Angeles
INVESTMENT ADVISORS

THIRD QUARTER 2006

Dance!

Jerry Rabinowitz was born in 1918 to Polish immigrants who ran a deli on the East side of Manhattan. A few years later, his dad, Harry, and Harry's brother opened the Comfort Corset Company (a bit of an oxymoron), and the family moved to New Jersey, where Jerry grew up and was expected to join the family business when he was older.

Jerry entered NYU in 1935, but lasted only a semester. He failed two of his classes, so his mind really wasn't on his studies. Additionally, the Great Depression put a pinch in the family business so he could no longer afford tuition. He needed to work, as did millions of Americans at the time, but for some reason, the corset business didn't much appeal to Jerry; he had dancing on his mind.

So Jerry Rabinowitz became a dancer. He had a little talent, and managed to find a job with a small ballet company. He had grand ideas for staging elaborate ballets but, of course, there was no money, and his plans never moved beyond his imagination. Most days, he would commiserate with fellow struggling dancers, writers and musicians, and they all vowed that one day, if they ever had enough money, they would perform their ideas in their own ways.

Jerry Rabinowitz would revolutionize dance in America; and not just dance, but theater, movies, all the performing visual arts would be forever changed, not by Jerry Rabinowitz the dancer, but by the genius of his

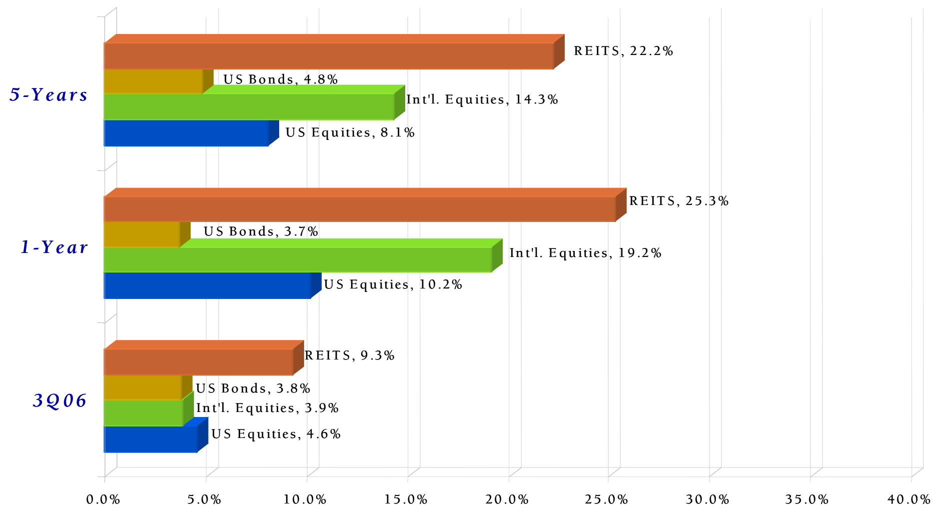
visionary concepts and his manic determination to see them through.

It was a strong quarter across virtually all the capital markets. The pause (or end, as some believe) of the Fed's two-year tightening campaign, along with some weaker economic data, helped bonds rally, with yields falling about 50 basis points. Equities performed well, if modestly, in almost every market around the world. The real action was found in the Middle East, with Egyptian equities jumping 32% in the quarter, wiping out its losses this year (YTD, Egypt is now up 4%). Unfortunately, Jordan continues

INSIDE GRAPHS:

1

CAPITAL MARKET PERFORMANCE



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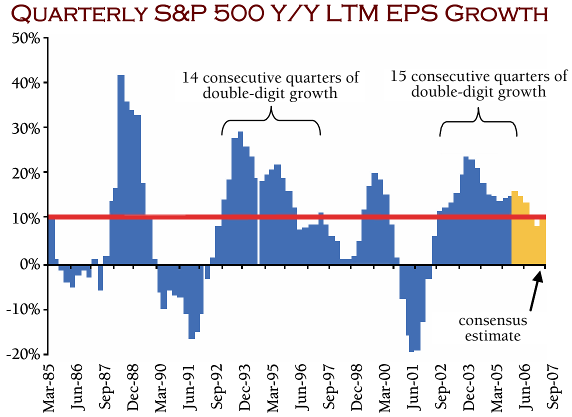
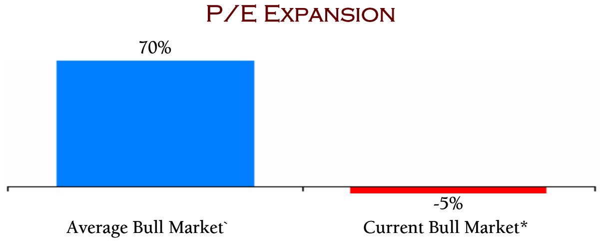
QUARTERLY S&P 500 Y/Y LTM EPS GROWTH



Source: Thomson Financial, FactSet; Courtesy: Morgan Stanley

3

% OF PERFORMANCE ATTRIBUTABLE TO P/E EXPANSION



**11 March 2003 through 30 September 2006*
Bull markets defined as 10% reversals in the S&P 500 Index
Source: S&P, Ned David Research, Haver; Courtesy: Morgan Stanley

to lag, down 1% in the quarter and off 26% this year, the worst market in the world.

If you accept, at some level, that markets reflect economic conditions (current and/or anticipated), we can offer some "real" explanations for the solid equity performance. Corporate profits continue to surge: the past quarter saw the fifteenth consecutive double-digit earnings growth, a post-WW2 record (see Graph 2).

Typically, bull markets are driven by multiple expansion, but this recent rally, remarkably, has occurred in the face of multiple contraction (see Graph 3). Companies have stockpiled this cash, thus bolstering their balance sheets (see Graph 4, pg. 3).

Perhaps the most compelling, and controversial, explanation for strong equity markets is liquidity. That there is ample liquidity is evidenced in rising equity prices, tight credit spreads, surging gold prices and a boom in leveraged buyouts (see Graph 5, pg. 3).

But is there really ample liquidity? Prime evidence to the contrary is found in the (inverted) yield curve. Historically, an inverted yield curve was caused by tight monetary policy, usually in response to rising inflation, and indicative of slowing economic growth, or often a recession, to come.

Cognitive dissonance is a psychological term, describing the discomfort in holding simultaneously two conflicting beliefs. Either inflation will rise and the economy will continue to expand, as the equity, credit and gold markets suggest, or we risk a recession, as the Treasury curve intimates.

Before we consider why the inverted yield curve may be wrong about the economy, we should acknowledge the history gods. Monetary tightening does not end benignly: a recession or financial crisis almost always follows (think 2000, 1998, 1994, 1989, 1980, to choose only the recent past). But if there is something different this time (keep a hand on your wallet when you hear that phrase), it may be found in the extraordinary expansion of foreign holdings of dollar reserves (see Graph 6). If so, the inverted curve doesn't signal tight money, but the opposite: excessive stimulus from artificially low long-term interest rates.

So the inverted yield curve could be flashing its historic warning of slowing growth and waning inflation, or it could be reflecting the seismic shift in global capital flows, from fast-growing emerging economies to the mature economies, a reversal of the historic pattern.

The US sends about $800 billion abroad each year in exchange for goods (net of what we receive for our exports). What happens to those dollars? They could be used to consume other goods, or to invest domestically, but for the most part, these dollars are returned to the US in the form of purchasing our debt (half the federal debt is owed to foreigners). But why would these countries, mostly in Asia and the Middle East, prefer to recycle dollars back into US Treasury bonds? Are they crazy?

Well, maybe, but there is an important domestic agenda behind this policy. Emerging economies are dependent on exports, and a cheap currency makes exports more attractively priced. But in order to maintain a cheap currency, a government must have a supply of it to sell. And that supply comes either from printing it or by borrowing it domestically. Printing money is inflationary (by definition), so borrowing domestically is the preferred route (this process is called sterilized intervention). But this borrowing would normally drive domestic interest rates higher, which would attract foreign capital and raise the value of the currency. The market mechanism supplies no free lunch.

So how do these countries get away with maintaining cheap currencies with low inflation? The answer is that their citizens are saving like there's no today (see Graph 7, pg 4).

This debate on what the yield curve is signaling has taken on almost Seussian dimensions (are short rates too high or are long rates too low?), but the answer has important implications. The traditional signal is that there is a high risk of a recession next year; the recent rise in inflation will reverse, and the Fed will soon begin lowering short-term rates, and investors should be buying bonds, avoiding stocks and be happy to get a (barely) positive return.

The alternate universe suggests that conditions will continue to be supportive for growth and equities. Far from being irrational, emerging countries have every interest in perpetuating this regime; after all, it has allowed for strong economic growth with low inflation. Some very smart people believe this can't continue indefinitely, that foreigners won't continue to allow nearly all their earnings to support the dollar and keep US interest rates low, and that this will all end in a dollar/debt crisis similar to the early 1970s that saw an implosion of the Bretton Woods system with a collapse of the dollar and a spike in interest rates.

They may be right, but an interesting perspective (notably from James Paulson of Wells Capital) on this looming balance of payments crisis draws an analogy to the Marshall Plan. At the time, the Marshall Plan

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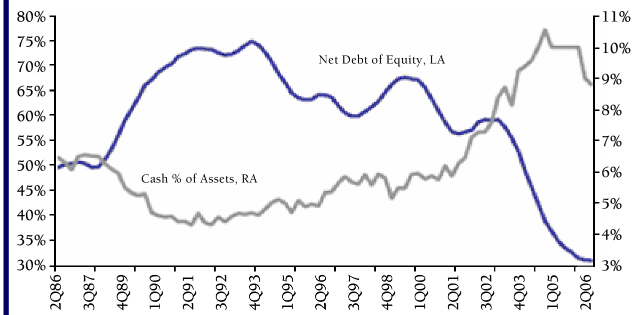
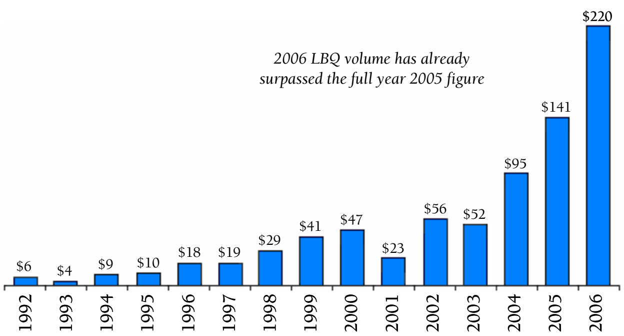
S&P 500 ex-Financials



Source: Compustat; Courtesy: Morgan Stanley

5

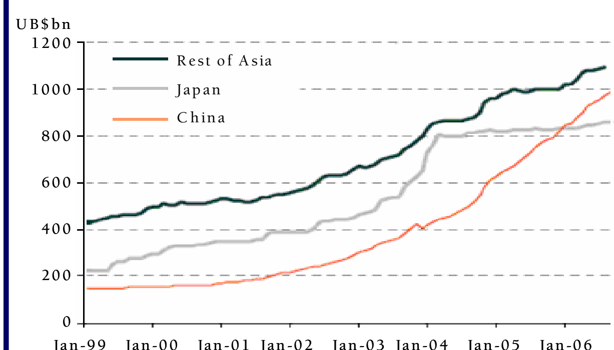
US LBO Deal Volume (In billions)



Source: FactSet Mergerstat; Courtesy: Morgan Stanley

6

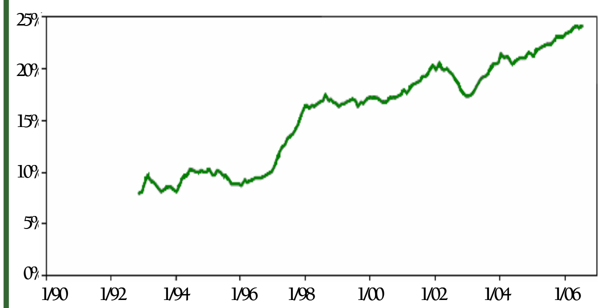
Asian Central Bank Reserves



Source: CEIC; Courtesy: Lehman Brothers

7

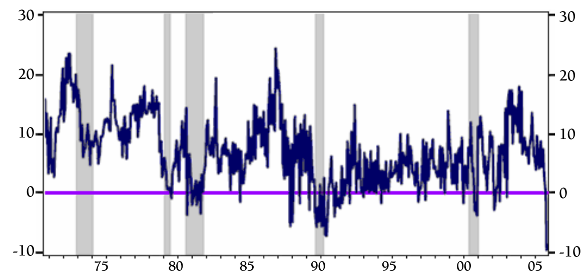
CHINA PERSONAL SAVINGS RATE



Courtesy: Bridgewater Associates

8

NEW 1-FAMILY HOUSES: MEDIAN SALES PRICES



Source: Census Bureau; Courtesy: Merrill Lynch

was criticized for throwing good money into the black hole (almost literally) of Western Europe. Yet it provided the stimulus for rebuilding and rebirth that would pay us dividends many times over by creating markets for our goods and another engine for the world economy. By running large trade deficits with emerging countries (last year our trade deficit with China was the equivalent of 9% of China's GDP), we are effectively doing the same, helping them climb out of poverty and become important contributors to the world economy.

It seems to be working. China, in particular, will likely have a bigger impact on the world economy than either the Asian tigers or Japan (which grew to the second largest economy in the world) after World War 2. Between 1960 and 1990, Japan grew from 3% of world GDP to 14%, and its share of world exports more than doubled. Between 1995 and 2020, according to Goldman Sachs estimates, China will have surpassed this growth rate. In just the past ten years, China's share of world exports has more than doubled (see Table).

Housing probably holds the key to the direction of the US economy over the next year. These global forces discussed above are important, but over the next few years, we can see these capital flows continuing. And if we could look out 20 or 30 years, we are reasonably confident of the growing wealth of these emerging countries, especially Asian. But in the near-term, the US economy will turn on the impact of this cooling housing market.

The median price of a new home fell 9.7% year-over-year in September (see Graph 8), although existing home prices were still slightly higher than a year ago. Housing matters because we own a lot of it, about $20 trillion worth, twice the value from just five years ago. Since 1959, we've had ten episodes of >20% declines in housing starts, not including the current one, and in seven of those cases, a general economic recession followed (which is what the yield curve is telling us today).

Over time, there has been a reasonably close connection between income growth and home prices, and prices have gotten a little ahead of incomes recently, but not dramatically so (see Graph 9, pg. 6). Also, this correction follows an unprecedented boom in housing prices, and is not, therefore, necessarily indicative of either tight money or weakness elsewhere in the economy. For now, the cooling in housing is a welcome economic rebalancing that has yet to impact the rest of the economy. But it bears watching.

TABLE 1
GROWTH RATES AND EXPORTS OF SELECTED COUNTRIES

	GDP/Global GDP				Exports/Global Exports			
	Base year	End year	Change	Average yoy change	Base year	End year	Change	Average yoy change
Japan (1960-1990)	3.3	14.0	10.7	0.36	3.7	8.5	4.8	0.16
Tigers* (1960-1997)	0.4	2.6	2.2	0.06	1.6	8.3	6.6	0.23
China (1995-2005)	2.5	5.0	2.5	0.26	2.9	7.4	4.4	0.41
China (1995-2020)	2.5	13.0	10.5	0.42	na	na	na	na
India (1995-2005)	1.2	1.7	0.5	0.04	0.6	0.9	0.3	0.03
India (1995-2020)	1.21	3.18	2.0	0.08	na	na	na	na

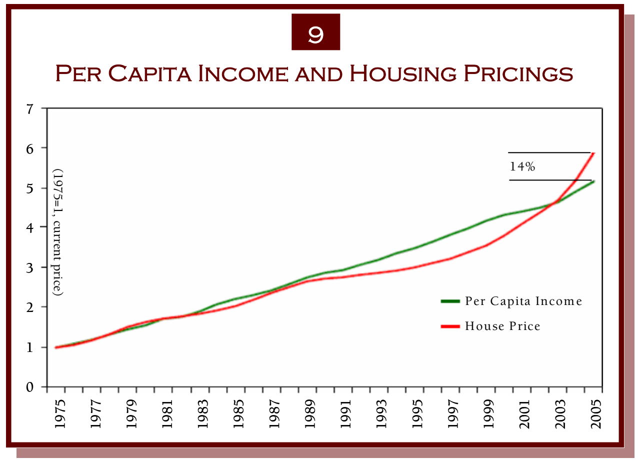
**HK, Korea, Singapore, ex Taiwan (as it can be included only from 1980)*
Base year for exports is 1968 (due to Singapore data)
Courtesy: Goldman Sachs

On a cold day in January 1949, Jerry Rabinowitz excitedly called his friend Lenny to come over to his apartment with his friend Arthur to discuss a brainstorm Jerry had. The American musical had always contained dance, music and drama, but since the musical evolved from vaudeville, each of these forms was largely separated from the other: the plot was developed by the drama, a song would appear periodically to showcase the music, and if there were no lyrics, there would be a group of dancers in the background. The musical was essentially a vaudeville show with a semblance of a plot tying (barely) everything together. Jerry had a radical idea: a show where drama, music and dance were equally integrated, each one capable of advancing the plot, each one present simultaneously at virtually all times, while making an important social statement.

Despite the fact that they each found the concept intriguing, the three of them immediately began to fight over its development, and by the end of the day, stormed out of Jerry's apartment barely on speaking terms.

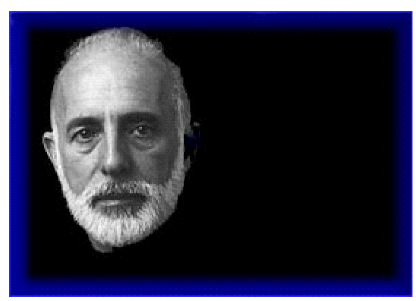
Six years later, Lenny ran into Arthur at the pool at the Beverly Hill Hotel (where he was working on the script to *On the Waterfront*), and while they were chatting, noticed the headline that day in the *LA Times* was about a gang war between Mexicans and Americans. They looked at each other with the same thought. The next week, back in New York, they got together with Jerry and agreed to work together on a musical about gangs, not Jewish and Irish as Jerry had originally proposed, between Puerto Rican and American gangs, wrapped in a doomed love story borrowed from *Romeo and Juliet*.

So Arthur began writing the dialogue, Lenny started working on the music, and Jerry put it all together. Jerry was despised by all, offending Arthur by bringing in an unknown 25-year old lyricist, chastising Lenny to improve his music, and driving the unknown actors (all dancers) mercilessly, yet, as Chita Rivera noted, "he made you do what you were really capable of doing, something you never dreamed you could possibly do." The prologue to the play, always spoken or sung to introduce the plot, was all dance. The murders at the end of Act I were also danced, with no words, to the strange, dissonant and powerful music Lenny wrote. Everything about it was so radical, yet its greatness was instantly recognized and widely acclaimed. It retains its power more than fifty years later, and its collaborators are acknowledged as the greatest librettist (Arthur Laurents), the greatest composer (Leonard Bernstein), the greatest lyricist (Stephen Sondheim) of American theater. And while he is considered the greatest choreographer of the stage, it was his vision and drive, and the choreography, of Jerome Robbins that created this masterpiece.



Source: CEIC; Courtesy: Morgan Stanley

West Side Story completely changed the American musical, on stage and in the movies, and influenced every visual performing art since 1955 through its seamless integration of dance, drama and music.



These elements had been present in theater since ancient times, but no one had ever visualized them together in such a way. Jerome Robbins confirmed the truth of Marcel Proust's observation that *the real voyage of discovery consists, not in seeking new landscapes, but in having new eyes.*

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