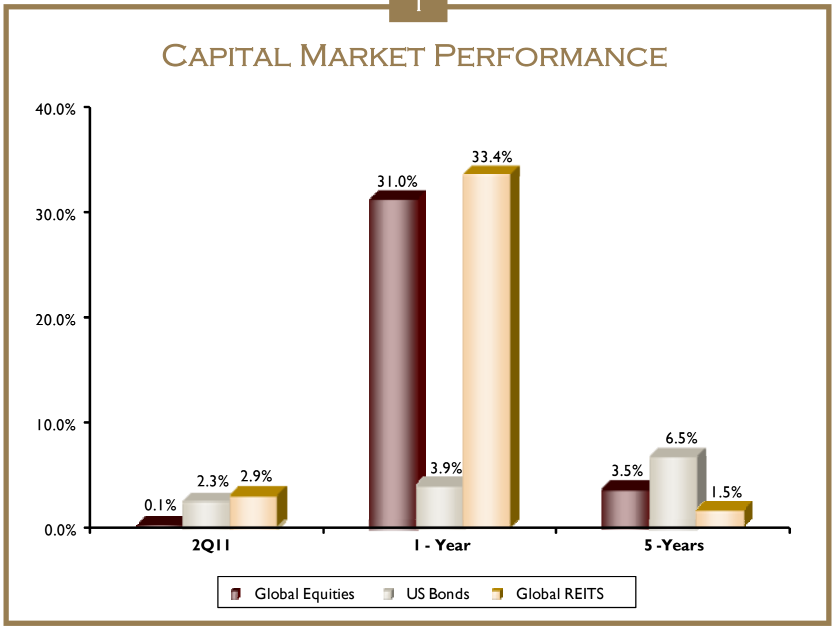


*"The first economic storm to batter investors came in Europe."*

The first economic storm to batter investors came in Europe. Most investors understand that Greece is insolvent, and that no amount of liquidity addresses this underlying fact. Most also understand that Greece is insignificant economically, about 2% of the European economy, with less than half the GDP of Los Angeles. But we were also told of the small size of the sub-prime market in the US, and therein lies the concern. Investors are asking, if European politicians cannot put a fence around Greece, as tiny an economy as it is, how will they address the problems in Portugal and Ireland, or even Spain and Italy? So the problem isn't Greece. The problem is the ability of policymakers to resolve the debt issues of these other countries. The link between Greece and the rest of Europe is the banks. Bank regulators determined years ago that lending to any sovereign in the EU was risk-free for capital purposes, making no distinction, for example, between German bunds and Spanish bonos. So the issue is two-fold: falling bond prices threaten the capital stability of the European banking system, and also make it more difficult for countries to finance their debts.

Greece, Ireland and Portugal have all seen their borrowing costs soar to double-digits, but recently concern has been focused on Spain and Italy, as their cost of funds has broken above 6% (see Chart 2). The cost of

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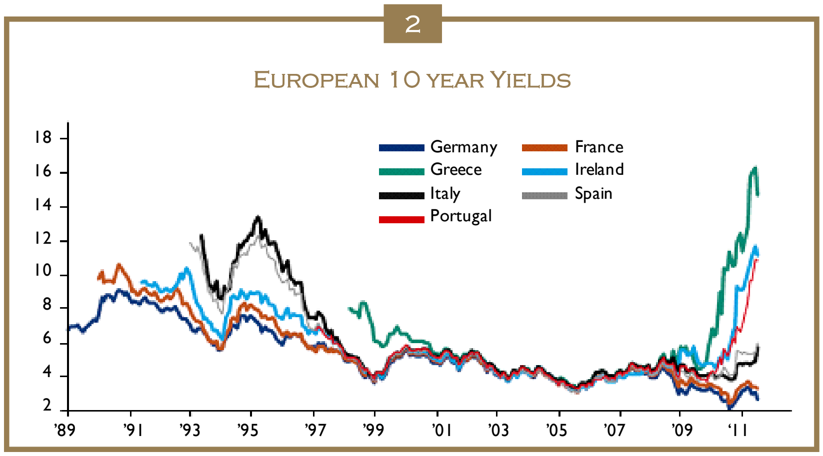


*Source: BofA Merrill Lynch Global Equity Strategy, Bloomberg, Datastream* borrowing is not sustainable above the nominal growth rate of a country, and none of these countries have a nominal GDP growing faster than 6%. This means that economic growth is eventually insufficient to service its debt.

The challenge is compounded by a structural obstacle in the Eurozone: monetary sovereignty was ceded to a central authority (the European Central Bank—ECB), but fiscal policies remained with each nation. Thus, there is no mechanism for fiscal transfers within the Eurozone as there is in the United States. Central banks may (or may not) prove adept at addressing liquidity crunches, but they are not geared for handling solvency crises because those require some combination of debt restructuring and/or wealth transfer. Europe's fundamental problem throughout has been to treat the debt crisis as a liquidity problem rather than what it truly is, a solvency problem.

Policymakers began to address this dilemma by agreeing to expand the role of the European Financial Stability Facility (EFSF) to include the authority to takeover troubled banks, purchase sovereign bonds, restructure those bonds, and to provide credit guarantees. The EFSF was given €440 billion of lending authority (about a third of which has already been spent), and this should be sufficient to handle any near-term contingency for Greece, Portugal or Ireland (based on their refinancing schedules).

However, there are devils in the details. The deal assumes private bondholder participation in the scheme, and that is not assured. The amount and terms of IMF agreement in the lending have not been worked out. A joint IMF-EC-ECB commission is supposed to certify each quarter that the borrowers are adhering to their austerity plans, a process wrought with political tension. This expansion of authorities of the EFSF and greater funding from European governments are subject to parliamentary votes in each of the Eurozone members, and approval is far from guaranteed. Indeed, voters in Finland and in Germany have already expressed their discontent with this "bailout" in several regional elections. For Germany, the cost of this deal may ultimately rival their reparations following World War I or unification with East Germany (see Chart 3). German voters are not likely to be pleased.

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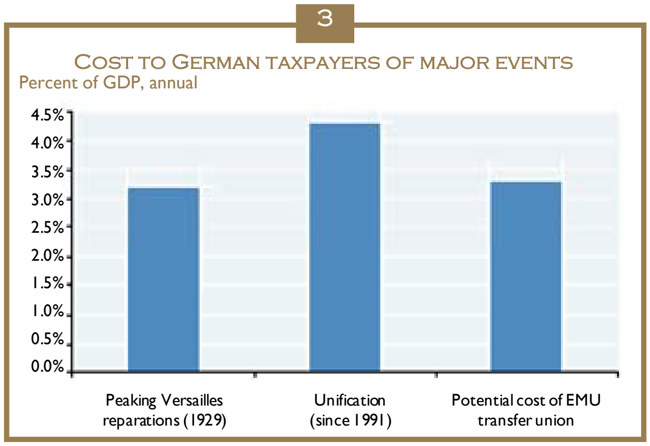


*Source: Carl-Ludwig Holtfrerich, Halle Institute of Economic Research, Zentrum fur Europaische Politik (Freiburg), J.P. Morgan Asset Management.*

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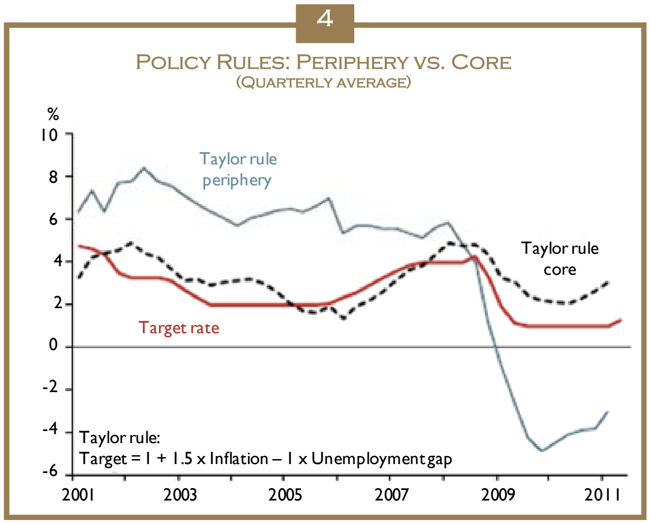


*Source: OECD, Eurostat* *Courtesy: FRBSF*

The EFSF is a step in the right direction, although it fails to tackle even Greece's underlying insolvency. Even if the EFSF enables Greece to borrow at subsidized rates, there is simply too much debt for that economy to sustain. And a forced austerity program will not only face political backlash, it is ultimately self-defeating because it curtails the very economic growth a borrower needs to be able to service its debt.

Compounding the challenge is that the ECB has chosen to pursue a monetary policy that simply averages the demands of all the countries in the Eurozone, guaranteeing that its policy will be too accommodative for some (like Germany) and too restrictive for others. As Chart 4 (pg. 3) shows, the "Taylor Rule," a blunt but reasonable measure of appropriate monetary policy that balances growth and inflation, is very different for core and periphery Europe. By adopting an average, the ECB ensures a policy that is suitable for no country.

> *"The challenge is as much (if not more) political than economic."*

Even assuming the immediate crisis in these three countries is delayed for a period, the window of capital market access for Spain and Italy (and even Belgium and France) is rapidly closing. The EFSF/IMF package, not yet even formalized, is grossly insufficient, by a factor of four, to provide support to these countries (see Chart 5).

The challenge is as much (if not more) political than economic. Europe has come to the proverbial fork-in-the-road with its structural flaw, and will have to choose between closer integration of tax and fiscal policies or some sort of dismantlement of the Euro experiment. The process is difficult enough among a group with shared experiences and values, but a much bigger challenge among peoples with widely diverse perspectives as exist in Europe.

Data from the World Values Survey reveal two dimensions of cross-cultural variation: traditional versus secular-rational

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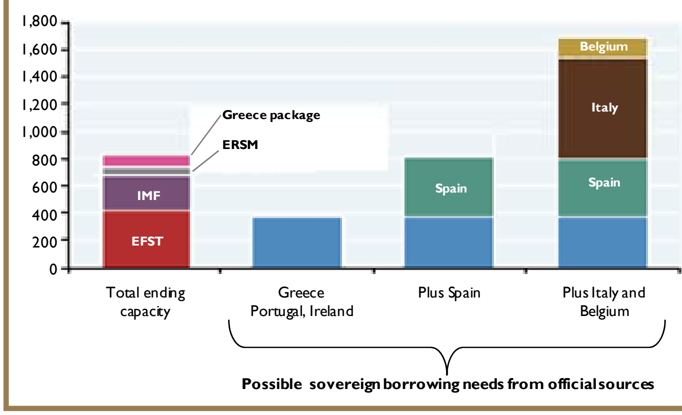
LENDING CAPACITY VS. SOVEREIGN FUNDING NEEDS

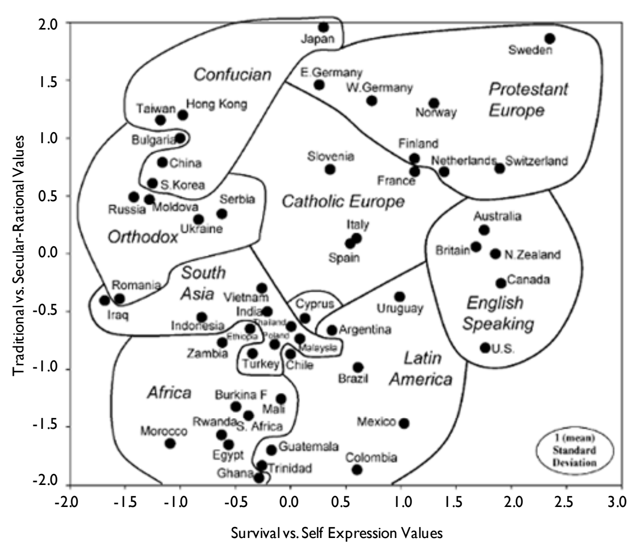
Official sector lending capacity vs. sovereign funding needs (including deficits) through 2013-Billions, EUR




Source: AllianceBernstein, Public Filings

6

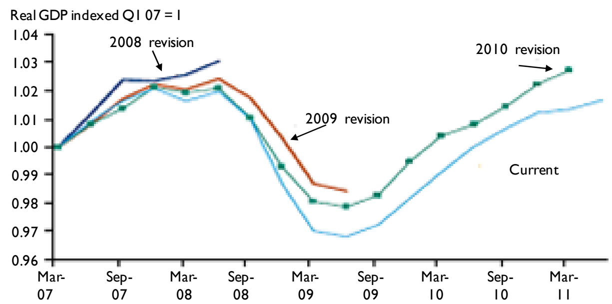
GLOBAL CULTURAL MAP




Source: Data from World Values Survey. The oval at the higher right shows the mean size of the standard deviation on each of the two dimensions within the 53 societies (the shape is oval because the S.D. on the horizontal axis is larger than on the vertical axis).

7

US GDP Revisions




*Source: BEA, BofA Merrill Lynch Global Research*

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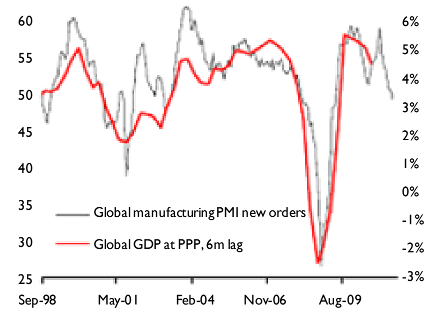
Global Manufacturing GDP




*Source: Thomson Reuters, Credit Suisse Research*

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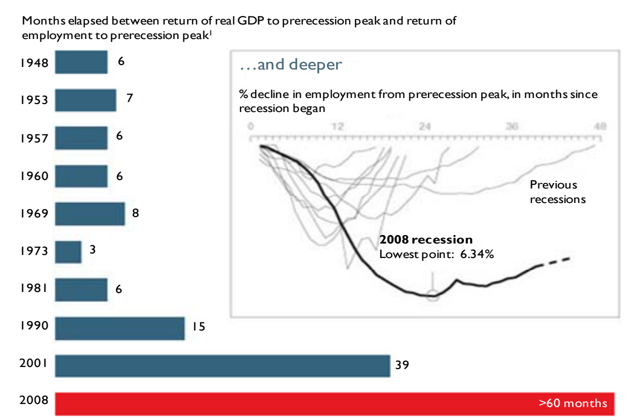
US Employment and GDP Recoveries




*[1] Returns to prerecession peaks are established by start of more than 1 quarter above prerecession levels; US recessions are labeled by beginning year, with the exception of the most recent. The National Bureau of Economic Research estimates that the current recession began in December 2007, GDP returned to its prerecession peak in December 2010.*

*Source: US Bureau of Economic Analysis; US Bureau of Labor Statistics; McKinsey Global Institute.*

(emphasizing religion, national pride and obedience versus secularism, autonomy and rationality) and survival versus self-expression (order, conformity and economic security versus self-expression, trust and tolerance). As Chart 6 (page 4) shows, Italy and Spain share common values but they are very dissimilar with Germany and Scandinavia. The crisis in Europe is as much about differing value systems as it is about economics.

Weakness in US economic data is another serious concern. The economy expanded at a very sluggish 1.3% rate in the 2nd quarter, well below expectations, and previous periods were revised much lower (see Chart 7). Those revisions to prior estimates mean that economic output has yet to surpass the 2007 peak. The 42 months below peak GDP is twice as long as any period post-WW2. New manufacturing orders contracted for the first time two years, in the US and globally, presaging a downturn in the global economy (see Chart 8). Since 1950, GDP growth has fallen below 2% 12 times; in 10 of those times, the economy subsequently fell into recession (1956 and 2003 were the exceptions).

*"The crisis in Europe is as much about differing value systems as it is about economics."*

The disappointing softness in the economic recovery is most visible in the employment and housing data. The unemployment rate was at 4.7% in November 2007, and two years into recovery is still above 9%. In the past year, full-time employment has fallen 0.5%, although part-time employment is up 3%. More than 14 million are officially unemployed, and that number rises to more than 20 million when we include those discouraged workers. The average duration of unemployment is over 40 weeks, an all-time-high, and a record 44% have been out of work six months or more. Job losses have been greater and more protracted than any previous post-war period, and it will be years before we see employment return to prior peak levels (see Chart 9, page 5).

The percentage of people in the work force peaked at over 67% of the population ten years ago, and has now fallen below 64%, the largest decline on record and back to where we were 30 years ago. Combined with the growing duration of unemployment, we should be increasingly concerned that the employment crisis has turned structural, that is, permanent (or, at the least, prolonged). Another structural change we may be seeing is how labor is used. Historically, at least till 1990, there was greater job security, and during recessions, labor productivity, in the form of reduced hours, rather than job cuts absorbed the losses due to recession. Over the past 20 years, and especially so in this latest downturn, labor productivity remained relatively high, whereas jobs were quick to be slashed. Twice in this recovery, job growth moved above 200,000 per month, only to fall below 100,000 again. Companies are hiring in response to rising demand, but are quick to lay-off at the first signs of weakness, indicating wariness with the sustainability of this recovery.

*"Unemployment may remain high and wages stagnant in the US for the foreseeable future."*

There may be an additional factor at work in the employment dynamic, according to Michael Spence, the 2001 Nobel Laureate in Economics. For much of our history, economic growth and employment growth went hand-in-hand. Globalization, the process by which economies integrate, abetted that economic growth, and since the developing countries were small and producing low value-added goods, the effect on employment growth in the developed world was minimal. But as developing countries moved up the food chain, producing higher value goods, and as their economies now account for more than half of the world's output, globalization is redistributing employment opportunities and incomes in the developed economies. For the first time, economic growth and employment are diverging.

Between 1990 and 2008, the number of employed workers in the US increased from 122 million to 149 million. 98% of these 27 million new jobs were in the non-tradable sector of the economy, the sector that produces goods and services that must be consumed domestically. Government (with 22 million workers) and health care (16 million workers) are the two largest industries in the non-tradable sector, accounting for 10 million of the new jobs created during this period. The tradable sector of the economy—manufacturing, engineering, consulting—the goods and services that can be consumed globally, had a combined 34 million workers in 1990 and added only 600,000 in the period to 2008. So there has been a big shift in job creation from the faster growing tradable sector to the more static non-tradable sector. Furthermore, wages are closely correlated with value added, and since value added has not increased much in the non-tradable sector, neither have wages. Employment opportunities and incomes are high for the handful of highly educated people in the tradable sector of the economy, and they are diminishing for everyone else. This is not a market failure, or even an inefficient outcome for the global economy (just the opposite). But employment and incomes will not grow in the non-tradable sector of the economy. If countries wish to compete for employment opportunities and higher incomes, they will need a workforce that can compete globally. That requires a continually advancing educational labor pool, and that is a whole other topic. Unemployment may remain high and wages stagnant in the US for the foreseeable future.

Employment losses have multiplier effects. Income taxes are not paid, mortgages move into default, foreclosures rise. Banks sustain losses on those mortgages, municipalities lose tax revenue and neighborhoods are blighted.

In the US, more than 30% of mortgages are

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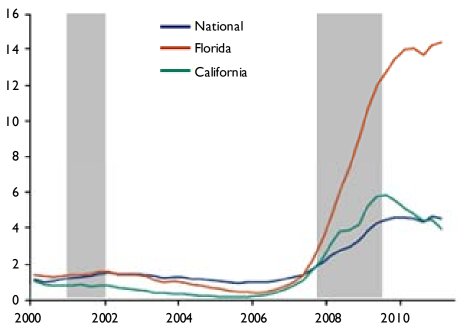
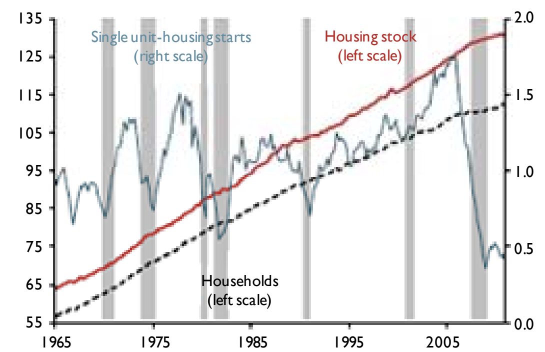
Foreclosure inventory
(% of all mortgages)




Source: MBA, BofA Merrill Lynch Global Research

11

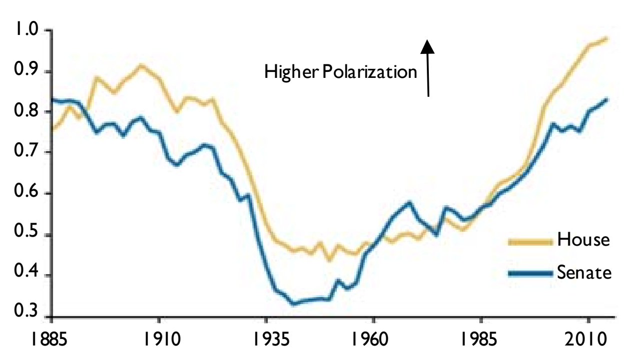
Housing market supply & demand factors




Source: Haver Analytics Courtesy: FBRSF, July 2011
Note: Seasonally adjusted annualized rates

12

Political Polarization in the US, 1885-2010




Source: "Polarized America" by McCarty, Poole and Rosenthal; Morgan Stanley Research
Note: This measure of political polarization is derived from analysis of the voting patterns of Congress and is based on the relative divergence in the average positions of Democratic and Republican legislators.

underwater, and nearly one-in-ten households are delinquent or in default. Home prices in the 20 largest cities are on average one-third below the 2006 peak. New home sales are running at an annual rate of just 164,000 units, the lowest in at least 50 years despite a doubling of the population in that time. Nationally, about 4% of mortgages are in foreclosure, but there are large regional divergences driven by the differences in the two dominant legal processes: judicial, where the court is involved, and trustee, who can sign-off on a foreclosure. The efficiency of these two approaches in dealing with the overhang of foreclosures is starkly different. An interesting comparison is between Florida and California. Both saw huge gains in prices in the decade preceding 2006, 170% and 215%, respectively. Both experienced high defaults, with 12.7% of mortgages delinquent in Florida by 2009 and 11.3% in California. But Florida is a judicial state whereas California follows the trustee process. Consequently, foreclosures in California are now below the national average, whereas in Florida foreclosures continue to grow (see Chart 10).

*"...political polarization is growing..."*

There are approximately 130 million housing units in the US. This number is closely linked to the number of households. Demographic growth is relatively constant. But new construction is highly variable, coinciding closely with the business cycle (see Chart 11). Much as we may be seeing a structural shift in employment dynamics, we may be witnessing a similar structural change in the housing market. The home ownership rate peaked at 69% in 2005 and has now fallen to 66%. Excluding delinquent mortgages, the home ownership rate would be below 60%, and that rate looks likely to continue to fall for some time.

As in Europe, the economic challenges of the US require political leadership. Unfortunately, not only is that leadership lacking, political polarization is

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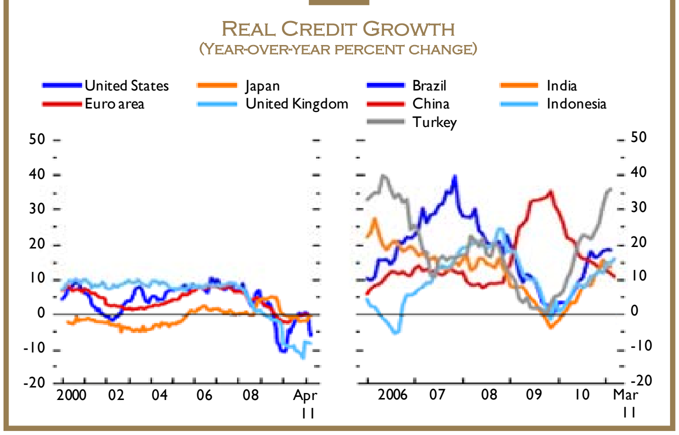


Sources: Haver Analytics, IMF, International Financial Statistics; and IMF staff calculations.

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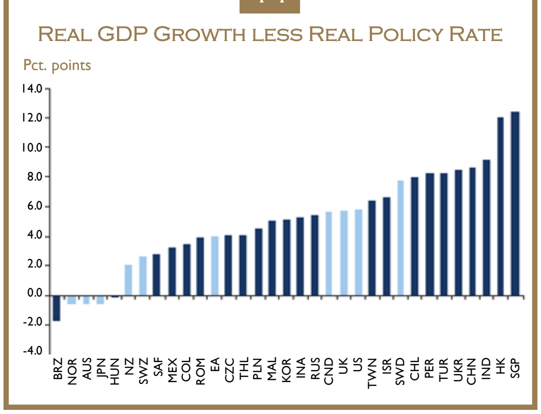


Note: Inflation and policy rates latest available month
Source: Haver Analytics; As of July 6,2011

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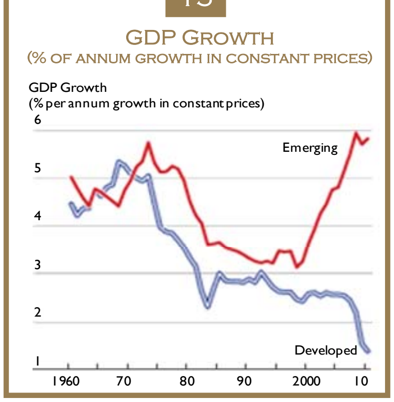


Source: Smithers & Co Courtesy: Financial Times

growing, making consensus that much more difficult to achieve. The crises of the Great Depression and World War II brought Americans together politically. We are, demonstrably, far from that level of political accord today (see Chart 12, page 7).

Stresses are not confined to the mature economies. The fast-growing economies face a different threat: inflation. Headline inflation is over 6% in China and Brazil, and more than 8% in India. Credit growth is rising at double-digit rates in these countries, in contrast to the contraction in the developed world (see Chart 13).

The cause of rising inflation in these countries is clear: lax monetary policies. With the exception of Brazil, which has tightened aggressively, real interest rates are very low in most countries. For the growth-challenged mature economies, it may be appropriately simulative to set rates below GDP growth, but this is not the case in the faster growing economies where inflation is rising (see Chart 14). The recent economic slowdown has relieved some of the cyclical inflation pressures, but inflation will return in countries that have set very accommodative monetary policies.

Rather than a one-off event, the financial crisis of 2008 was a pivot point in the global economy (see Chart 15). The growth trends of China and India barely skipped a beat, and Brazil saw a modest dip and a quick resumption of growth. But most developed countries (Australia is the exception) have yet to recover their losses three years later, and their growth trajectories will continue to lag, if they remain positive at all (see Chart 16, page 9).

For developed countries, this is the environment of deleveraging. In the four years since the debt bubble popped in the US, stock prices are 15% lower, real GDP has yet to

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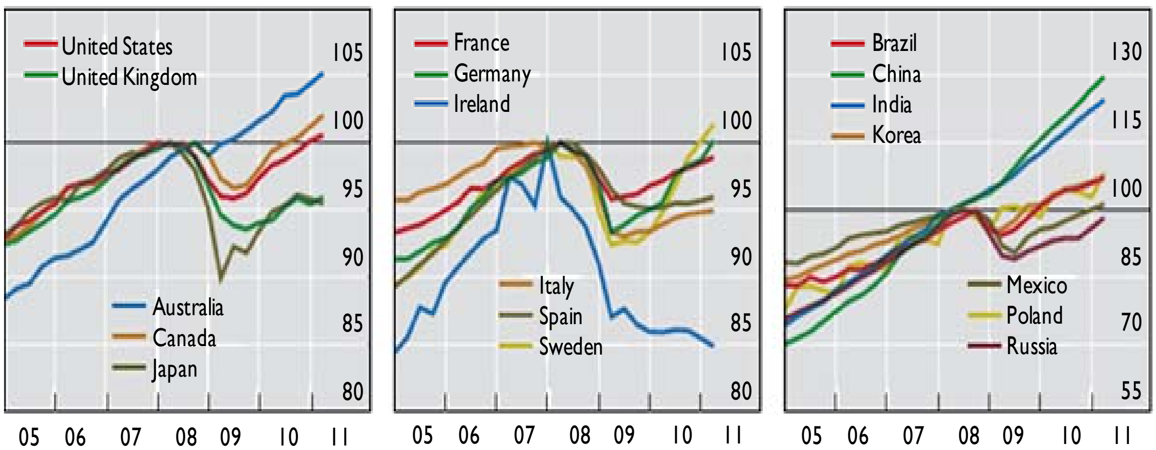
OUTPUT IN SELECTED ECONOMIES
PRE-CRISIS PEAK = 100[1]




*1 Defined as the highest value of the real GDP index for 2007-08. For China, India and Poland, the peak is defined as the first quarter of 2008.*
*Sources: Datastream; national data; BIS calculations.*

recover, bond yields are down more than 200 basis points and the overnight Fed funds rate is 500 basis points lower. Federal government debt has doubled from $4.9 trillion to $9.6 trillion (and climbing). The Fed has printed $1.8 trillion of reserves, gold is up 150% and the US dollar is off 60% against the yen and 50% versus the Swiss franc, but just 7% against the euro and 6% against emerging countries' currencies (primarily because these countries have added $2.7 trillion to their reserves, $1.7 trillion in China). Home prices have dropped one-third, the savings rate is up from 1.8% to 5%, and private sector debt as a percentage of GDP has fallen four consecutive years. Of course, it had increased every year from 1946-2007, so it may take some time to reverse decades of strong credit growth. The last period of decline in private debt occurred over 14 years (1933-1946), and interest rates were held near zero for most of that time. The Fed funds rate has been at zero for not quite 3 years, which puts into perspective those who call for interest rates to rise anytime soon.

In recent years, it has become fashionable to frame economic debates as Keynesian versus Friedmanite. But interestingly, both great economists shared a similar view that the cause of an economic contraction was insufficient aggregate demand. They differed only in their prescriptions: Keynes argued for deficit spending by the government to boost demand, whereas Friedman favored monetary stimulus to spur demand.

Perhaps America's greatest economist, Irving Fisher, held a different view of the cause of recessions. He saw the excessive buildup of debt relative to GDP as the key factor, not insufficient aggregate demand. In this case, only the difficult process of deleveraging can ameliorate the condition. In Fisher's view, neither government spending nor monetary stimulus can be effective, and indeed, will only be harmful to the economy that needs to delever. The record amount of fiscal spending has burdened us with an enormous level of debt, quite probably for generations to come. The unprecedented expansion of the Federal Reserve's balance sheet has distorted the true price of money and confis-

*"...neither a Keynesian nor a Friedmanite be..."*

cated trillions of dollars from savers in foregone interest. To paraphrase Shakespeare, perhaps neither a Keynesian nor a Friedmanite be, but a Fisherian who understands that the remedy to excessive debt is to delever.

Following a lunch with Frank Wilson, an IRS agent, Eddie began to turn over Capone's financial records, even providing the key to the bookkeeping code used to hide the data. Just before Capone's trial for tax evasion, Eddie tipped off prosecutors that Capone had fixed the jury, and at the very last minute, Judge James Wilkerson swapped juries with another federal judge. In 1933, Capone was found guilty on 5 counts and sentenced to 11 years at Alcatraz.

That same year, Eddie, Jr., known by all as "Butch," enrolled as a midshipman at the US Naval Academy. Having flown with his dad and Lindbergh as a child, he naturally chose naval aviation, and earned his gold wings in 1940. When war with Japan came in December 1941, he was a flight instructor at Miramar, but soon shipped out to Pearl Harbor with the Pacific Fleet.

In February 1942, the *USS Lexington* was sent to penetrate the enemy waters off of Papua New Guinea. In the afternoon of 20 February, 450 miles at sea, the *Lexington's* radars picked up a formation of Japanese bombers, and scrambled fighters to engage. Thirty minutes later, a second group of bombers in a V-formation were spotted on the other side of the carrier from the first group, just 12 miles away. The *Lexington* had only two Grumman F4F Wildcat fighters on deck, and Butch and his wingman, "Duff" Dufilho, were launched. The bombers were met just nine miles from the ship, but Duff's guns were jammed, and in their haste to launch, Butch's four guns had only 450 rounds each, enough for a total of 34 seconds of firing. While help was coming from the first group of fighters launched earlier, only Butch stood between the nine bombers and the destruction of the *Lexington*.

Butch began a diving attack at the rear of the bomber formation. He downed his first bomber, then ducked below and to the other side of the formation, nabbing a second bomber on the other side. By now, five of the bombers were close enough to the *Lexington* to drop their ordinance, but all missed. Butch came around again, and in a final burst, downed three bombers simultaneously and damaged a fourth. His commander arrived on the scene to see the three bombers fall to sea at the same time.

With his five kills, Butch became the first naval ace of World War II and the first naval aviator to be awarded the Congressional Medal of Honor, the highest honor this country can bestow. Part of his citation reads,

*"As a result of his gallant action—one of the most daring, if not the most daring, single action in the history of combat aviation—he undoubtedly saved his carrier…"*

After his White House ceremony with President Roosevelt, Butch toured America as a national hero, and then rejoined his squadron. On a dark night, 26 November 1943, his F6F Hellcat was caught in a crossfire and fell to the sea, never recovered.

Eddie, Sr., "Easy Eddie" never saw his son earn his wings or become a hero. On 8 November 1939, he left his office at the dog track in Cicero, Illinois in his black Lincoln Zephyr. At an intersection close by, two gunmen riddled his body with shotgun shells, and he was killed instantly. He was 46 years old.

After the war, Robert McCormick, legendary publisher of the *Chicago Tribune,* searched for an appropriate commemoration of Butch's heroism. He suggested naming an airport west of the city in his honor.

On 19 September 1949, Orchard Depot Airport (identifier: ORD) was renamed O'Hare International Airport. A replica of Butch's F4F Wildcat can be found next to Terminal 2.


Today, some seem to have forgotten Eddie O'Hare's lesson. The trust, the credit of the United States and all its obligations should be sacrosanct, and its currency not only a medium of exchange, but a store of value, for this generation and generations to come. Eddie O'Hare realized that the most important thing he could leave his son was not wealth or possessions, but his good name. He was willing to pay for it with his life.

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MICHAEL A. ROSEN
PRINCIPAL & CHIEF INVESTMENT OFFICER
AUGUST 2011

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