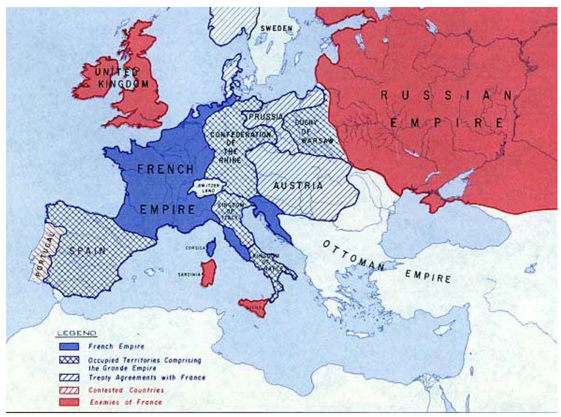
Angeles
INVESTMENT ADVISORS

FOURTH QUARTER 2005

BALANCE OF POWER



Consider the map of Europe in 1812. From the Atlantic to the Urals, from the Baltic to the Mediterranean, Europe was French. Consider, too, the amazing events that led to this. In July 1789, the Bastile was stormed and the French Revolution began. Three years later, King Louis XVI was guillotined, followed by Robespierre's Terror that slaughtered 40,000 people that year. In 1799, less than ten years after the Revolution proclaimed *The Rights of Man*, France was ruled again by one man: the Corsican, Napoleon Bonaparte, who announced, *The Revolution is over. I am the Revolution.*

A year later, in June 1800, Napoleon incredibly led his troops over the Italian Alps to surprise the Austrians at Marengo, leading to the conquest of Italy. Five years later, in perhaps the greatest tactical maneuver in military history, the superior armies of Russia and Austria were lured into a trap at Austerlitz, and routed by the French forces. In September

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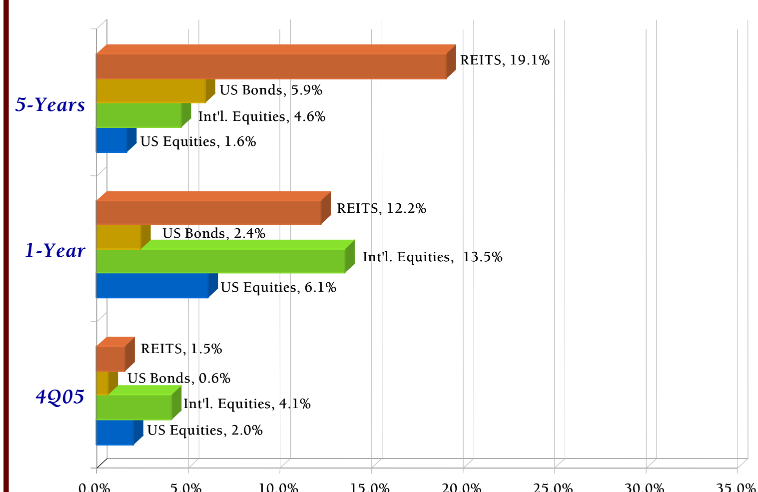
CAPITAL MARKET PERFORMANCE



INSIDE GRAPHS:

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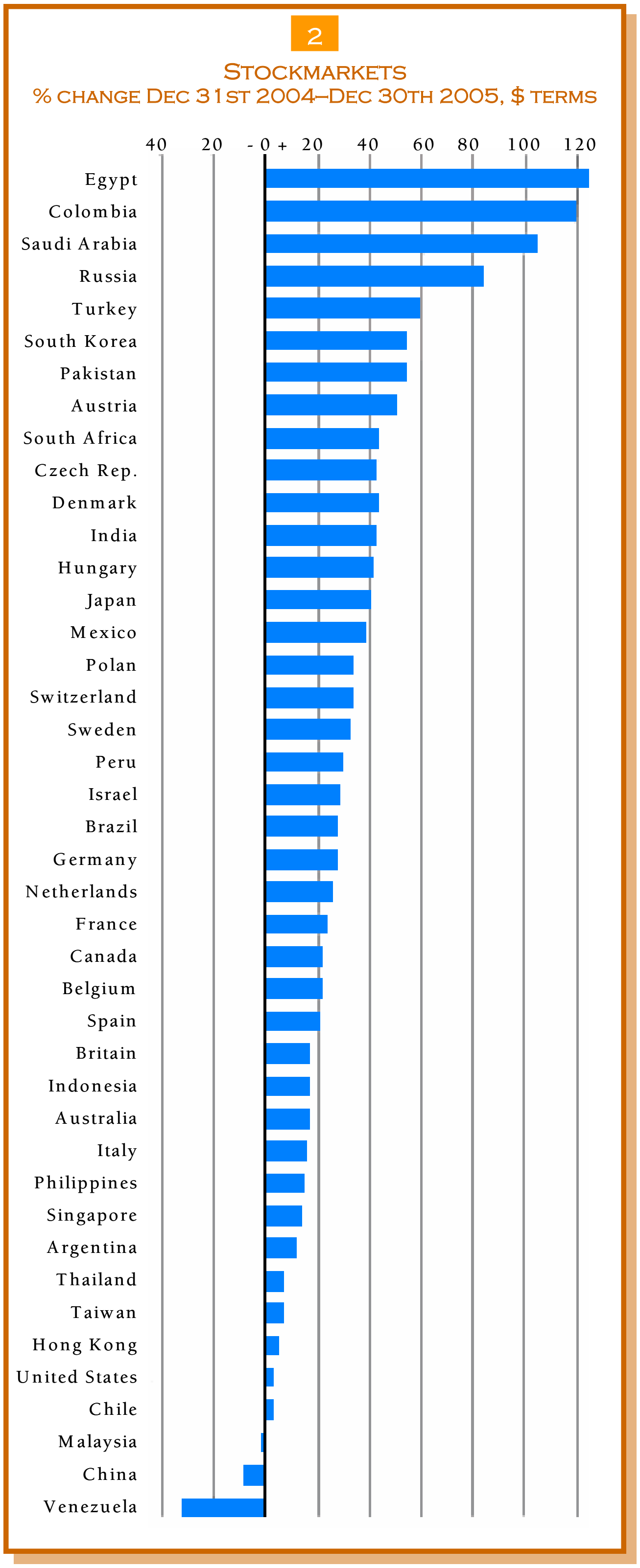


Graph Courtesy: The Economist

1812, following a ferocious battle at Borodino, Napoleon entered Moscow, conqueror of all of Europe.

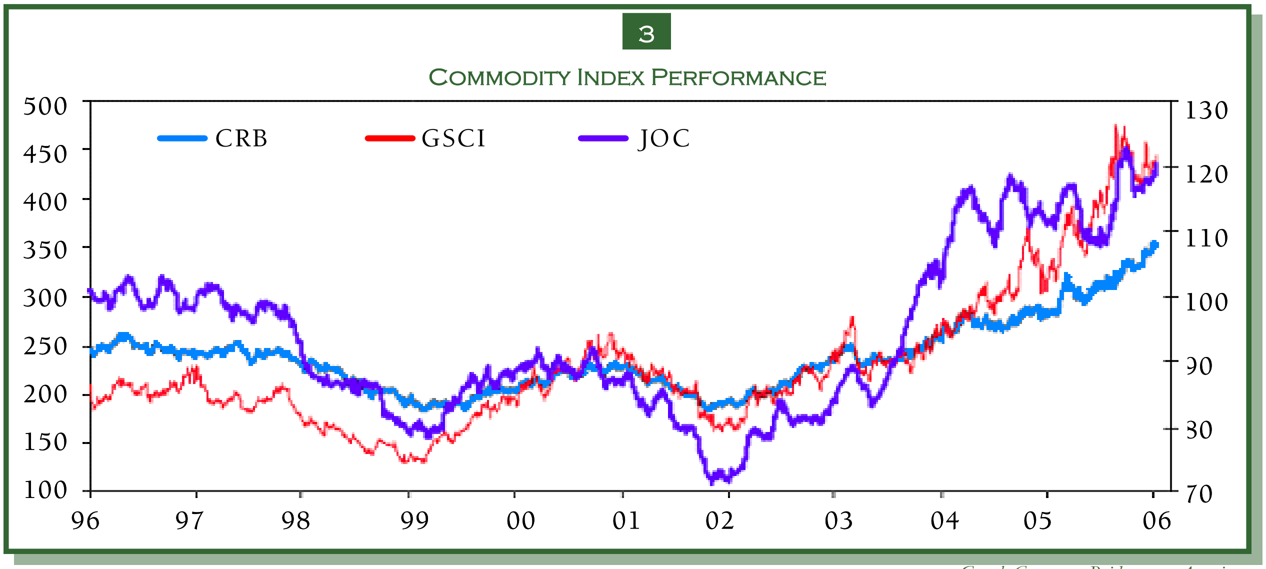
We know the rest of the dramatic story, but what interests us is a little-noted event that took place three years before the fall of Moscow. In the summer of 1809, Napoleon marched down the Danube, culminating at the Battle of Wagram, outside Vienna. There, he crushed the Austrian army, and dismembered the Hapsburg empire. In that humiliating moment, the diminished Hapsburg dynasty appointed a little-known career diplomat to be its new foreign minister. From this inauspicious start, and without any real power to wield, would rise the greatest diplomat the world has seen, architect not just of Napoleon's defeat, but of a new world order that would maintain the peace for a hundred years. We think his adroit balancing of competing, powerful interests while maintaining his focused objectives hold valuable lessons for us today.

The final quarter of 2005 concluded a year of modest-to-disappointing results in US financial markets. US equities posted small gains, as the real action was overseas, as Graph 1 highlights.

Of course, commodities have had a nice run, too. Cotton grew 27%, orange juice squeezed up 48%, and sugar sure was sweet, up 104% in 2005. In contrast, bonds couldn't earn their coupons as the Fed pushed short rates up to meet long-term rates, making the yield curve about as flat as Kansas.

Here's the conundrum: we have rising inflation (3.4% last year), falling unemployment (4.7% at last count), and the riskiest assets (including condos in Las Vegas) soaring in value. Commodities (see Graph 3, page 3), including gold and oil, are at 25-year or record highs. Emerging markets (both debt and equities) have skyrocketed, with bond yields the closest to US Treasuries since the late 19th century. Yet, we have Treasury yields at 4.5% across all maturities. Why is there no risk (yield) premium for long-term bonds in this environment?

One explanation, espoused notably by Bill Dudley of Goldman Sachs, is the high confidence the markets have in the Federal Reserve's abilities to contain inflation (that scourge of fixed income investors). Evidence in this ability is seen in the sharp decline in inflation volatility, especially relative to interest rate fluctuations (see Graph 4, page 3). If inflation risk is mitigated for long-term investors,



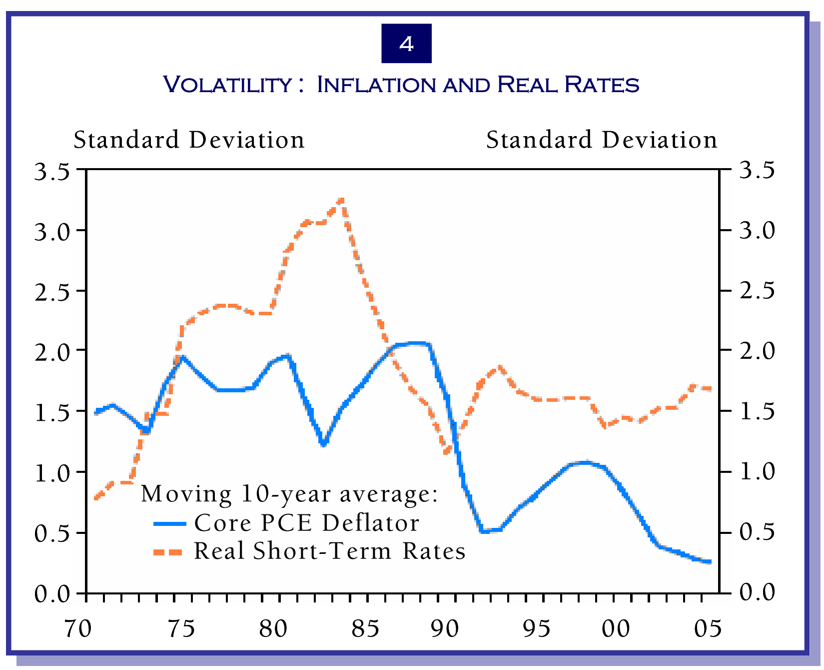
Graph Courtesy: Bridgewater Associates

the greater investment risk shifts to changes in real (inflation-adjusted) rates. This encourages investors to purchase long-term bonds in order to lock-in a real rate of interest and remove the risk of earning lower real rates in the future.

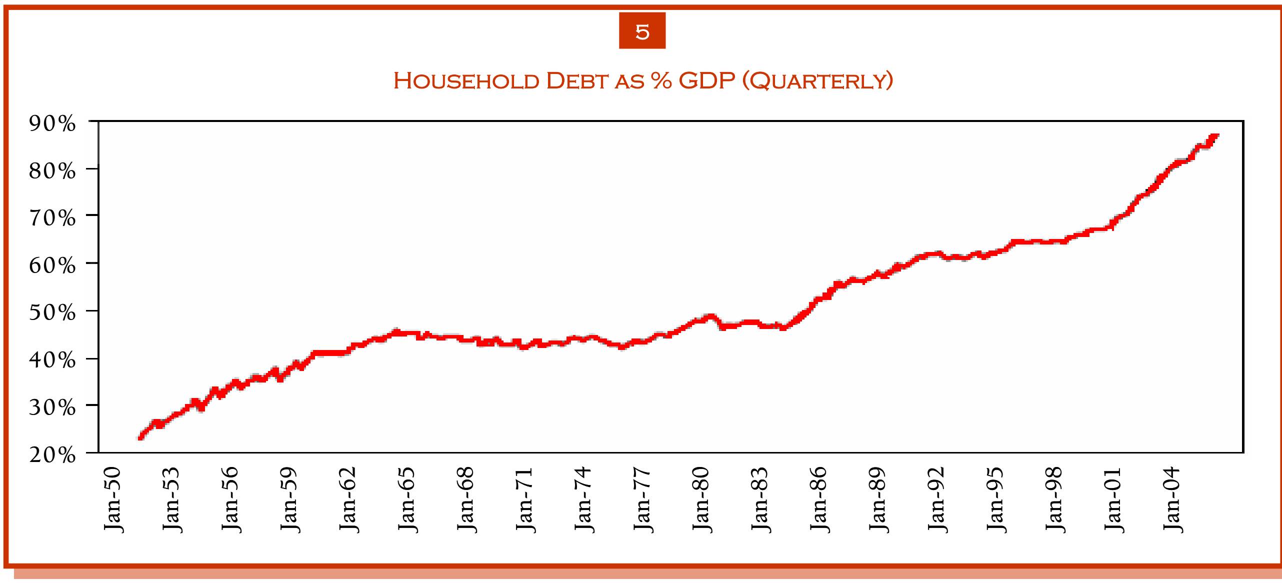
This analysis has a number of important implications. It suggests that the yield curve could be permanently flattened, and that long-term interest rates may not move much higher. In this analysis, the inverted yield curve would no longer be a harbinger of recession, as it historically has been, and short-term rates may have to rise more than expected to offset the stimulus of lower long-term yields.

Central bankers may have earned the markets' respect for reducing the volatility of inflation and other economic data, but it is premature, if not misguided, to declare as permanent the current state of blissful stability. The Fed successfully managed the collapse in business investment in 2001-2002 by flooding the markets with liquidity, cutting the Fed funds rate to 1%. Consumer spending never slowed, and we had the barest and quickest of recessions. All that liquidity found its way into consumption (especially in housing), so that we are now in uncharted territory in debt (a record high—see Graph 5, page 4), savings (a record low, at least since 1933—see Graph 6, page 4) and consumption (see our balance of trade over the past century—Graph 7, page 5).

As the Fed has slowly tightened the spigot, raising overnight rates 14 times in past 18 months, other (especially Asian and Middle Eastern) central



Source: Department of Commerce, Federal Reserve; Courtesy: Goldman Sachs

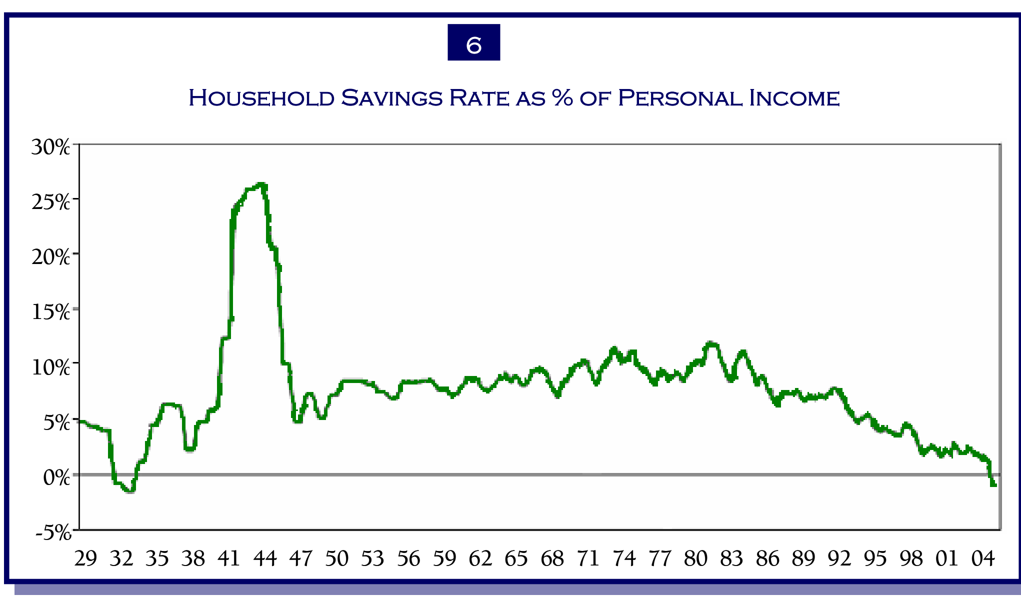


Graph Courtesy Bridgewater Associates

banks have recycled their dollars into our markets. This has been going on for some time, but foreigners now own more than half (57%) of the US Treasury debt outstanding (see Graph 8, page 5). This has helped to provide the liquidity needed to sustain ever rising debt and consumption levels.

One could interpret these data as evidence of the precarious state of the world economy, but an ominous outcome is not certain. In the last mild recession, the Fed (with help from some foreign central banks) was able to stimulate consumers to pick up the slack from businesses that needed time to repair their balance sheets. That process is completed as businesses have de-levered and are flush with cash from record profits. Companies are under pressure to spend that cash, in capital projects or acquisitions, or to distribute it to shareholders. It is plausible that businesses could provide marginal stimulus to the economy, this time giving consumers time to repair their balance sheets. Foreign holders of our currency have a vested interest in our economic health, and are unlikely to take any action that undermines it. Last year, China surpassed Japan as the largest holder of reserves in the world, and before the end of 2006, China will surpass $1 trillion of reserves. We are in the early stages of a massive shift in relative wealth to developing (mostly Asian) countries, but we're also in this together.

It seems clear to us that the American consumer must, and therefore will, de-lever, and possibly



Graph Courtesy: Bridgewater Associates

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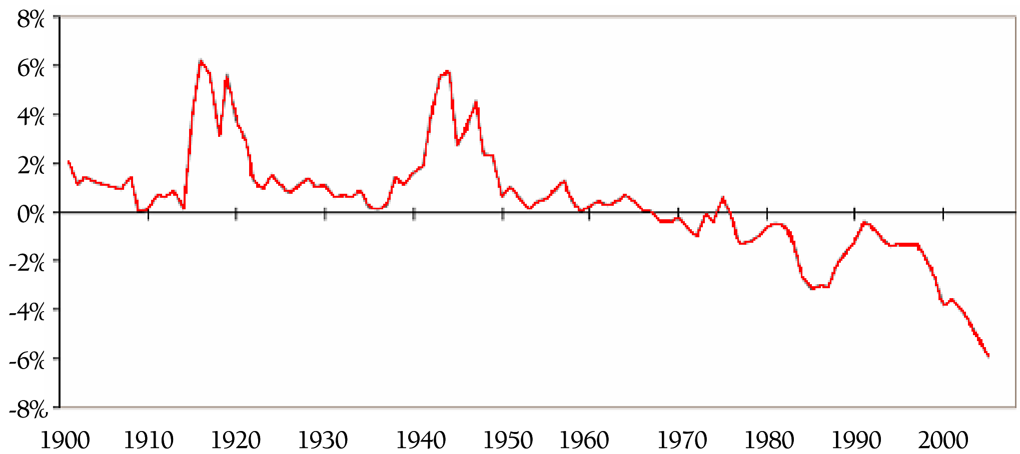
BALANCE OF MERCHANDISE TRADE AS PERCENTAGE OF GDP



Graph Courtesy: Bridgewater Associates

sooner rather than later. If the world were static, *ceterus paribus,* this would entail a slowing of the world economy, even, under certain conditions, a hard landing for asset prices, including housing and commodities. But we see a far more complex ecosystem, and not just because of global interdependence. De-levering entails the *relative* change between a numerator (debt) and a denominator (assets or income). This can certainly be a painful process in a slowing or contracting economy, but the evidence (for now) points to continued growth: more jobs are being created, incomes are rising, capacity is tighter. For investors, we think the risks are currently on the upside: for higher inflation, stronger growth, and further tightening by the Fed. At least, until we see evidence to the contrary.

Metternich (Clemens Wenzel Nepomuk Lothar von Metternich-Winneburg) had three objectives when he became Austria's foreign minister in 1809: to oppose Napoleon without offending him; to ensure the strategic importance of a country that had lost most of its territory and power; and to craft a post-war order that would sustain a balance of power with Austria at the fulcrum. He began his work by convincing the Hapsburg archduchess, Marie Louise, to marry Napoleon (who had Josephine exiled for failing to produce a son), cementing ties between the Hapsburgs and Napoleon. Metternich then persuaded Napoleon to permit the creation of a large Austrian army that could conceivably help him in the coming conquest of Russia, while simultaneously convincing Russia that this army would be used *against* Napoleon (a neat trick). He asked Russia to send a few troops to their border in order to "tie-down" his army, making it "impossible" to assist Napoleon in Russia. Should Napoleon succeed in conquering Russia, Austria could not be faulted for not assisting; but

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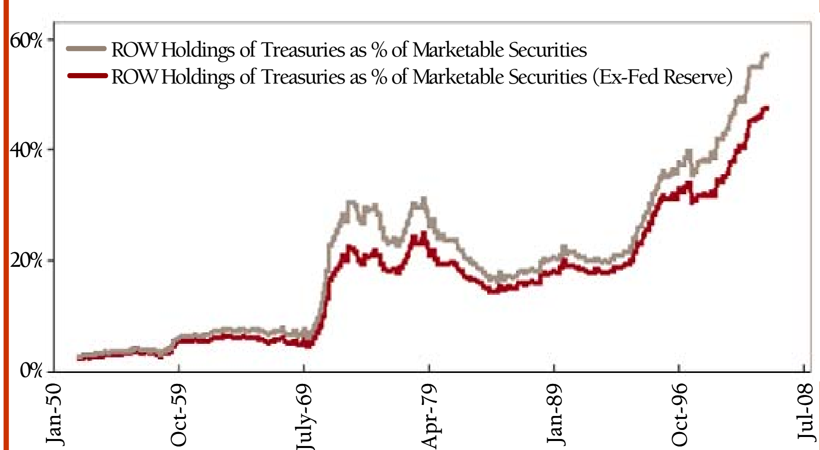
FOREIGN HOLDINGS OF US TREASURY DEBT (%)



Source: FRB Flow of Funds, Bureau of Economic Analysis *Graph courtesy Merrill Lynch* if Napoleon were turned back, Austria would have already communicated its friendship to Russia, and would be in a position to assist in Napoleon's defeat, which is exactly what happened.

Once Napoleon began his horrific retreat from Moscow in December 1812 (he marched into Russia with 500,000 men and exited with less than 50,000), Metternich continued the diplomatic and military coordination among the great powers—Russia, Prussia and Britain—that led to Napoleon's capture in Paris in 1814 and exile to Elba. Metternich called for a Congress in Vienna among all the powers to redraw the map of Europe and establish the conditions for peace.

Allies in war quickly became antagonists at the bargaining table, and Metternich played each against the other with subtlety and finesse. He prevented Russia from absorbing Poland, and Prussia from taking Saxony. He created a new German confederation under Austrian control, and restored Austrian influence in Italy. He established the Quadruple Alliance (Russia, Prussia, Britain and Austria) as guarantors of this order. With the exception of a ten-month war between France and Prussia in 1870, Europe enjoyed a hundred years of peace.

It took a Napoleon to shatter the world order, and it took a Metternich to restore the world, albeit a new world and a new order. We are today surely at the beginning of a similar seismic shift, as half the world's population that had been hidden from progress behind a wall of a nefarious ideology reemerges to join the world economy. We can try with limited ability to quantify the impact this shift will have—on the global labor supply, on the demand for resources, the ecological effects and political pressures. One thing of which we can reasonably be assured is that we will grossly underestimate these forces. We also know that the path ahead is never as smooth as it seems, or as rocky as is feared. As the great poet Ovid wrote 2,000 years ago, *there's nothing constant in the world, all ebb and flow, and every shape that's born, bears in its womb the seeds of change.* We are well-served to study Metternich, to keep in focus our objectives amidst the fog of uncertainty, and our balance amidst the ever-changing powers.

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