Angeles
INVESTMENT ADVISORS

Commentary
First Quarter 2012

Waste Land

Pieter Bruegel, The Triumph of Death, c.1562, Museo del Prado

Saint Louis was a booming town in the mid-19th century, the gateway to the American west. Henry and Charlotte were a typical young couple in this dynamic era: energetic, hard-working, raising a family. Henry's father was a Unitarian minister, a co-founder of the new college in town, named after the nation's first president. As Henry worked his way up the corporate ladder at the Hydraulic-Press Brick Company, eventually to become its president, Charlotte raised four girls and a boy when, in 1888, at the age of 44, she was surprised with the birth of another son, whom they named Tom, after her grandfather.

Tom suffered throughout childhood from a debilitating double hernia that prevented him from playing sports or even horsing around with friends. Forced to be by himself much of the time, Tom found solace in books, especially those of fellow Missourian Mark Twain. At 18, Tom was sent to Harvard, where he graduated with a philosophy degree in just three years. He moved to Paris and the Sorbonne before returning to Har-

vard to study Indian philosophy and Sanskrit. In 1914, he received a scholarship to Oxford, but spent most of his time enjoying London, marrying a Cambridge girl in 1915. The following year, he had completed his dissertation work for Harvard, but chose not to return for the final oral exam, and dropped out of Oxford. He taught French and Latin at Highgate School for a year, then joined Lloyd's Bank to begin his banking career. His medical condition excused him from fighting in the world war, but its devastation had a profound influence on him.

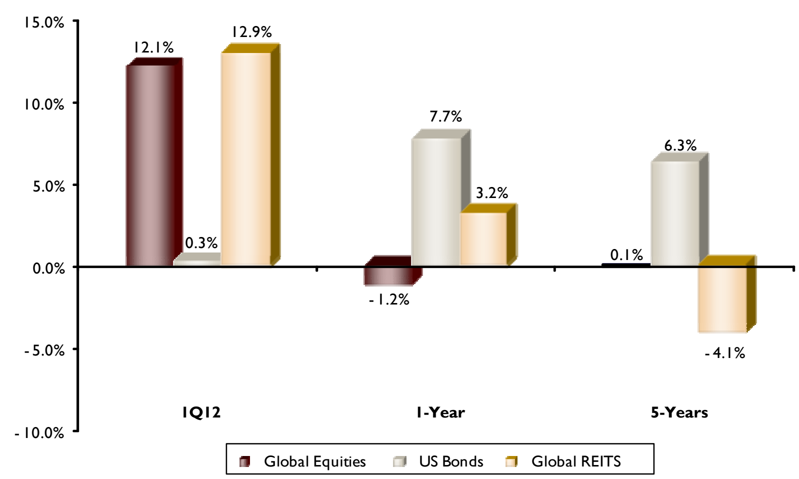
"Risk on! was the battle cry …"

Tom saw the war not as a breakdown of societal and cultural mores as much as the inevitable culmination of a golden Victorian order that was, in its soul, at least in his view, perverse and destructive. He felt a personal anguish in the face of death and betrayal, and given his growing religious belief, lamented the loss of divine purpose: *nearness to death no nearer to God*, he was to write years later.

A decade earlier, Albert Einstein was working as a clerk in the Swiss patent office while simultaneously developing his theories of relativity that were to up-end our understanding of the universe. Similarly, we can imagine young Tom toiling as a bank clerk while wracked with despair over the monumental destruction of the war. From this inner turmoil sprung a stunning work of art, not so much a bridge from the Romantic to the Modern era as a bomb that eviscerated the past to create a landscape of the future that is with us today.

1

CAPITAL MARKET PERFORMANCE



Risk on! was the battle cry of the first quarter of 2012. The charge was led by the European Central Bank's new head, Mario Draghi who, perhaps by virtue of being Italian, knows an impending financial disaster when he sees one. His haughty predecessor, Jean-Claude Trichet, more German than French in his adherence to strict monetary discipline, seemed prepared to stand on such principle and permit the collapse of the financial system he oversaw. But Signore Draghi stands on no principle but pragmatism, and just as life needs water to survive, so do banks need liquidity. He opened the flood gates with more than €1 trillion of cut-rate loans to any and all comers, thereby averting a financial collapse. Thus saved, the markets soared.

Draghi's lifeline was aimed at banks on the European periphery, but the biggest beneficiary was the German market, as it leaped 20% in the quarter. Only Egypt (+40%) and Kazakhstan (+35%) managed better. Indeed, Madrid is the new ground zero of the European crisis (grabbing the baton from Athens which has faded from the headlines for now), and the only developed equity market that lost ground in the quarter (-4%). But over the past twelve months, only three developed equity markets posted positive results (New Zealand and Ireland each +12%, the US +6%). Commodity prices were mostly higher this quarter, led by soybeans (+17%) and oil (+14%), although there was good news for baristas as coffee fell 20%.

Europe's current monetary union was always more motivated by political aims than by economic ones, and it suffers from a complex and limiting organizational structure that requires consensus among very divergent economies and political perspectives. Beyond the monetary system, there is no automatic fiscal transfer mechanism or labor mobility across Europe that could help balance conditions throughout the region.

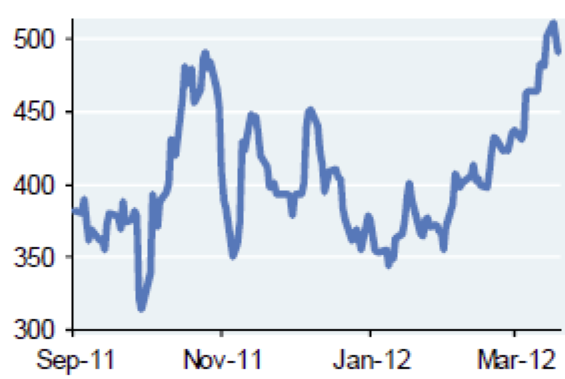
The European Central Bank has no mandate to ensure the creditworthiness of its constituent states, so it was unable to erect a firewall around Greece two years ago when it would have cost a little more than €200 billion to buy up every outstanding bond of Greece. Instead, the ECB added €1 trillion to its balance sheet, plus pledges from member states and the IMF. Following the Greek default (er…restructuring) earlier this year, the markets shifted focus to the struggling economies of Italy and Spain, which saw their sovereign borrowing costs jump to around 6%. That may not sound usurious, but when an economy is shrinking and the government borrowing rate is five times that of Germany or the US, these levels are literally unbearable. Unable to buy government debt directly, unlike the Federal Reserve or the Bank of England, for example, the ECB extended more than €1 trillion of loans to hundreds of banks throughout Europe, hoping banks would use these funds to purchase government bonds and earn a "risk-free" spread. It worked; Spanish banks, for example, increased their holdings of Spanish government debt by more than one-third, or €60 billion, this past quarter. Sovereign borrowing costs thus fell, and the ECB had saved the day (or, at least, the quarter).

Foreigners saw this liquidity flood as a window of opportunity to dump their own holdings of Spanish (and Italian, et al.) debt, from around half the debt outstanding to about one-third. As the central bank's pool of liquidity has now been used up, it may be only a few months before Spain and Italy run out of cash. Sovereign risk is now deemed higher than before the recent injection of funds (Chart 2), proof that liquidity and solvency are related, but distinctly separate, concepts. The ECB's cash injections provided needed liquidity to the banks, giving politicians space to address the serious structural solvency problems of their governments. That space is rapidly closing.

"...window of opportunity to dump their own holdings..."

2

SPAIN: CREDIT SPREADS
5-YEAR CDS, BASIS POINTS



Source: Bloomberg Data as of 04/17/2012

Spain's problems, which include a 25% official unemployment rate (50% for 18-25 year olds), are emblematic of the growing divide between the core northern countries and the southern peripheral states. Logically, (private) money is flowing out of the peripheral countries and into the core (Chart 3). The peripheral economies are contracting, widening the gap in growth rates with their northern bretheren to record levels (Chart 4). Danger remains to these economies. The growing current account deficits must be financed, an accounting axiom, if not by private capital, which is fleeing, then by official transfers either from the ECB or the northern European governments. The crisis has not been solved, only postponed by ECB lending, and probably not for long.

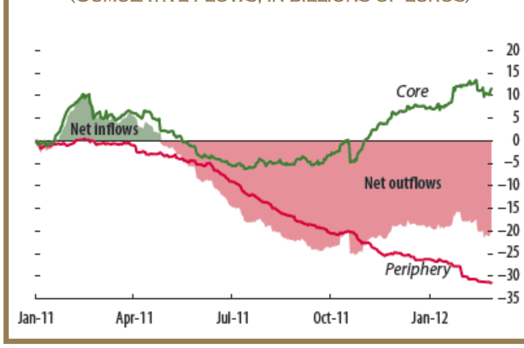
Europe's growing divide mimics the divergence in economic performance between developed nations and the emerging world, although this has been a long-term trend (Chart 5). A mere decade ago, the developed countries accounted for two-thirds of world economic output, but over that time emerging economies contributed more to global growth than the developed world *every single year* (Chart 6). 2012 will mark the crossover point when emerging economies will represent more than half of the global economy. And in just a few years, China will hold a larger share of the world economy than either Europe or the US, for the first time in 200 years (Chart 7, page 5).

"Danger remains to these economies."

Growth has been relatively strong in the US, although the pace has moderated in the past few months. Ca-

3

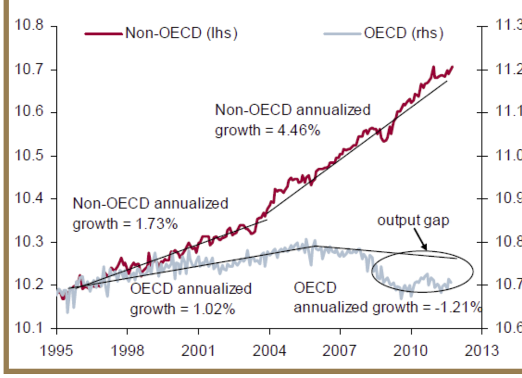
CUSTODIAL HOLDINGS OF SELECTED EURO AREA SOVEREIGN BONDS, 2011
(CUMULATIVE FLOWS, IN BILLIONS OF EUROS)



Sources: BNY Mellon iFlow[sm]; and IMF staff estimates.
Note: Core=Austria, Belgium, Finland, France, Germany, and Netherlands. Periphery=Greece, Ireland, Italy, Portugal, and Spain.

5

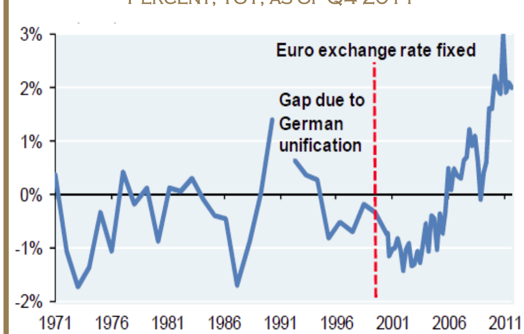
EM HAS OFFSET OECD WEAKNESS



Source: IEA, Credit Suisse

4

REAL GDP GROWTH, CORE MINUS PERIPHERY
PERCENT, YOY, AS OF Q4 2011



Sources: Statistical Office of the European Communities, OECD, IMF, J.P. Morgan Asset Management.

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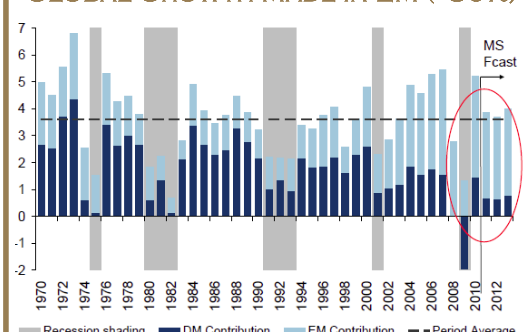
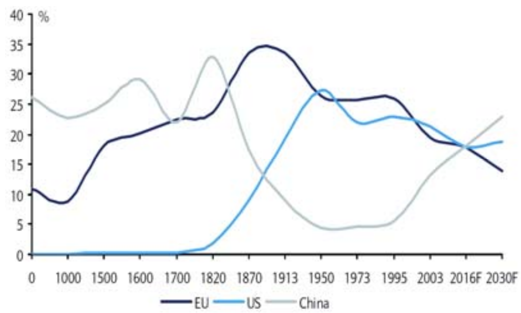
EM-DM DIVIDE
GLOBAL GROWTH MADE IN EM (>80%)



Source: IMP, Morgan Stanley Research forecast.

7

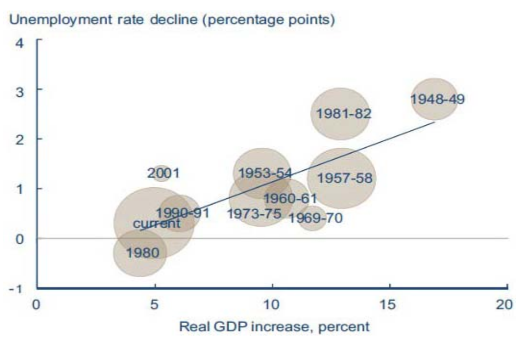
CHANGING SHARES OF THE WORLD ECONOMY
CHINA, US AND EU, 0-2030



Note: These shares are based on purchasing power parity international dollar.
Source: Maddison, Angus, 2006, "Asia in the world economy, 1500-2030", Asian Pacific Economic Literature, 20(2): 1-37, IMF, World Economic Outlook, IMF, Washington DC, April 2011.
Source: Equity Gilt Study 2012, Barclays.

8

RECOVERY IN REAL GDP AND UNEMPLOYMENT



Note: Size of bubble represents GDP decline during recession.
Source: Bureau Economic Analysis: Bureau of Labor Statistics

pacity utilization, at 77.8% is close to the long-term average of 79%, and retail sales are growing at a healthy 6% rate. Credit card delinquencies are back to 2007 levels, business spending remains strong and corporate lending is rising. Auto sales have been a particularly bright spot, with production now running around 15 million cars per annum, close to peak production and nearly double the rate in the depth of the recession.

But the pace of growth is moderating. GDP grew 2.2% in the first quarter, down from 3% in the prior period. Consumer spending was strong (+2.9%), but incomes lagged (up just 0.4%) and this spending was financed by a drop in the savings rate (from 4.7% of income to 3.8%). Inventories added 0.6% to the GDP number, so the real underlying growth rate was just 1.6%. Half of the 2.2% rise in GDP was accounted for by auto production. The US economy is growing, but for a variety of reasons, it is expected to grow at a rather sluggish pace.

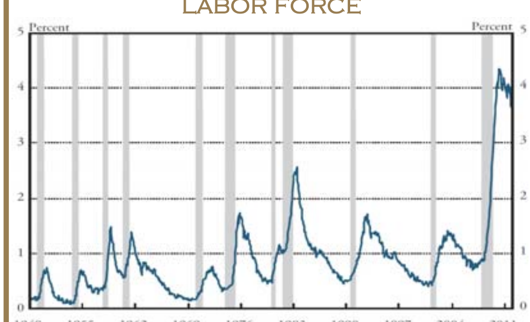
Jobs are being created and the unemployment rate has fallen from its peak, but progress has been slow, and is likely to remain so with a less than robust recovery. Job creation is highly correlated with economic growth (Chart 8). GDP growth of 2% is not likely to be sufficient to sustain more than very modest job creation.

As disconcerting as the slow rate of job growth has been, the unprecedented rise in the long-term unemployed is cause for serious concern (Chart 9). It becomes more difficult for long-term unemployed workers to find jobs as their skills erode, and the impact on their long-term earnings is meaningful. Workers forego an average of 1.4 years of earnings (in present-value terms) when they lose their jobs, but if displaced when the national unemployment rate exceeds 8%, they lose a staggering 2.8 years of earnings.

"...they lose a staggering 2.8 years of earnings."

9

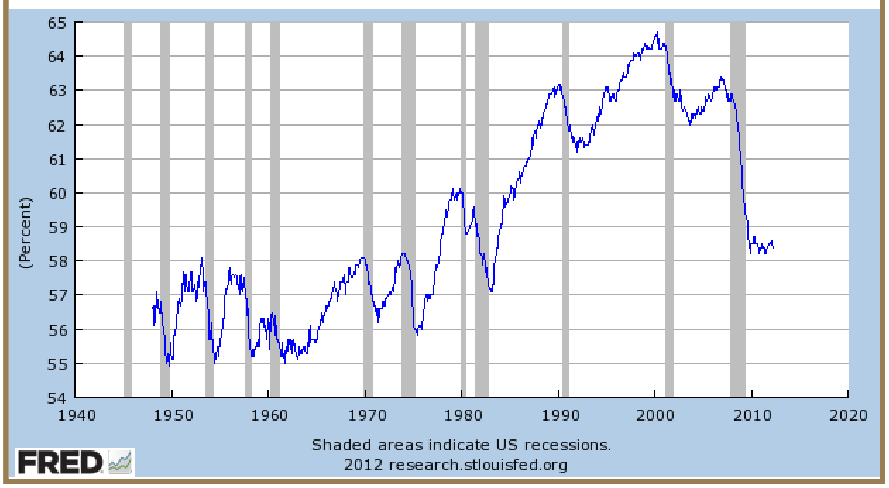
PEOPLE UNEMPLOYED FOR AT LEAST SIX MONTHS AS A PERCENTAGE OF THE LABOR FORCE



Note: Gray bars are recessions as defined by the NBER.
Source: BLS

10

CIVILIAN EMPLOYMENT - POPULATION RATIO (EMRATIO)



Source: U.S. Department of Labor: Bureau of Labor Statistics

This represents a permanent loss of income, as it is difficult (if not impossible) for most ever to recover these earnings.

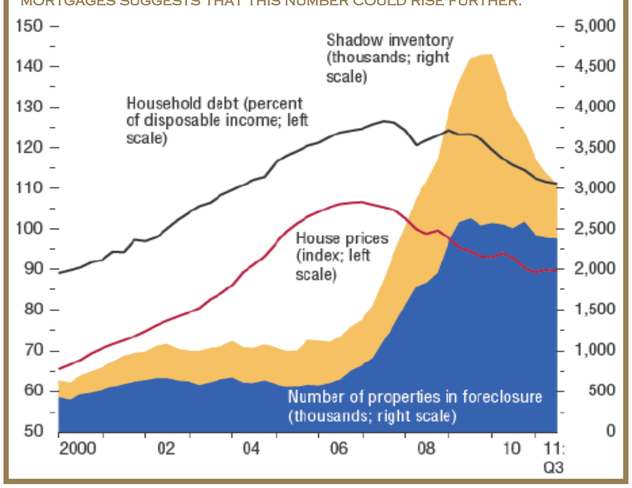
Also troubling for the economy is the sheer drop in the size of the labor pool. The employment-to-population ratio has seen its largest decline on record over the past few years (Chart 10). Around half of this fall may be attributed to cyclical factors, so when (if) the economy grows, some should re-enter the work force. But half is due to demographic factors, primarily the rising share of older workers. Thus, the ratio of employed in the population is likely in a long-term decline. This has enormous implications, not only for the growth potential of the economy (it would be lowered), but also for how we fund our government, particularly the large entitlement programs of Medicare and Social Security (via payroll taxes).

"...most of the adjustment in housing has been made."

11

THE U.S. HOUSING MARKET, 2000-11

THERE WERE ABOUT 2.4 MILLION PROPERTIES IN FORECLOSURE IN THE UNITED STATES AT THE END OF 2011, A NEARLY FIVEFOLD INCREASE OVER THE PRECRISIS LEVEL, AND THE "SHADOW INVENTORY" OF DISTRESSED MORTGAGES SUGGESTS THAT THIS NUMBER COULD RISE FURTHER.



Source: Office of the Comptroller of the Currency: Office of the Thrift Supervision; U.S. Treasury; Federal Reserve; Haver Analytics; and IMF staff calculations.
Note: Shadow inventory indicates properties likely to go into foreclosure based on a number of assumptions. It includes a portion of all loans delinquent 90 days or more (based on observed performance of such loans); a share of modifications in place (based on redefault performance of modified mortgages); and a portion of negative equity mortgages (based on observed default rates). Data on modifications and negative equity are not available prior to 2008:Q2.

Housing, the epicenter of our most recent boom-and-bust, has also been slow to recover. Home prices continue to fall, and new housing starts are a fraction of previous levels. By the end of 2011, 2.4 million homes were in foreclosure, with a huge shadow inventory of delinquent mortgages that will end up in foreclosure, thus keeping prices depressed for some time (Chart 11).

We may not see a sustained rise in home prices for some years, but it does appear that most of the adjustment in housing has been made. Price-to-income ratios have fallen back to historical averages, and in

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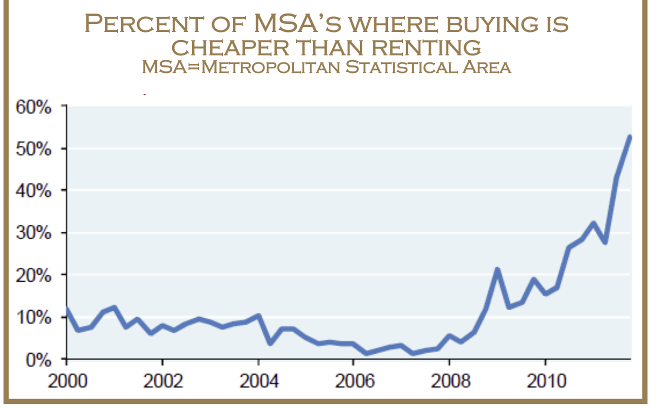

Source: J.P. Morgan Securities LLC, AxioMetrics, CoreLogic, Freddie Mac. Data as of Q42011

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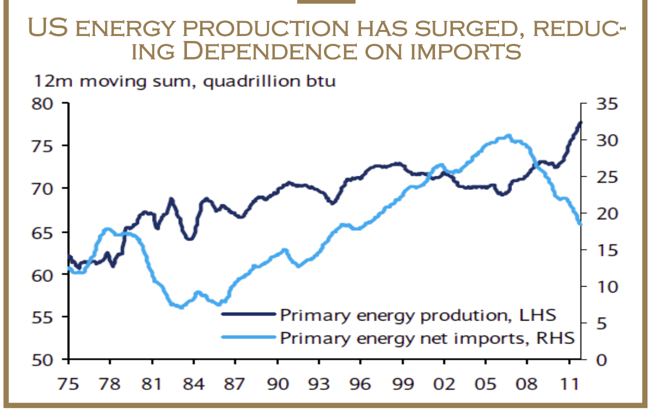

Source: US Energy Information Administration, Barclays Research

more than half the cities in the US, owning a home is now cheaper than renting (Chart 12). Household debt-to-income ratios have come down, and debt service costs are as low as in a generation.

Energy may be the trump card for the United States in the coming years. The US possesses one of the world's largest reserves of oil, natural gas and thermal coal. Energy production has been rising, and net imports falling (Chart 13). US oil production is forecast to increase by a third by the end of this decade, reducing imports by 1 million barrels/day, cutting the trade deficit in oil by half.

The US already benefits from much lower energy costs than in most of the world, especially in natural gas, which has fallen to around $2/mm BTU due to huge domestic supplies and rapid production growth, versus $8 in Europe and $15 in India and Japan. The differential in natural gas prices alone is a relative benefit worth more than $200 billion, or 1.5% of GDP, versus other countries. This is a source of enormous competitive advantage for the US economy. But to realize this advantage fully requires appropriate policies and regulations. We're waiting.

April is the cruelest month, breeding
Lilacs out of the dead land, mixing
Memory and desire, stirring
Dull roots with spring rain.

When *The Waste Land* was published in 1922, its combination of personal anguish, mortality, longing yet yearning toward possibilities resonated immediately with readers who saw in it their own condition. It expresses the chaos of a culture in transition from a unifying set of values to a pluralistic and apprehensive experience.

The wonder of the poem lies not merely in capturing the disillusionment of a generation, but in *how* the poem is constructed and its meanings conveyed. Throughout are allusions to Ovid, Shakespeare, Dante, among others, and a loose outline of the biblical Grail legend. Through these references, and an extensive use of footnotes that are central to the body of the poem, more and deeper meaning can be conveyed with an economy of words. The literary references pay tribute to the contributions of previous artists, but combine their disparate techniques and perspectives to express a new sensation using irony, self-mockery and obliquity. Its approach has influenced every

"Energy may be the trump card..."

art form since, from Andy Warhol's paintings to Quentin Tarantino's films.

Perhaps the most important reference in the poem is found in its epigraph, where the Sibyl of Cumae, familiar to readers of Virgil's *Aeneid* or Ovid's *Metamorphoses*, or even viewers of Michelangelo's Sistine Chapel, is introduced. The legend is that Apollo agreed to grant her any wish in exchange for her virginity. She scooped up a handful of sand and asked to live for as many years as she held grains in her hand. The wish was granted, but she refused to keep her end of the deal. Taking revenge, Apollo told her she had asked for (nearly) eternal life, but not for eternal youth, and as the decades, and then the centuries passed, her body was reduced to near nothing, and she begged to die. The priests kept her in a jar, and eventually all that remained was her voice.

The Sibyl was a metaphor for a foolish and prideful society. Death is not an option or a solution, for the Sibyl or for a culture whose very foundations have been shaken not only by war but by a sclerotic social structure.

We have collectively spent trillions of dollars, euros, yen and pounds to mitigate the harsh ramifications of our misguided actions and policies. To what effect? Do we have the fortitude to begin necessary structural changes, in our both politics and our economics, or are we in the interregnum between one crisis and another looming, larger catastrophe as world was in 1922?

Later, he was to write, with words every bit as relevant today as they were then: *Where is the wisdom we have lost in knowledge? Where is the knowledge we have lost in information?*

The Waste Land ends with the three Sanskrit words, *Shantih Shantih Shantih*. This phrase, meaning peace, is chanted at the end of each mantra, three times in order to eliminate the barriers that exist in the three realms—the physical, the internal and the divine—so that we may achieve a sense of calm before accomplishing our task.

Our challenges are formidable, the stakes monumental. But we have overcome previous challenges, and we can draw on inspiration from the poem that changed poetry, changed how we see the past, and how to prepare for the future. That was the wonder of *The Waste Land*, the genius of T. S. Eliot.

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

Michael A. Rosen
Principal & Chief Investment Officer
May 2012

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