Angeles

INVESTMENT ADVISORS

SECOND QUARTER 2005

Treasure Ships

Khubilai Khan, grandson of Genghis Khan, conquered China in 1279, thus creating the largest unified empire history has ever seen, stretching from eastern Europe to southeast Asia. It lasted barely a hundred years. The local Han Chinese ousted the last Mongol holdout in the southern province of Yunnan in 1381, marking the end of the great Mongol empire and the beginning of the Ming Dynasty in China. As was the custom, following that battle all enemy males were castrated. One, an 11-year old boy from the family of Ma, was assigned as a servant to Zhu Di, one of the sons of the new Ming emperor. The boy, who was renamed Zheng He (pronounced "jung huh"), grew tall and strong, and became close friends with Zhu Di. Zheng helped Zhu defeat his brothers in a civil war, and when Zhu became the third Ming emperor in 1401, Zheng was named Admiral, head of all of China's navy.

That an anonymous boy from a remote province could rise from a captured prisoner and eunuch servant to confidant of the Emperor and Admiral of the Navy is remarkable enough. But consider how advanced was China's naval technology in 1400. China had been using a stern-post rudder since the first century, a big improvement over oars, and had a magnetized compass since the eighth century. Its ships had been built with multiple masts for centuries before, and its

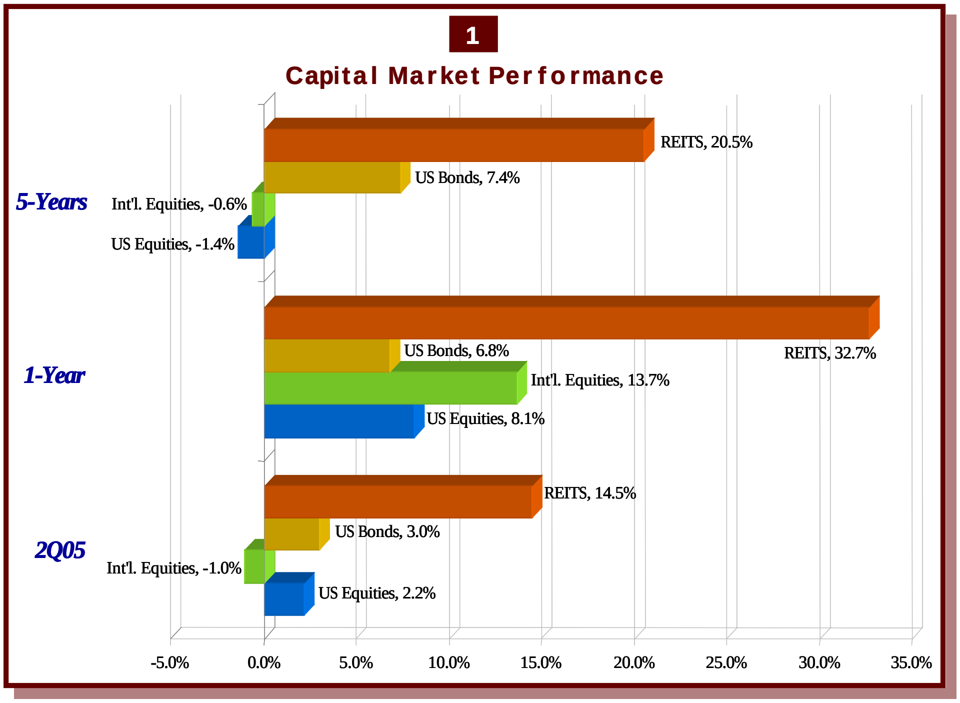
sails, made of the strongest red silk, were fore-and-aft lug sails, able to run close to the wind. All of these innovations were only about to be introduced in Europe. Chinese ships had as many as 13 watertight compartments, an advancement Europe adopted only in the eighteenth century, 350 years later.

The new emperor, who took the name Yong Le, ordered Zheng to construct and lead a naval expedition, to demonstrate to the outside world the power of China and the benefits of paying tribute to the Ming emperor. Zheng spent the next few years at the two large shipyards outside the capital of Nanjing, supervising the construc-

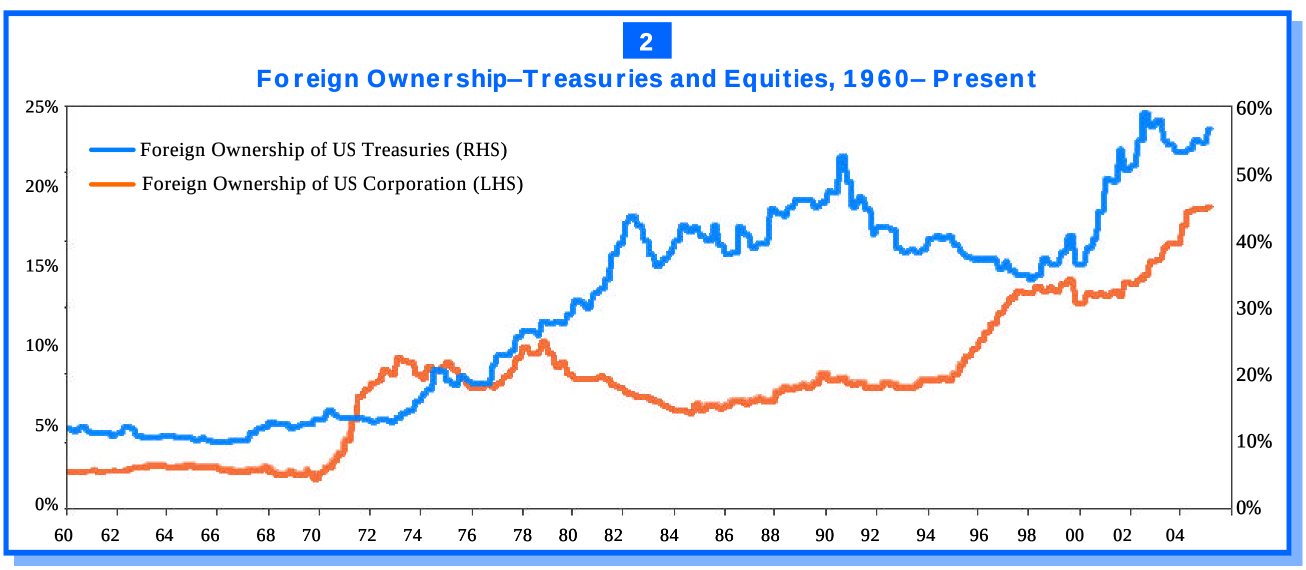
INSIDE GRAPHS:

tion of what would be the most impressive armada in history. This armada, and Zheng He, both for what they accomplished as well as for what they did not achieve, would change the course of world history.

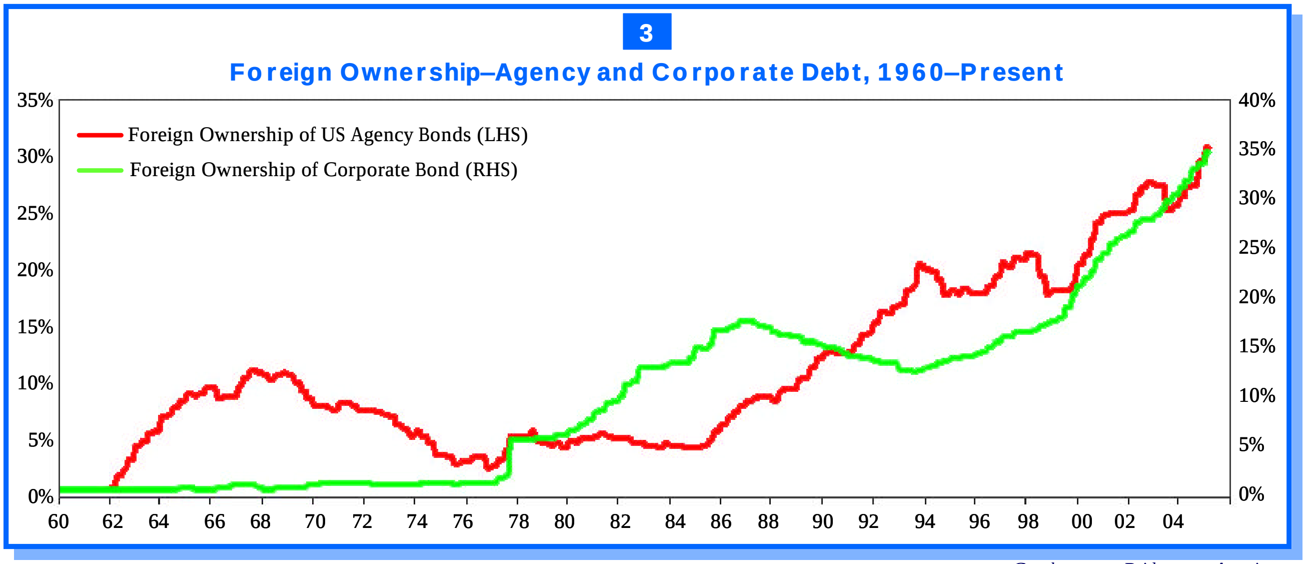
The second quarter of this year saw modest performance across most asset classes. US stocks made up the ground lost in the first three months of the year, and bonds reversed their modest loss to move ahead for the year. Non-US stocks did better in local currency terms, but the strength of the dollar off-set those gains for US investors. The star market for the quarter was, again, Egypt, up another 30% for a nice 100% gain year-to-date. Jordan added 24% last quarter, but the country in the middle, Israel, lost 2%. But outside the Middle East, most everywhere was plus or minus a little for the quarter.



Unless it was a piece of property (and not just a Miami condo). REITS roared back from first quarter losses (see Graph 1) as investors saw fundamentals improving and yields attractive in this low interest rate environment. Over the past year, the metropolitan office vacancy rate declined from 16.8% to 15.4%. Rents are improving, but are still well below 2000 peaks. True bargains may be hard to find, and the 20-30% annual returns enjoyed over the past few years cannot possibly persist, but the underlying cash flows appear to be well-supported, and even if capital gains are just in-line with



Graph courtesy Bridgewater Associates



Graph courtesy Bridgewater Associates

inflation, it's no surprise to us that investors have come to appreciate the asset class in the US and abroad.

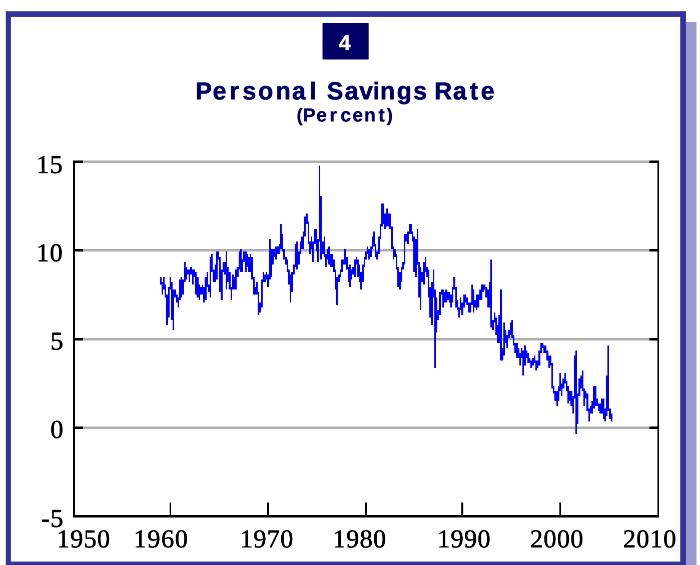
Condos are not the only things that are hot. The markets' malaise this year obscures a raging debate and growing tensions in the world economy. Like most good debates, participants agree on most of the facts; it's their meaning and implications that divide the combatants.

The fact at the crux of the tensions is the growing imbalances of world capital flows. Imagine a map of the world with the United States in the middle. Now, hold the map in two hands and fold it so all four sides are up and the United States is at the bottom of this saucer. Now, ask a friend to throw money randomly at countries around the map, perhaps throwing a little more at OPEC countries for all the oil they have, and a little more at Asia because it's growing so fast. Where does all the money end up? In the United States! Try as we do to send our dollars abroad—for oil, clothes, electronics—it just keeps coming back to us.

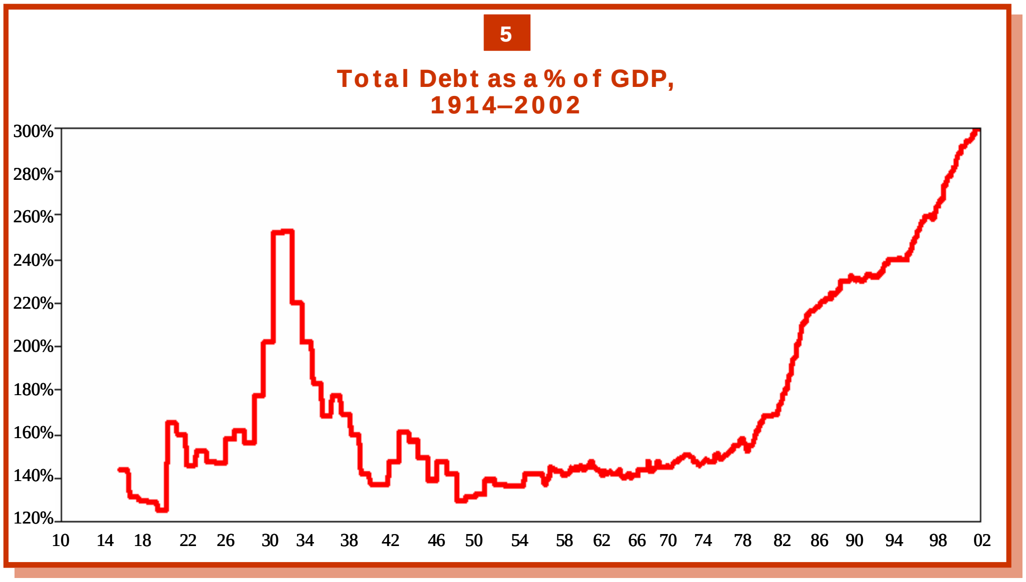
The net effect of this dynamic can be seen in a few charts. Foreigners now own nearly a quarter of the equity of US companies (direct and via the stock market), a third of our agency and corporate debt, and nearly half of the Treasury debt (see Graphs 2 & 3). Foreigners now own over $2.2 trillion (23% of US GDP) more of US assets than we hold of theirs.

Since foreigners seem eager to send us capital, Americans have taken advantage of this opportunity to reduce savings (now a mere 0.6% of income—see Graph 4) and accumulate debt (see Graph 5, pg 4) in order to maintain our consumption growth. Consequently, our current account deficit has climbed to 6.4% of GDP (and rising).

So while these are the facts, as noted, there is considerable disagreement as to what it all means, or even whether any of this matters at all. The Panglossian view is that these imbalances are positive, optimal and stable. As the hundreds of millions of rural Chinese (and Indians, and others) are absorbed into export-led economies, their excess savings are recycled into the financial assets (primarily bonds) of the importing nations (primarily the US), which has the symbiotic effect



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



Graph Courtesy Bridgewater Associates

more dramatic in Japan, where an average deficit over the past 22 years of 1.7% of GDP has swung to a surplus equal to 6.2% of GDP.

Even if there were a virtuous cycle of savings and consumption, there are limits. No one really knows where those limits are (although many claim to), but they are there. Foreign reserves now represent about 10% of China's GDP. As this grows, it requires ever more effort to sterilize the domestic impact of this flood. In a truly free market, export earnings would cause the currency and domestic interest rates to rise, making exports more expensive and economic growth to moderate. But by choosing to sterilize (recycle) these capital flows in order to maintain a currency peg, China has effectively abandoned its domestic monetary tools, principally, an effective interest rate policy that would raise rates in order to stem real estate speculation.

That's the immediate problem. The longer term risk is that China is accumulating ever more reserves (Treasury bonds, especially) at inflated prices, and at some point will realize losses on these invest-

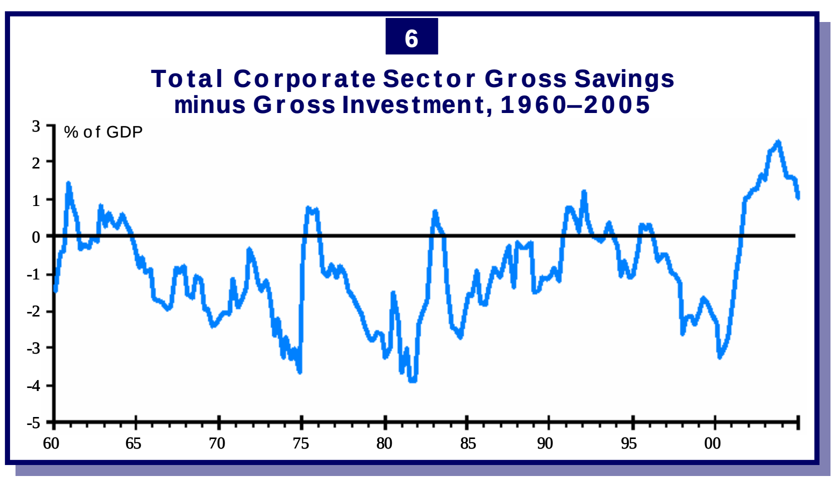
of simultaneously stimulating demand for their exports (by keeping consumers' financing costs low) and strengthening their financial reserves.

Seen this way, the "global savings glut" (Ben Bernanke's phrase) is the explanation for worldwide low interest rates. Given that this dynamic of transitioning a billion people from the farm to industry will extend years, if not decades, there is reason to expect this virtuous cycle, and low interest rates, to continue indefinitely.

Unfortunately, the global savings glut hypothesis doesn't stand up to closer scrutiny. From 1983-2000, the IMF estimates the world savings rate was equivalent to 23% of world GDP. In 2004, the IMF estimates that number was 24.9%, an increase, but a pretty modest one.

Of course, the components of savings have changed. In the 1983-2000, gross savings averaged 16.9% of GDP in the United States, but fell to 13.6% in 2004. Likewise, gross savings averaged 25% of GDP in emerging countries, but rose to 31.5% in 2004.

Additionally, companies have increased their savings. Over the past 40 years, US companies ran a financial deficit (savings minus investment), on average equal to 1.2% of US GDP. Since 2002, there has been a surplus equal to 1.7% of GDP, a big swing (see Graph 6). The shift has been even



Graph Courtesy J.P. Morgan

ments. To paraphrase J. Paul Getty, when you owe a country a billion dollars, that's your problem; when you owe it a trillion dollars, well, that's their (China's) problem.

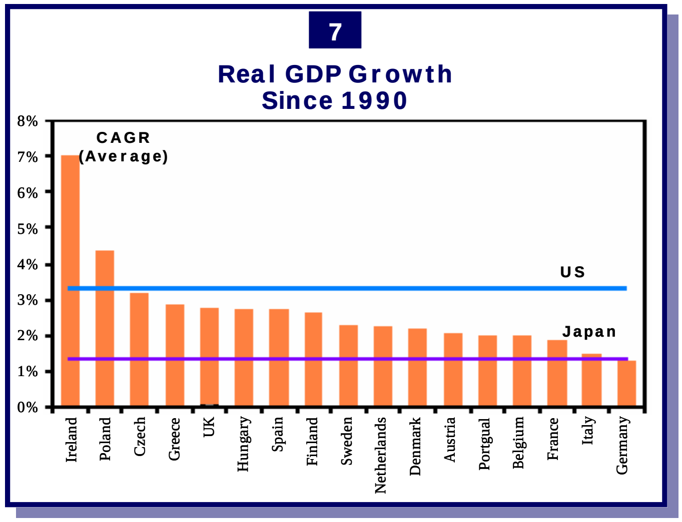
It would be fine to ignore these as China's problems, but, of course, we are all affected. China's change in currency policy this month may be modest in scope and sparse in details, but we think it marks a recognition that the tensions created by these imbalances need to be relieved, preferably gradually and controlled rather than violently and unexpectedly.

Sitting in Los Angeles, looking westward across the ocean, it seems obvious to focus our attention so heavily on the dynamics of the Asian-American relationship. *Dynamics* is the operative word, because this is a relationship that is important and evolving on many levels: economically, politically, militarily, socially. It's curious that the largest economy in the world, that of the EU, doesn't seem to matter. Why is that?

Europe may collectively be the largest economy, but its growth rate over the past 15 years has lagged well behind most of the rest of the world (see Graph 7). But our graph also highlights that certain countries have fared considerably better than others.

The explanation for this disparity in economic performance is not complicated: countries with the political will to demolish sclerotic institutions and embrace free markets have prospered. We can speculate on what caused the political will to embrace change to develop in some countries and not others, but one idea that strikes us looking at this chart is that the countries on the left mostly had nearly bankrupt economies 15 years ago whereas the ones on the right seemed to be in much better shape. In 1990, the economies of Ireland, Poland, Czechoslovakia (back then), Greece, Hungary were—how shall we say it politely?—basket cases. Germany, then as now, the continent's largest economy, was then exulting in the collapse of the Berlin Wall and the unification of east and west. Perhaps it takes an economic crisis to spur political change.

Institutional inertia and sclerosis are justified in continental Europe to provide social stability and protection from the insidious effects of global capitalism. The effect, instead, is greater pain and suffering for all. A few charts illustrate this.



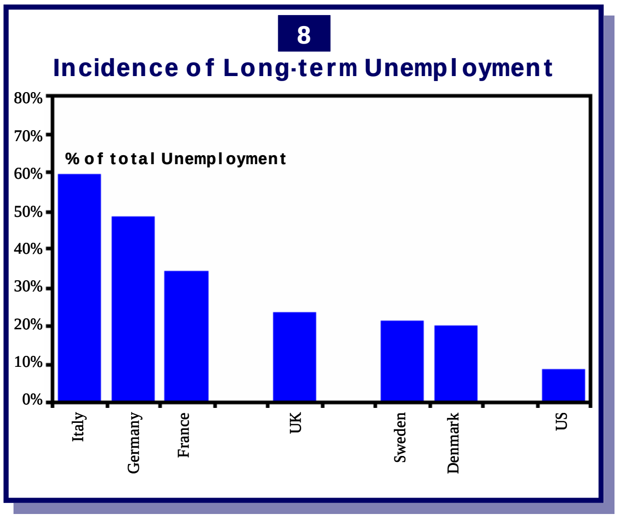
Source: Eurostat *Graph Courtesy Goldman Sachs*

Labor regulations are very strict in the EU, where workers' "rights" are protected and unemployment benefits generous. The consequence of this enlightened policy is an unemployment rate of 10% in France and Germany, compared with 5% in the US and UK. Barely 5% of unemployed in France, Germany and Italy leave the dole each month, versus 15% in the UK and 33% in the US. Consequently, the incidence of long-term unemployment is significantly higher in continental Europe than in the US (see Graph 8, pg. 6).

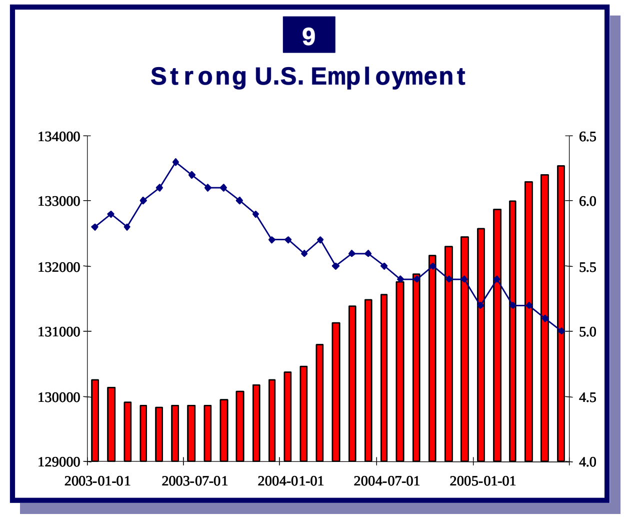
"Sitting in Los Angeles, looking westward across the ocean…"

In theory, the EU permits the free movement of goods, services, capital and labor. In practice, these are restricted. Prices of goods across EU countries are far more disparate than in the US, and a recent directive to ease the border restrictions for service workers was vetoed by France and Germany. Capital is still subjected to differing tax schemes, and labor mobility is virtually nonexistent. For example, in 2000, 4% of Americans moved to a different state; just 0.1% of Europeans moved to another country.

This past quarter, both the French and the Dutch solidly rejected the proposed new EU constitution (it was only 850 pages). Some might interpret this as a vote for change, but it seems that politicians have determined that continued inertia is preferable (hence the rejection of the Bolkestein directive that would have opened services to greater competition). Europe seems content with stagnation, and barring broad economic liberalization, the world's largest economy won't be for long.



Source: OECD *Graph Courtesy Goldman Sachs*

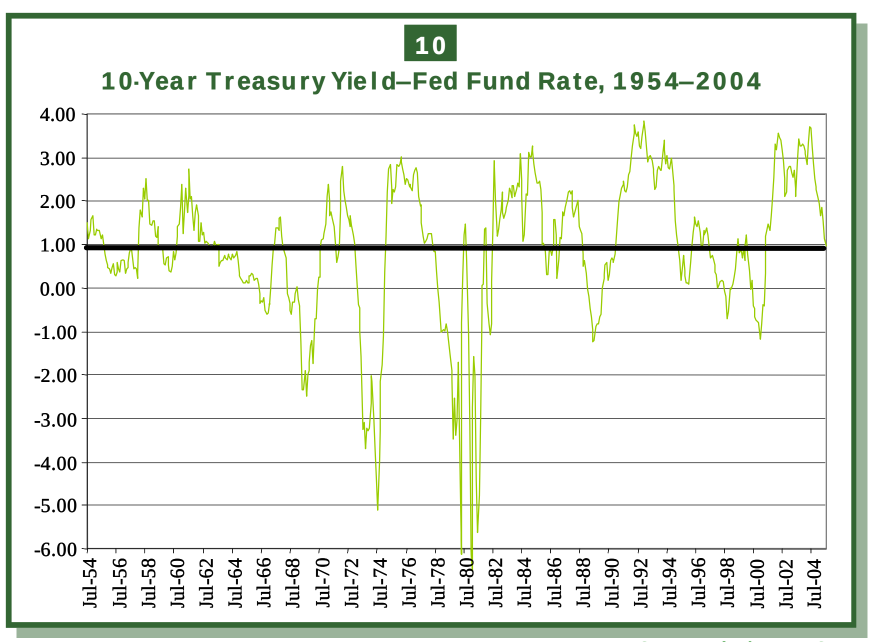


Bars=civilian employment (in 000—LHS)
Line = unemployment rate (% - RHS)
Source: Bureau of Labor Statistics

Despite serious challenges facing the US economy (principally, soaring levels of debt—see Graph 5, pg. 4), the economic data have been consistently good. Graph 9 belies all the talk of a "jobless recovery," with employment steadily increasing and the unemployment rate steadily declining over the past 2 ½ years.

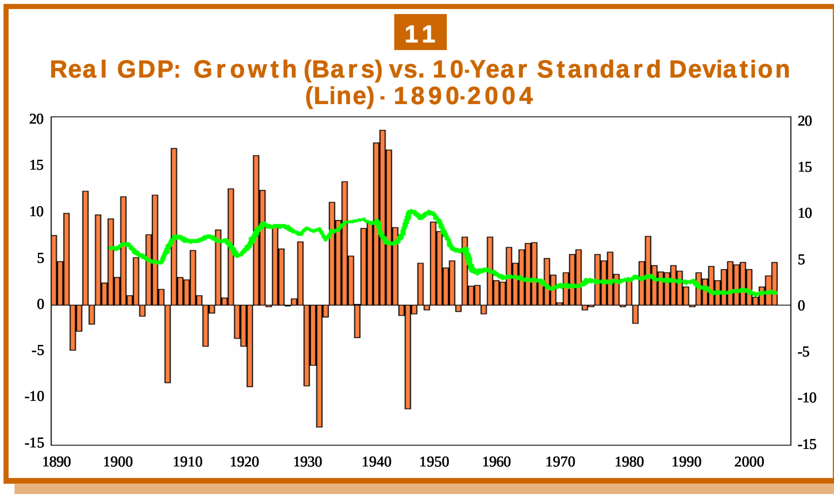
The flattening of the yield curve is often pointed to as a harbinger of a slowing economy, and it's true that every recession since 1960 has been preceded by an inversion of the curve. But the yield hasn't inverted; in fact, it's a little steeper than its long-term average (see Graph 10).

It has been unusual, though, that long-term yields have fallen amidst the tightening in the short-end. Rather than foreshadowing recession, the decline in long-term yields may more likely derive from a lower risk premium. And why would the market demand a lower risk premium for long-dated bonds? Perhaps because the economy is less prone to dramatic swings in output (see Graph 11). Other market indicators, such as tight credit spreads and buoyant equity markets, along with strong economic data, suggest that the flattening yield curve does not presage imminent recession.



Source: Federal Reserve System

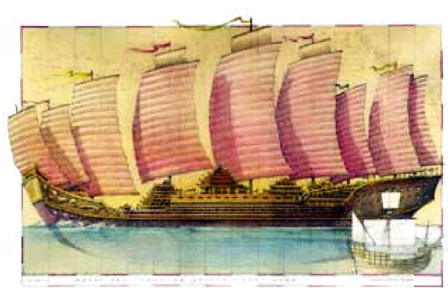
By 1405, the emperor's fleet was ready, on a scale that boggles the mind. Zheng He commanded 400 ships and 28,000 sailors. Not until World War One, more than 500 years later, was such a naval fleet assembled. Some of Zheng's ships were 400 feet long, about the size of a small aircraft carrier, with nine masts that dwarfed Columbus' flagship Santa María built 90 years later (see



Source: Bureau of Economic Analysis
Graph Courtesy Citigroup

picture). Within a few years, China's navy had 3,500 ships (in contrast, today's US Navy has about 300 ships).

For the next 26 years, Zheng led seven expeditions that carried the Chinese flag to the shores of Africa. But with the exception of a small island off the Kenyan coast called Pate, inhabited today with Asian-looking people and customs, likely descendants of Chinese sailors that shipwrecked there on one of the expeditions, it is a mystery why there is so little evidence of the impact of Zheng's extraordinary achievements. In fact, the real mystery is why China didn't conquer Europe and settle the Americas, why this letter is written in English instead of Mandarin.



In 1415, the Grand Canal was completed, and goods could now be easily transported through China's interior, especially to the capital Nanjing, alleviating the need for coastal shipping. Mongol hordes began threatening in the north, and in 1424, when the Yong Le emperor died, a power struggle ensued between the eunuchs, who favored the opening to other lands, and the Confucian scholars, who believed these journeys violated Confucian precepts against travel.

Zheng He died at sea in 1431, and when his crew returned to Nanjing two years later, they were thrown in jail, the ships logs were destroyed, and Zheng He, the greatest explorer the world has ever known, was expunged from history. The scholars made ship building a capital offense, and within a hundred years, China had no ocean-going vessels.

For most of human history, China (with India) accounted for the majority of the world's economic output. But in 1433, China made the decision to halt contact with the outside world, and so began its gradual decline as the dominant world power.

In 1400, it would have been preposterous to suggest that China would begin a 600 year decline and a small, isolated island off northwestern Europe would conquer the world. Perhaps China will return to its days of glory and grandeur and come to dominate the world again. Perhaps Europe will evolve into a tourist destination with nice museums. But one lesson from history is that choices matter, and investors should consider not where policies are, but where they are likely to be. Today, Europeans are choosing restrictive policies and economic stagnation, as China has chosen to pursue liberalization and growth. But both were not always the case, and may not necessarily always be so. At least Zheng He did not live to see the catastrophe that befell his beloved navy, or witness the beginning of the long decline of his adopted country.

MICHAEL A. ROSEN
PRINCIPAL & CHIEF INVESTMENT OFFICER
JULY 2005