Angeles
INVESTMENT ADVISORS

Commentary
Fourth Quarter 2011

Bushido

Four to five hundred years ago, feudal Japan was wracked with internal wars. It was the Sengoku Period of warring states, a 150-year span of near-continuous strife as various groups fought for dominance throughout the archipelago. The Battle of Sekigahara in 1600 settled the matter with the victory of the Tokugawa faction. Japan was now united, with the emperor remaining the titular head of the country, but with power residing with Tokugawa Ieyasu, who took the title of shogun. Over the next 268 years, the Tokugawa Shogunate established a strict social hierarchy throughout the country, with daimyos (lords) at the top, followed by samurai (warriors), then farmers, artisans and traders (appropriately, at the bottom). Social mobility and economic progress were limited, but for over two centuries, the Tokugawa dynasty brought internal peace and stability to this fractious country, helping to forge a common national identity.

Centuries earlier, a personal code developed, drawing on Confucian texts and elements of Shinto and Buddhism. It was called *bushido*, literally, the "way of the warrior," roughly analogous to the code of chivalry that arose in medieval Europe, but it was much more than that.

Bushido elevated seven virtues for the warrior to follow scrupulously: Rectitude, Courage, Benevolence, Respect, Honesty, Honor and Loyalty. The warrior was also expected to master the martial arts and, most importantly, prepare for an honorable death. Honor lost could be restored only one way, through *seppuku*, ritual suicide.

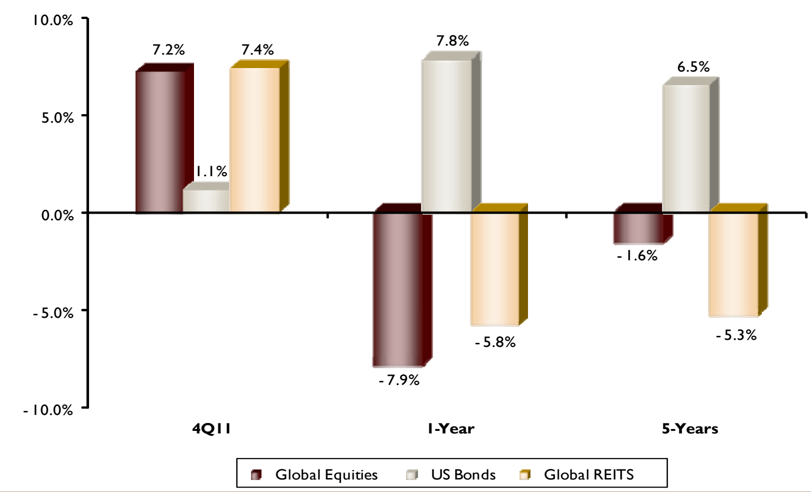
The Tokugawas codified parts of the *bushido* into formal law, but *bushido* is a philosophy, not precepts, and at its core, connects death with honor: one must live honorably at all times because death can come at any time, and a dishonorable death is the ultimate sin. More than two hundred years after Tokugawa Ieyasu unified his country, Japan would face an existential crisis brought on by external events that cast doubt on the very essence of its society and culture. Then, from the remotest end of the country, there arose a samurai who would lead Japan though this crisis, helping his people forge a path to modernity while embodying the highest ideals of *bushido*. Many nations today face a similar crisis, and we would be wise to study this samurai's example.

Equities rebounded sharply in the last quarter of 2011, ameliorating, but not reversing, losses from earlier in the year. The luck of the Irish returned, as Ireland posted, by far, the best results of any country in both the quarter (+22%) and over the past year (+11%). Not surprisingly, the gods abandoned the Greeks, as that market fell 22% in the fourth quarter, capping (or maybe, anchoring) a 60% decline for the year.

"The 200+ year cycles of bond yields are clear..."

1

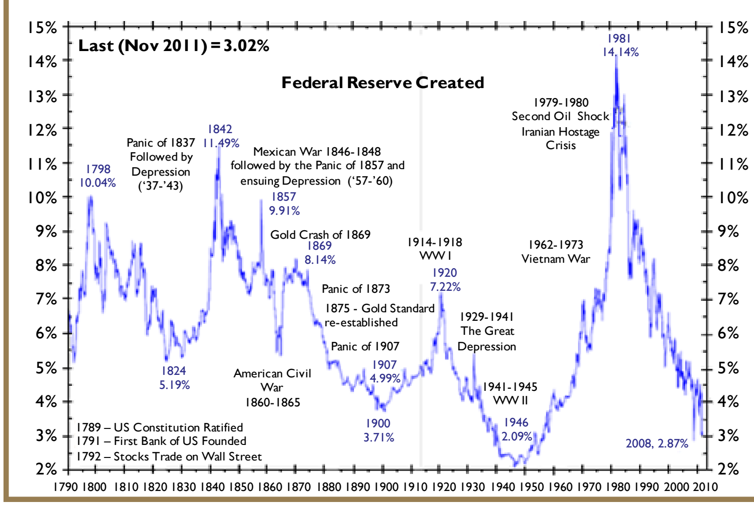
CAPITAL MARKET PERFORMANCE



Commodities followed equities, with a strong quarter (+9%) but modest losses (-1%) for the year. Oil rallied in 2011, but natural gas dropped 37% as production soared. Cocoa, that perennial favorite of young and old alike, fell 30% in price, bringing joy to its consumers. Bonds saw a modest return in the past quarter, closing another strong year. Best was long duration US government bonds, such as TIPS, which gained 14% in 2011.

2

LONG TERM INTEREST RATES BACK TO 1790



Source: Bianco Research, LLC

US stocks have doubled from their lows in March 2009, and while there have certainly been periods of outstanding equity returns, ours has really been an era for bonds. Since 1980, bonds have outperformed equities in the US. This 32-year span of bond outperformance is surpassed only by the 44-year period of 1852-1897.

The 200+-year cycles of bond yields are clear in Chart 2. For investors, the message is also very clear, because returns are a simple function of starting and ending yields. Locking in a 2% annual yield for 30 years in 1946 was a disastrous investment. But being able to earn 14% every year for 30 years starting in 1980 was brilliant. Of course, in 1946, there were good reasons for 2% yields, as the economy was contracting following the war effort and memories of the

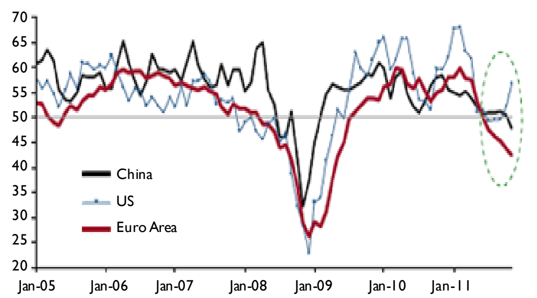
Great Depression were still fresh. Likewise, inflation topped 10% in 1980, and all efforts to control it throughout the 1970s had failed, so a 14% yield in that context did not seem like much of a bargain (especially since short-term rates were even higher).

Over the past 30 years, stocks kept pace with bonds for the first two decades, but this past decade has been unforgiving, with essentially no return in equities while bond yields continued to decline. There are good reasons for long-term yields to be 2-3% today, and even reasons to think yields will remain low for the foreseeable future. But at these levels, achieving the 8% return bond investors enjoyed last year, while not impossible, will become increasingly difficult.

Natural disasters (Japanese earthquake/tsunami, floods in Thailand) and politics (Arab revolts) roiled the global economy during the year, but it was rising inflation, especially in many emerging countries, that induced tightening of fiscal and monetary policies that dampened growth prospects as we headed into the new year. Notably bucking this trend, with growth actually accelerating, was the US, as new manufacturing orders attest (Chart 3).

There are a few factors that explain US economic strength. Businesses slashed inventories aggressively in the middle part of the year, and are now rebuilding them to meet demand. More than two-thirds of the economy's growth in the fourth quarter came from inventory restocking. For the past two years, corporations have seen record profits (Chart 4) as they've cut costs and reduced debt, unlike their European and Japanese counterparts, and this has been reflected in equity prices. Since September 2009, European equities have lost 5%, the Japanese market is off 20%, while US stocks are up 30%.

3



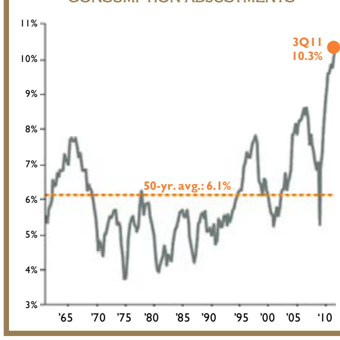
MANUFACTURING PMI NEW ORDERS

Source: ISM, Markit Economics, NBS, Credit Suisse

The combination of rising sales and lower costs is reflected in the US productivity data, which have outpaced most of the world (Chart 5). Productivity is a measure of efficiency, the amount of output per unit of input, and, in the long-run, the principal driver of living standards. Its immediate impact is higher profits, since businesses can produce more

4

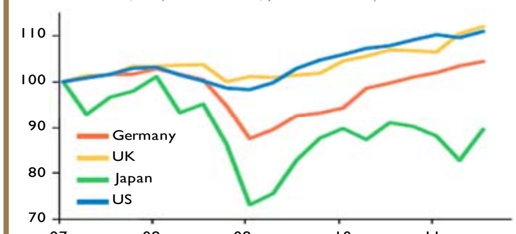
ADJUSTED AFTER-TAX CORPORATE PROFITS (% OF GDP)
INCLUDES INVENTORY AND CAPITAL CONSUMPTION ADJUSTMENTS



Source: BEA, Factset, J.P. Morgan Asset Management

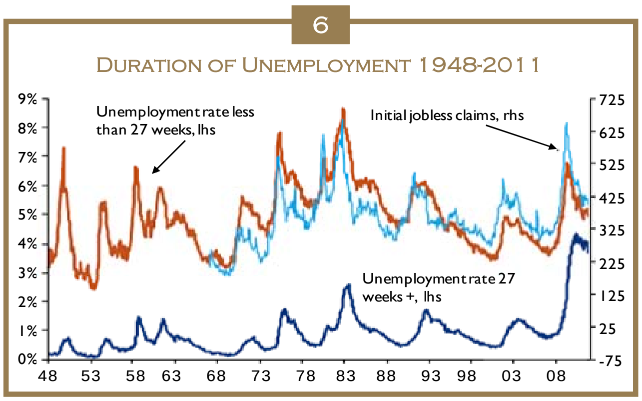
5

CORE G10 MANUFACTURING PRODUCTIVITY (1Q07=100), 2007-3Q11



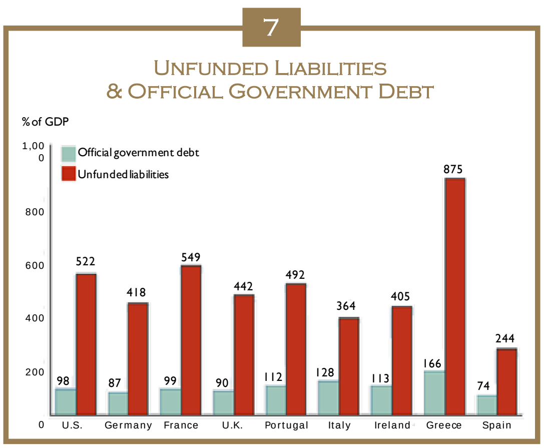
Source: Haver and Morgan Stanley Research

"There are a few factors that explain US economic strength."

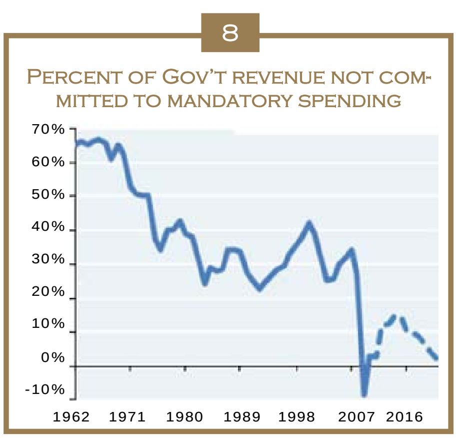


Source: BLS, Dept of Labor, Bank of America Merrill Lynch Global Research

"Debt remains at the heart of the economic challenges..."



Sources: Jagadeesh Gokhal, "Measuring the Unfunded Obligations of European Countries," 2009; OECD.
Note: Unfunded liabilities are the differences between the projected cost of continuing current government programs and net expected tax revenues. Government debt based on 2011 forecasts from the OECD.
Courtesy: BCG



Source: CBO, J.P. Morgan Asset Management

goods and services with relatively less cost, but that also translates into less demand for workers.

The growth of the US economy in the second half of 2011 induced some modest job creation. There are 850,000 more people working over the past six months, and while we have added 2.9 million jobs in the past two years, there were 8.8 million jobs lost in 2008-09. The 131.9 million workers in the US is the same number as it was in 2000 despite a population increase of over 30 million, and an increase in (nominal) GDP of 50% (from approximately $10 trillion to $15 trillion) in that time.

There is a cyclical and a structural aspect to unemployment. In the current cycle, the short-term unemployment rate has followed closely prior business cycles. The difference today is the persistence of structural, or long-term, unemployment (Chart 6). This is one of the reasons the unemployment rate will remain elevated for some time to come.

Weak employment (and income) growth are reasons to be cautious about any strength of economic recovery. Additionally, we have done essentially nothing to address our budget deficits, effectively punting any decisions into 2013; meanwhile, the debt accumulates. Federal government debt outstanding is close to $15 trillion, coincidently, the size of annual GDP. This excludes the unfunded liabilities of Social Security and Medicare, the present value of which is estimated at $59 trillion. It is of little solace that this is a global phenomenon (Chart 7). It is virtually impossible to cut any part of the federal budget without addressing these entitlements (Chart 8).

Debt remains at the heart of the economic challenges, and the good news is that progress has been made to reduce debt burdens. House-

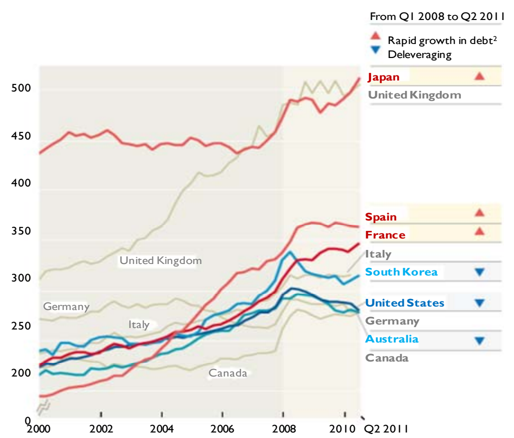
9

US HOUSEHOLD DEBT AS % OF GROSS DISPOSABLE INCOME
QUARTERLY, SEASONALLY ADJUSTED

Source: Haver Analytics, McKinsey Global Institute Analysis

10

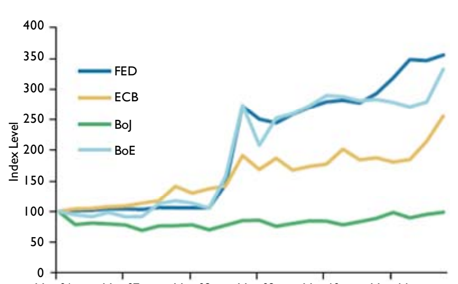
DOMESTIC PRIVATE- AND PUBLIC-SECTOR DEBT[1]
AS % OF COUNTRY GDP; Q1 1990-Q2-2011
(OR LATEST AVAILABLE), QUARTERLY DATA



[1] Defined as all credit-market borrowing, including loans and fixed-income securities. Some data have been revised since our June 2010 report.
[2] Defined as an increase of 25 percentage points or higher.
Source: Haver Analytics; national central bank; McKinsey Global Institute analysis.

11

CHANGE IN CENTRAL ASSETS
(Q1 2006=100)



Source: Haver, Morgan Stanley Research

hold debt in the US has fallen around $600 billion over the past three years. This adjustment is about halfway completed, based on projected trends (Chart 9). This is far more progress than UK households, for example, have made, where consumer debt levels remain a third higher than in the US. In the past three years, the US is among those countries that have reduced total (private- and public-sector) debt (Chart 10).

The reduction of debt combined with a decline in interest rates have lowered the household debt service ratio to 11.1% of income, well below the 14% peak in 2007 and near historic lows. The US banking sector also stands out, particularly in relation to the European financial system, as having made progress deleveraging balance sheets, and we are seeing signs in the US of incipient growth in loans. These steps, a reduction in debt levels and in debt service costs and the strengthening in the US financial system, represent progress, necessary steps on the road to recovery.

"The ECB faces the biggest challenges."

Necessary, but not sufficient, which is why central banks are pursuing conventional and unconventional means to lubricate the gears of their economies. The Federal Reserve, in an attempt to bring some transparency to their deliberations, has promised to hold short-term rates at zero at least through the end of 2014. The Fed has been the most aggressive of central banks in flooding the financial system with liquidity, with the Bank of England close behind, and the European Central Bank (ECB) only now shifting course to follow (Chart 11).

The ECB faces the biggest challenges. One of the sources of tension in Europe is found in the current account deficits run by the peripheral (Greece, Italy, Portugal, et.al.) countries. It is an accounting axiom that a current account deficit must be offset exactly by a capital account surplus. If there is a mismatch, the currency must adjust to account for this difference (again, this is basic math).

But countries in the Eurozone cannot adjust their currencies and, simultaneously, capital is flowing out of the periphery to the core of the Eurozone. To prevent the European financial system from imploding, the ECB has been forced to print money to balance these flows.

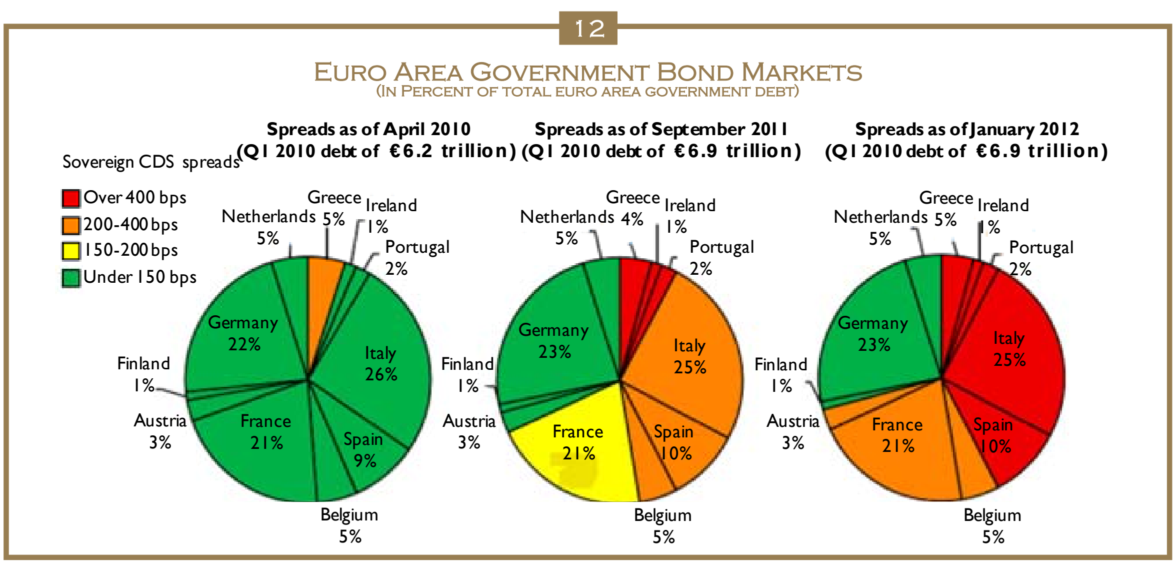
The expansion of the ECB's balance sheet is necessary to address the mismatch in capital flows, but it has traded one risk for another because its balance sheet is growing with peripheral assets and core country liabilities. In other words, and by way of example, the ECB takes money from the Bundesbank and sends it to the Banca d'Italia. In return, the Banca d'Italia posts its assets (Italian government debt) as collateral which is given to the Bundesbank. So the ECB's balance sheet grows with Italian assets and German deposits.

"...it has traded one risk for another..."

The scale of these actions is not small. The ECB's balance sheet has grown €700 billion in just the past six months to around €2.7 trillion. Nearly a third of the balance sheet is loans to the peripheral countries, and approximately €500 billion is owed to the Bundesbank. Buying bad debt and monetizing it is poor policy, but without it, there would likely be sudden and sizeable sovereign defaults in the peripheral countries.

The ECB and Europe's politicians have done too little, too late. The risks of widespread defaults are rising. The market assesses the default risk of France and Austria to be where Greece was just two years ago, and Italy, Spain and Portugal are where Greece was just a year ago (Chart 12). Time will tell if the ECB's recent strong actions were sufficient in size to head-off widespread defaults. Even if they were, the ECB will later face the inevitable deleveraging of its own balance sheet, a story to be told another day.

Matthew Perry, Commodore, United States Navy, sailed his black-hulled ships into Uraga harbor in Edo (Tokyo) Bay in July 1853 with a demand to open trade between the United States of America and Japan. The Tokugawa officials meeting the American delegation were stunned by the advanced technology of the ships, especially in armaments, and realized that Japan had failed to keep up with the modernization of the West, thus placing themselves at the mercy of foreign powers.



Source: Bank of International Settlements; Bloomberg L.P.; and IMF staff estimates

An agreement to permit trade with the United States was signed six months later, but this "opening" planted the seeds of a fierce internal conflict about how to respond to this existential threat. In 1867, Emperor Komei died and his son, the 15-year old Prince Mutsuhito assumed the name Meiji, meaning "enlightened rule," and became the 122nd emperor of the Chrysanthemum Throne. His ascension split open the growing rift in Japanese society.

Kagoshima is at the southernmost tip of the southernmost of the three main islands of Japan. A samurai named Saigo Takamori was born there in 1828, and held a number of unimportant jobs throughout his military career. He was promoted when a favored faction held power, banished when a new regime was in control. Throughout his career, though, he was known as a conciliator, establishing ties even to factions he had been ordered to subdue.

Saigo opposed the opening of trade with the West. He favored rebuilding Japan's military power to expel the foreigners. This required overthrowing the Tokugawa Shogunate, which was riddled with corruption, and restoring the emperor to power. By this time, Saigo was widely respected in the country, and he led a coalition of like-minded samurai to confront Tokugawa Yoshinobu with the demand that the shogun resign. He did, because Saigo's forces were stronger, but he did not go quietly, and the following year Tokugawa rebuilt his army in order to regain power. Saigo led the new Imperial army in what was called the Boshin War, routed Tokugawa, finally ending the Tokugawa dynasty.

Saigo remained in a high position in the new government, helping to enforce the transfer of power from the daimyos to the emperor. In 1873, Korea had still not recognized the legitimacy of Emperor Meiji, and for Saigo, the honor of the emperor and the nation was at stake. He agitated for war, but could not convince others to agree. He resigned, and returned to Kagoshima to start a school for samurai that would teach the philosophy of the *bushido*.

Saigo's respect and renown drew hundreds, then thousands of samurai from all over Japan. The school soon grew to 132 branches throughout the province, inculcating samurai in the seven virtues of the *bushido*, along with weapons and military training. By 1877, the government became worried by Saigo's popularity and devotion—he had formed essentially a separate government—and sent a battleship and an army of 300,000 to break-up the school and re-established central authority in the region.

A handful of students raided government arsenals, provoking a confrontation that Saigo wanted to avoid. He was semi-retired, his active military days behind him. But the government was not going to allow him to rest, and he reluctantly returned to lead 40,000 samurai against the full weight of the Imperial army and navy.

In February 1877, Saigo attacked Kunamoto castle, the impregnable fortress built in 1598. Saigo's pincer movements drove back the Imperial army, but Saigo was unable to take the castle. The next few months saw heavy fighting, as the government brought in three more warships. Fierce battles resulted in heavy casualties on both sides, but time and material were on the government's side.

By September 1877, Saigo's forces had been reduced to just 500. At the port city of Shiroyama, Admiral Kawamura brought five battleships and 30,000 troops to try to finish off Saigo; he was taking no chances. At 6 a.m., Kawamura ordered a full frontal assault, overwhelming the rebels. As his closest, and last, comrades fell, Saigo preserved his honor, and the code of the *bushido*, by committing *seppuku*.

Japan was a society racked with corruption and stifled by bureaucracy and hierarchy. Its economic and technological development was far behind Western countries, threatening its sovereignty. Some in the country wanted to modernize by adopting the technologies of foreigners, others, such as Saigo, looked to the ancient traditions as the best anchor of even a modern society. It is a timeless debate.

Of course, both perspectives are correct. Change is constant, and economies must evolve. That was as true of 19th-century Japan as it is in 21st-century Europe. Sclerotic structures must be dismantled, not reinforced. At the same time, a society that ignores its cultural values, that replaces one elite with another in the name of progress or modernity, seeds its own eventual collapse. That was as true of 20th-century Japan as it may be with 21st-century China or America.

Bushido teaches that death comes to all, and the only question is whether it is an honorable one or not. With Saigo's death, the samurai class was abolished and Japan moved forward to modernity. The people of Japan recognized both the tragedy and the heroism of Saigo, and saw in him a symbol of their deepest cultural values. Bowing to this popular view, in 1889 Emperor Meiji pardoned Saigo, formally acknowledging the dignity and honor of the man who was the last samurai.

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
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