Angeles
INVESTMENT ADVISORS

FOURTH QUARTER 2004

JANUARY 2005

Crossroads

For millions of years, the Mississippi River, the longest river in the world as measured from the source of its tributary, the Missouri, has flooded its delta region with the detritus drained from 31 states, creating an alluvial plain with the richest topsoil in the world. Almost anything will grow here, but the soil of the Mississippi Delta is best known for producing two crops. By day, white balls of cotton sprout from the dark soil. By night, it is the music of the blues that rises from the ground to fill the air.

In May 1911, in Hazlehurst, Mississippi, Julia Dodds gave birth to a baby boy. The father was not Julia's husband, Charlie Dodds, who had run up to Memphis with his mistress and changed his name to Spencer. But a few months later, Julia and her infant, and the other six children she had had with Charlie moved in with him in Memphis, along with Charlie's mistress and their children (and you thought your family was complicated). The boy returned to Mississippi as a teenager, where he loaded cotton during the day, and listened to the blues at night. He was small, even petite, but had extraordinarily large hands and incredibly long fingers. He took up the mouth harp and the harmonica, but he yearned to play the guitar. In 1929, he married 15-year old Virginia Travis, and the following year she gave birth to a baby girl. Both mother and daughter died in childbirth, and the blues truly descended on our struggling musician. With no job, no wife, no child, no talent and no prospects, he disappeared.

Walking along Highway 61, just out of Clarksdale, Mississippi, one night, at the junction of Highway 49 he came across a man with a wailing dog whose sounds sent shivers down his spine. No one is quite sure what happened then, but when he reappeared a few months later, the legend of that night spread throughout the Delta.

In African myth, the crossroads was a place to meet the Devil. In modern usage, it represents a decision point: turn left, turn right? Move forward, go back? These past few years have been pretty dramatic ones for investors, as markets have soared, crashed and rebounded. As we stand at the crossroads now, the signs seem hazy, and the direction we should turn is unclear: we know what has worked well in the past, but where will the rewards be in the future?

Well, we do have some thoughts to offer, and we will even draw our own road map a little later on. But first we'll turn back, and then around, to survey the landscape around us.

Equities came alive in the last quarter of 2004, salvaging a respectable year (see Graph 1, page 2). It was a broad advance, with most stocks rising. Small cap stocks outpaced large cap stocks in 2004, for the sixth straight year, although most of the relative gain came in the first

INSIDE GRAPHS:

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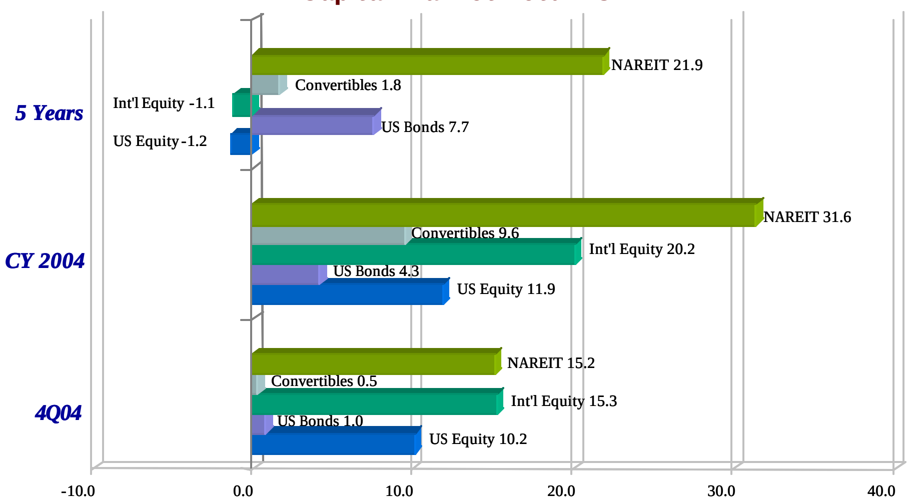
Graph 1
Capital Market Returns



half of the year. For the first time since the 1970s, energy was the best performing sector for the year. The worst sector was health care (drugs), the first time since 1993 (when fears of price controls abounded) that that sector was at the bottom.

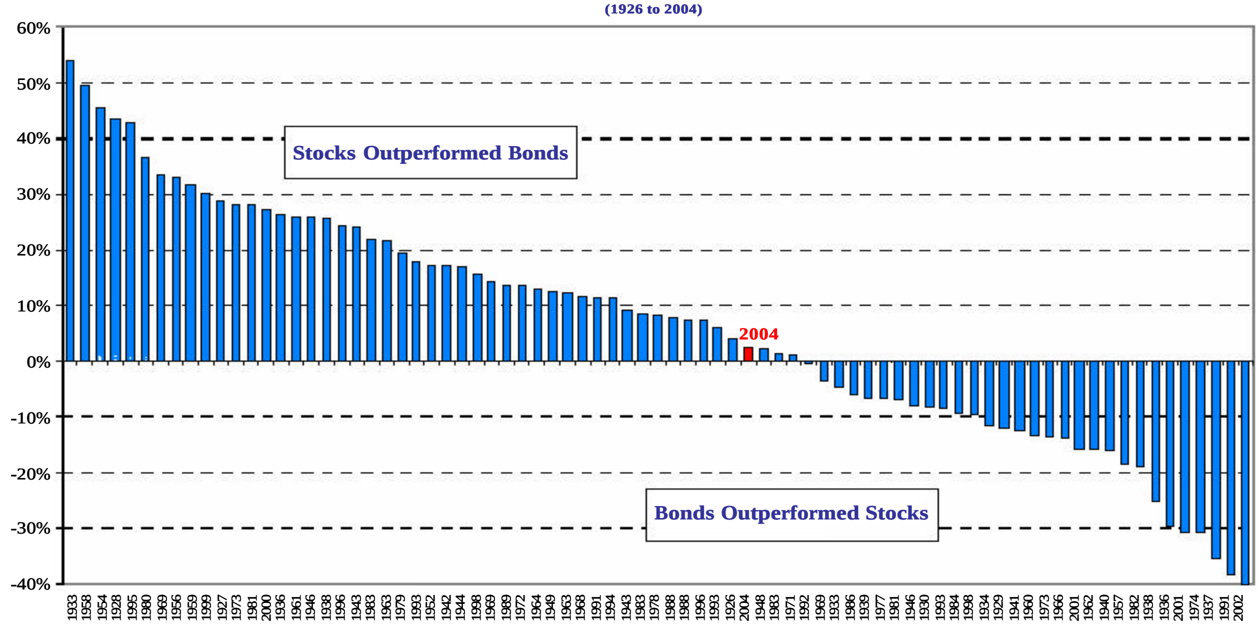
Stocks outperformed bonds solidly, but the magnitude was not as dramatic as it often is, where the range of relative returns can swing 100% (see Graph 2).

It was a good year for US equities, but a better one abroad. Performance last year in US dollar terms was nearly twice as good as in the US, and the trend seems to have turned in favor of non-US stocks following a long drought (see Graph 3, page 3).

Non-US stocks did a little better than US stocks in local currency terms (12.7% versus 12%), so most of the relative gain came from the currency, which leads us to one of the critical crossroads: whither the dollar?

Currency dynamics are complicated because currencies represent both a relative price and a store of value, both of which are influenced by many factors that often pull in multiple directions. Even as a relative price, the broad averages may obscure as much as they illuminate. Yes,

Graph 2
Annual Spread Between Stock and Bond Total Returns
(1926 to 2004)

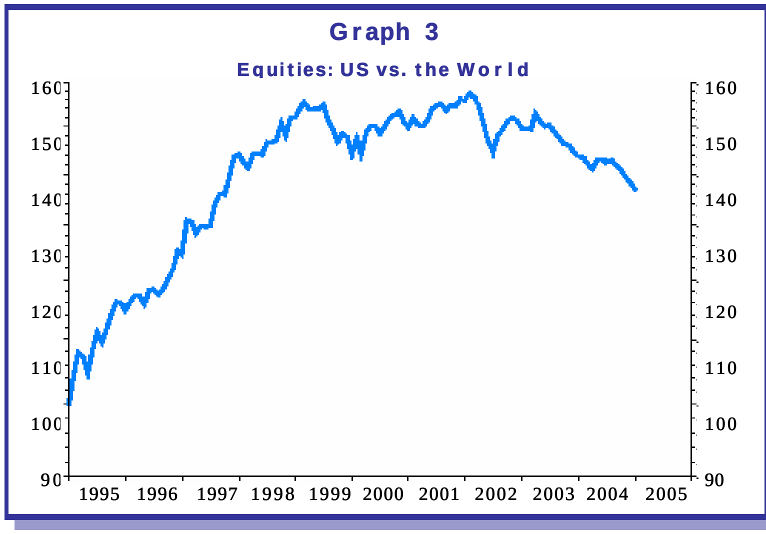


Source: Merrill Lynch Quantitative Strategy, Ibbotson Associates the dollar has declined recently. But most of that decline is versus the euro, and only in the past two years. Looking at other currencies and over a longer time frame, the dollar's relative value looks stronger (see Graph 4).

The dollar has declined against most currencies over the past two years, and the current account deficit may be playing a role (see Graph 5). The current account deficit, the shortfall between domestic savings and investments that must be plugged with foreign capital, is pushing 6% of US GDP, a level that historically precipitated currency crises in other countries. Of course, the US is unlike other countries, and the dollar is the world's reserve currency (store of value). Correcting this imbalance may prove to be difficult because it will require changes in the patterns of global consumption and savings. If it is true that the US needs to consume less and save more, it is equally true that the rest of the world needs to consume more and save less. And if the US adjusts, world economic growth will slow considerably, and it is hard to see who really benefits.

US consumers and Asian investors are not irrational. US consumers are responding appropriately to low nominal and real interest rates by refinancing and increasing their level of debt to raise consumption. Asian investors increase their savings for valid historical reasons (expropriation of assets, destruction of wealth, low returns on domestic investment), and benefit from building their foreign reserves. The important point is that these two phenomena of American consumption and Asian savings are inextricably linked, and are manifested in both the current account balances and currency prices.

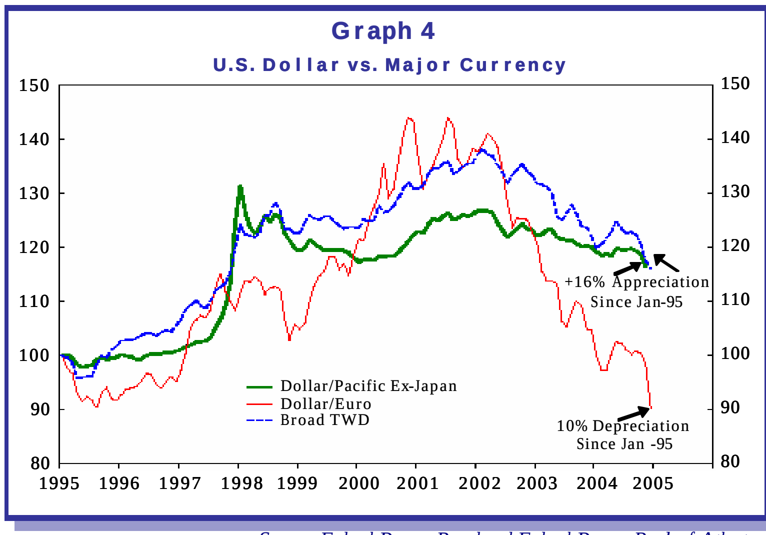
Low interest rates encourage American consumption, which lead to the rise of imports, causing the trade balance to move into larger deficit.



Graph 3

Equities: US vs. the World

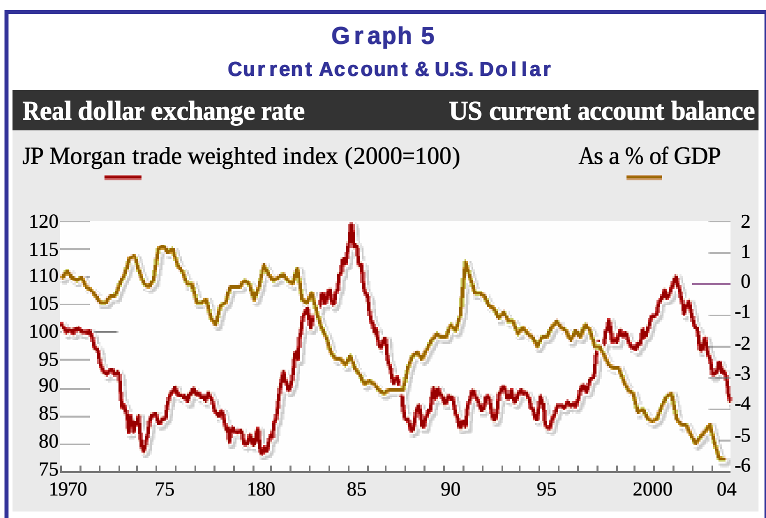
Graph Courtesy Merrill Lynch



Graph 4

U.S. Dollar vs. Major Currency

Source: Federal Reserve Board and Federal Reserve Bank of Atlanta

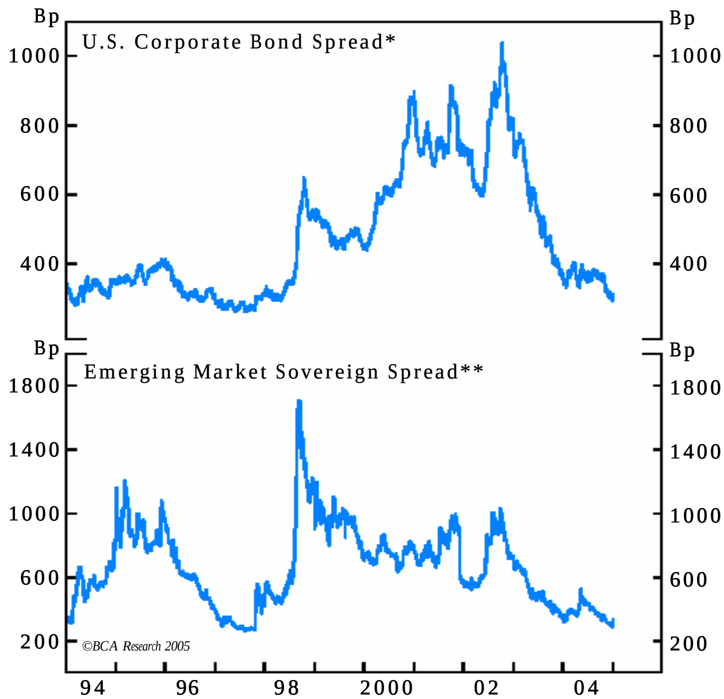


Graph 5

Current Account & U.S. Dollar

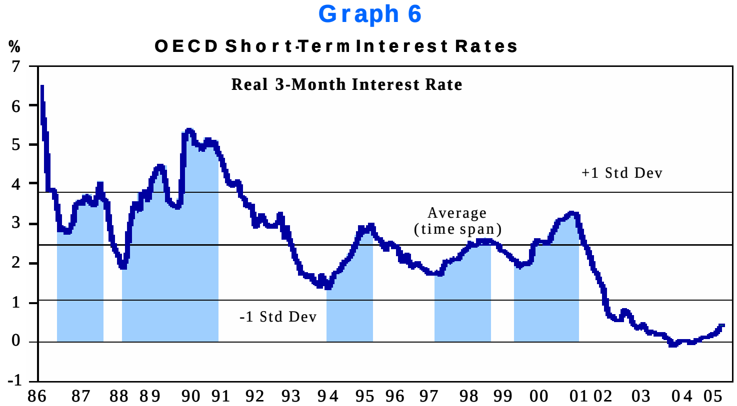
Source: OECD: Thomson Datastream

Graph 8

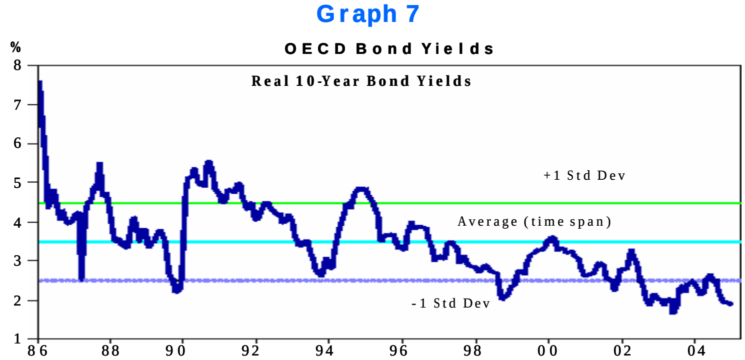


** U.S. speculative-grade corporate bond yield minus 10-year government bond yield. Corporate bond yield is Merrill Lynch data. ** Option-adjusted spread minus U.S. 10-Year government bond yield. Graph Courtesy: BCA Research*

Graph 6



Graph 7



Graphs 6 & 7 Courtesy: Goldman Sachs

The money we send abroad for goods is recycled back into dollars through the purchase of (mostly) Treasuries. Last year, the US current account deficit was more than $600 billion, while foreigners purchased more than $800 billion of US bonds. Buying our bonds helps keep interest rates low, supporting further consumption, and so on goes the virtuous cycle.

Until it stops. Logically, there are limits to these flows (we're already consuming more than 99% of our disposable income, so perhaps there's a little more room), but there are no fixed rules on what these limits are or when they will be reached. But there are signals that we may be approaching those limits.

Capital continues to flow into the US, but the sources of these flows are changing. Private foreign investors have reduced their US investments to a trickle, and foreign central banks have picked up the buying. But history is quite clear in its lessons on what happens when government policies oppose the free market: government intervention will fail (as George Soros will attest). So the eventual path of the dollar is likely lower. But the fate of the dollar is really part of a much larger picture.

Liquidity is the bigger picture. The recession of 2001 was the first economic downturn since the 1930s that was not triggered by monetary tightening in response to rising inflation. The 2001 recession was caused by an investment bust that followed a capital spending boom in the late 1990s. Central banks responded to the collapse in investment by slashing interest rates in order to encourage spending. Politicians joined in by increasing spending and cutting taxes (hence, fiscal deficits). These actions occurred not just in the US, but in Europe as well, where the supposedly inviolate Growth & Stability Pact, that applies sanctions on countries that run fiscal deficits greater than 3% of GDP, has been *de facto* abandoned, as the three largest economies—Germany, France and Italy—have blown through the deficit limit.

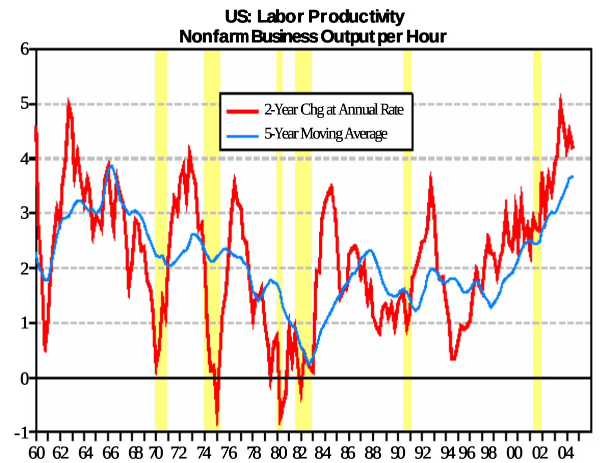
Real (i.e., after inflation) interest rates are negative in the short-end and near record lows throughout the curve, in the most obvious example of monetary stimulus (see Graphs 6 & 7).

This liquidity is also reflected in the prices of assets, where "risky" assets have become very cheap. Speculative credit and sovereign emerging market debt spreads have tightened dramatically as central banks have primed the monetary pumps (see Graph 8, page 4).

Another example of the flow of money into riskier assets can be seen in China. Never mind the bubble in Shanghai real estate, where an apartment is more expensive than in London or New York. Look at the yield on short-term rates in Hong Kong ("HIBOR"). The Hong Kong dollar is pegged to the US dollar, and the market generally demands a small premium (20 basis points, or so) for holding HK$ over US$. At times of crises that premium rises (in 1997-98, for example, HIBOR averaged 212 basis points over LIBOR). In the past two years, that premium has turned into a 220 basis point discount (i.e., HIBOR yields 2.2% less than LIBOR). Presumably, this makes sense if you think the HK$ will be revalued, but that's the bet.

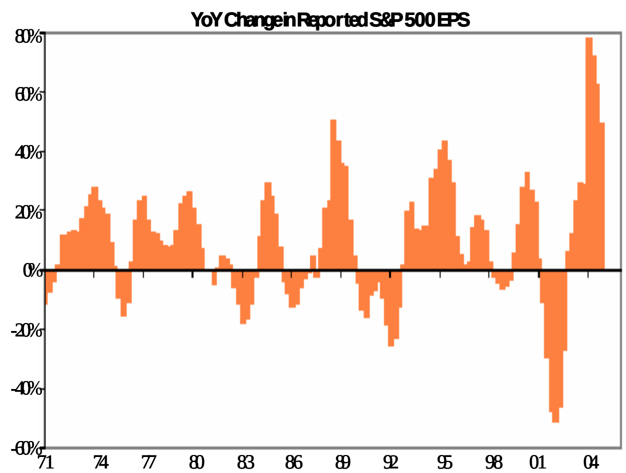
Risky assets may be rich, but it's also true that, in many respects, fundamentals have never been better. Corporations have raised productivity (see Graph 9) and profits (see Graph 10), paid off debt (see Graph 11) and don't default (see Graph 12).

Graph 9



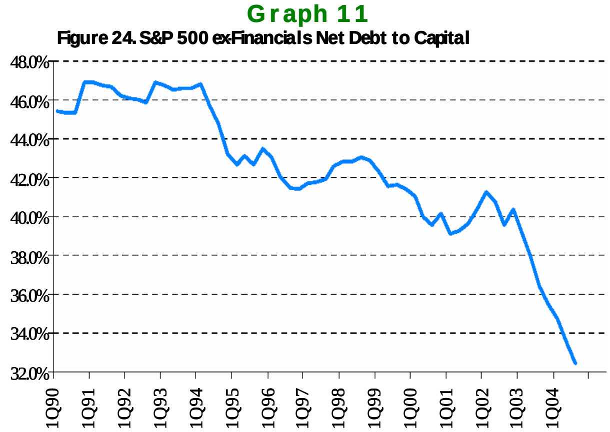
Source: Bureau of Labor Statistics/Global Insight, ML
Graph Courtesy Merrill Lynch

Graph 10



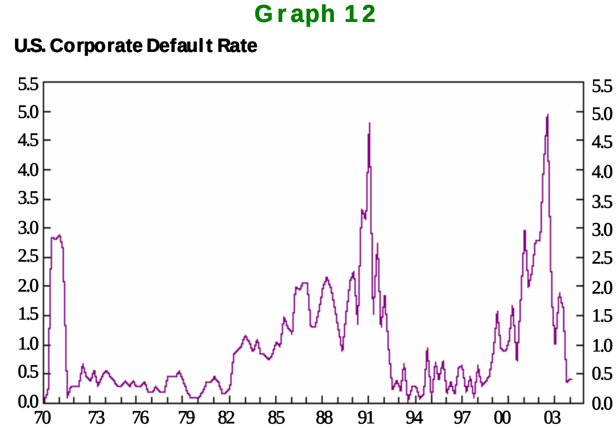
Graph Courtesy Merrill Lynch

Graph 11



Source: FactSet and Smith Barney U.S. Equity Strategy
Graph Courtesy Smith Barney

Graph 12

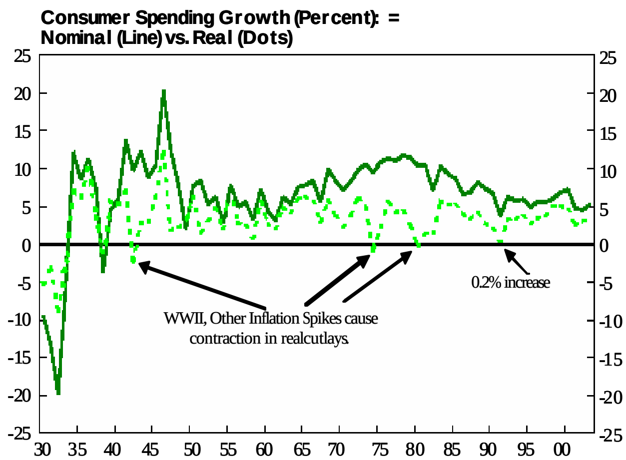


Note: Moody's data prior to 1990 and Citigroup data after.
Source: Moody's & Citigroup. *Graph Courtesy: Smith Barney*

Even consumers, that much-maligned group often caricatured as obese, loud and poorly dressed, managed to turn in the 66th consecutive year of rising expenditures (see Graph 13). And this despite rising taxes and oil prices and a 50% decline in mortgage refinancing.

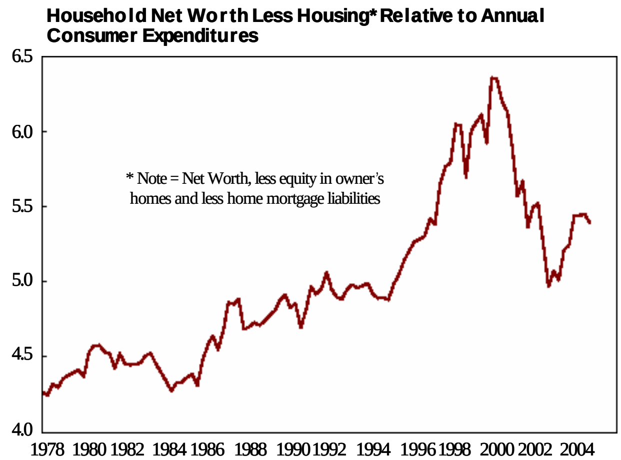
Consumer net worth (assets minus liabilities) is at an all-time high, admittedly helped by record home prices, but even stripping away home values, net worth is at a pre-1998 bubble high (see Graph 14).

Graph 13



Source: Bureau of Economic Anlaysis (BEA)
Graph Courtesy: Smith Barney

Graph 14



Source: FRB
Graph Courtesy: Smith Barney

High prices for risky assets can therefore be justified on their strong underlying fundamentals. But we think this is not the appropriate framework for investors. Successful investing requires anticipating the future, weighing the probabilities of expected risk and return, and positioning portfolios to benefit from the risks taken and be protected from the risks avoided.

To help investors think about where we are and where we are headed, we've created our own map, as shown below. We understand this is a crass simplification, but we hope it at least establishes a helpful framework.

Its premise is twofold: that there is an interaction between economic fundamentals and capital market prices, and that both economies and market valuations follow cycles. In this simple world, economic fundamentals can be either strong or weak, and valuations can be either high or cheap. Then, depending on the intersection of these four variables, investors should become more aggressive (buy) or defensive (sell).

In the lower right quadrant, the world is bleak. Economies are struggling, or worse, and assets are so cheap they cannot be given away. In this quadrant, economies and market prices are aligned, i.e., cheap prices are justified by the poor economic fundamentals. But this is when the astute investor starts buying. Nathan Rothschild allegedly remarked that the time to buy is when there is blood on the streets, a graphic, but apt metaphor. The examples abound: in recent times, think of buying emerging markets at the end of 1998 when Russia defaulted and Asian currencies lost 50-80% of their value. Or junk bonds in 2002 following the defaults of Enron, Worldcom and many others (in fact, more than 10% of credit defaulted that year). Poor fundamentals, but cheap, cheap prices.

Quadrant 2, in the lower left, sees the economy improve, but investors are still skeptical, remembering the pain in the recent past, forswearing those assets that burned them. *Business Week*'s "Death of Equities" headline in 1979 implied that investors would (and should) never own stocks again. Yet 1979 marked the later arrival of Paul Volker as chairman of the Fed, and a year later came Ronald Reagan, and the greatest bull market in history was germinated immediately following that headline.

The third phase, in the upper left corner, has the skeptics finally convinced that good times are here,

and prices rise. High valuations are justified by the strong fundamentals. In 1971-72, investors saw (correctly) the enormous potential growth in companies like McDonald's and IBM, part of the "Nifty Fifty," and prices soared. In the late 1990s, many proclaimed that the Internet would change how business is done, and that has turned out to be true. Unfortunately, 1973-74 and 2000-2002 each saw market declines of 50%. When prices are high and economic fundamentals strong, wise investors are pulling back.

The last phase sees the economy turn down, but prices remain high as investors ignore the risks and believe the good times will continue. They won't, and don't, and this phase is an investor's last chance to reduce risk before the real pain comes.

Now, we acknowledge that the world is never quite so simple, and the dynamics we've described do not always fit neatly into reality. Markets may lead economic fundamentals, rather than trail, but we think the framework—the interaction of economic fundamentals and market valuations, between what is anticipated and what could go wrong—could be helpful in identifying where we are in the bigger investment cycle. If this map is helpful, and the demand high enough, we'll have plastic laminate models made (in China, of course) and available for sale on our website.

For our money, we think Quadrant 3 (upper left) is closest to where we are today. Economic fundamentals are strong: the world economy grew at its fastest rate in over 30 years in 2004, and inflation is moderate. Corporate balance sheets have never been stronger, nor consumers wealthier. Politically, millions more people around the world are embracing democracy and free market capitalism. There are many good reasons for asset prices to be high.

Yet. Prices reflect the good news. Economic growth is expected to continue strong and central bankers are expected to keep inflation under control. Energy prices are expected to decline, budget deficits expected to shrink, and all necessary adjustments in interest rates and currencies are expected to be gradual and non-disruptive. May it be so.

But it seems to us that the risks seem to run the other way. Good news is reflected in higher prices, but history advises prudence: pare back the riskier parts of portfolios, and keep some powder dry.

Robert Johnson returned to Mississippi after a few months. He didn't tell anyone where he'd been or what he'd been doing, but just picked up a guitar and began to play. Those who remembered his modest talents were stunned by what they heard: an eerie, supernatural sound, from both the guitar and his voice, confusing and mesmerizing at the same time. Word quickly spread around the delta and beyond that here was a man, bereft in grief, who had sold his soul to the Devil in exchange for being able to play the blues like no one had before or since. Incredibly, some of his recordings survive, and they remain as remarkable today as they no doubt were 70 years ago.

Robert Johnson wrote only 29 songs before he died in 1938 (the Devil got his due). But in his brief time, he changed the course of music history. No musician since, whether in the blues, jazz or rock, has not been influenced by his music. When the Rock and Roll Hall of Fame opened in Cleveland in 1986, in its first group of inductees, which included Elvis Presley and Ray Charles, was Robert Johnson, the King of the Blues.

As investors, the road signs to the future are rarely clear. We weigh the facts as rationally as we can, and that leads us down a path. I think the story of Robert Johnson making a deal with the Devil at the crossroads is fiction. That is, I mostly do. Because when I hear that music, the unearthly sounds coming from his voice and guitar, I confess to having at least some small doubts.

I went down to the crossroad
fell down on my knees
I went down to the crossroad
fell down on my knees
Asked the lord above "Have mercy now save poor Bob if you please"
Yeeooo, standin at the crossroad tried to flag a ride
ooo ooo eee I tried to flag a ride
Didn't nobody seem to know me babe everybody pass me by
Standin at the crossroad
babe risin sun goin down
Standin at the crossroad
babe eee eee eee, risin sun goin down
I believe to my soul now, Poor Bob is sinkin down
You can run, you can run tell my friend Willie Brown
You can run, you can run tell my friend Willie Brown
(th)'at I got the crossroad blues this mornin Lord babe, I'm sinkin down
And I went to the crossroad
momma I looked east and west
I went to the crossroad baby I looked east and west
Lord, I didn't have no sweet woman ooh-well babe, in my distress

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