Angeles
INVESTMENT ADVISORS

SECOND QUARTER 2007

CAPITALISM

Joszi (pronounced *yo-shee*, a boy's nickname) was born in Triesch, about 75 miles south of Prague in 1883 to a family that had lived in that valley for 400 years. His father, who ran a textile mill, died in a hunting accident when Joszi was four, and his mother was determined to escape the small town and advance in Hapsburg society. She moved to Graz, where she soon married a retired general of minor nobility 30 years her senior, the perfect path to help her boy get into the best schools. On the day of Joszi's graduation from the esteemed University of Vienna, his mother legally separated from her second husband, her task complete.

With no job, Joszi toured Europe as a *bon vivant*, and after a few months in London he managed to marry a woman of minor nobility twelve years his senior (like mother, like son). Still with no job, he discovered he was permitted to practice law in Egypt, so the newlyweds moved to Cairo where he befriended the country's princess, convincing her to let him invest her money. He did so very successfully, earning enough money to live on for the next six years as he returned to Vienna. He earned a Ph.D. in economics, then took a position at the new university in Czernowitz (now in Ukraine).

Still only 26, Joszi had had a colorful life, but hardly an auspicious one. Nonetheless, he declared that he had three goals in life: to be the greatest horseman in Austria, the greatest lover in Europe, and the greatest economist in the world. Forty years later, reflecting on this, he expressed disappointment that he was able only to achieve two of these three goals. Joszi's life would unfold as a remarkable journey. At that very moment, an unknown academic from a remote outpost of the vast Hapsburg Empire would publish a book of startling insight that would change how we look at our lives. But the world wasn't ready for it then. Europe was on the brink of a cataclysmic war in which 60 million people were killed or injured, to be followed by two decades of economic upheaval, first with hyperinflation and then in a global depression. In the midst of a second, more destructive world war, Joszi published his masterpiece, the most influential book on economics in the 20th century. We recognize him today as one of the most

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important economists of all time, his insights more relevant today than ever, and more appreciated by us now than they were by his contemporaries.

We'll set our stage first, before returning to this extraordinary man.

Equities had a robust quarter in most markets as earnings were better and economic growth stronger than expected. Peru paced the world again with another 30% rise (up over 60% this year on the back of strong mineral exports), although troubles brewed in Sri Lanka, which lost about 9% in the quarter. Bonds did not fare well, with interest rates and credit spreads rising through the quarter as investors re-priced risk. Higher nominal yields came not from a change in inflation or inflation expectations, but from a rise in real rates, indicative that investors require more compensation to lend money. This is unusual because typically it is changing inflation expectations that account for most (about 80%) of the change in nominal yields. Should inflation (anticipated or actual) tick up, fixed income could remain under pressure.

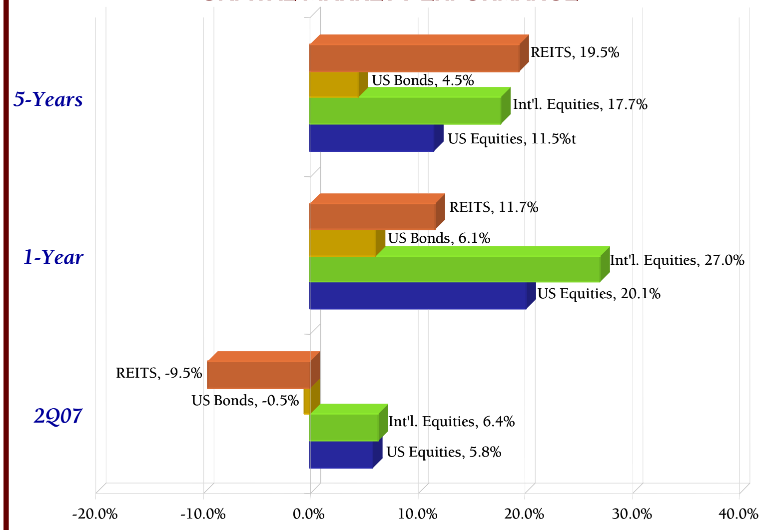
Bonds struggled, but real estate tumbled last quarter in Europe, Japan and North America. Perhaps rising interest rates were the culprit because real estate fundamentals only strengthened: vacancies declined, rents rose and private investors continued to see bargains. New supply remains constrained, and demand for space should stay firm as long the economy does.

Will the economy remain firm? Probably not, according to the headlines on housing data. Over the past year or so, inventory (homes for sale) has more than doubled, from less than four months supply to over eight months. Pricing data are more complicated, but the national average is probably flat to down a bit. Delinquencies are on the rise (see Graph 2) and credit standards are being tightened, so the combination of rising supply and declining demand should translate into further pricing pressures.

A glance at Graph 2 tells us that sub-prime borrowers are in trouble, and investors holding sub-prime paper are feeling their pain, but conditions for the rest of us are reasonably benign: delinquencies are about average (see Graph 2) and mortgage interest rates are still low (Graph 3). The mortgage strategists at Lehman estimate there could be $300 billion of defaults this year and next, but with a 70% recovery rate (the historical average), investor losses will be about $90 billion.

1

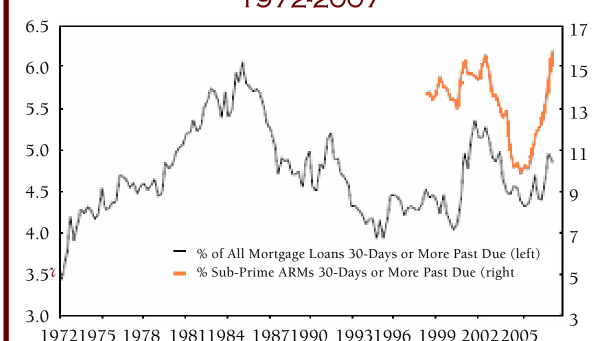
CAPITAL MARKET PERFORMANCE



Even in the friendly environment of 2005, there were $40 billion of mortgage losses, and a $90 billion loss is the equivalent of a 0.5% decline in the stock market. This is painful for the holders of this paper, and possibly for those borrowers, although that's less clear. "Sub-prime" is a euphemism for borrowers with poor or no credit history and/or unverifiable incomes, many of whom invested little or no equity in their homes at a time when lending standards were very lax. So the market corrects, but at this point, the sub-prime mess has had little impact on the overall economy. But it bears watching.

2

MORTGAGE LOANS PAST DUE 1972-2007



Total (bottom line) and Sub-Prime ARM (top line)
Source: Mortgage Bankers Association; Courtesy: Citigroup

Even as housing weighs on the economy, inflation remains a concern. Inflation has been lower and

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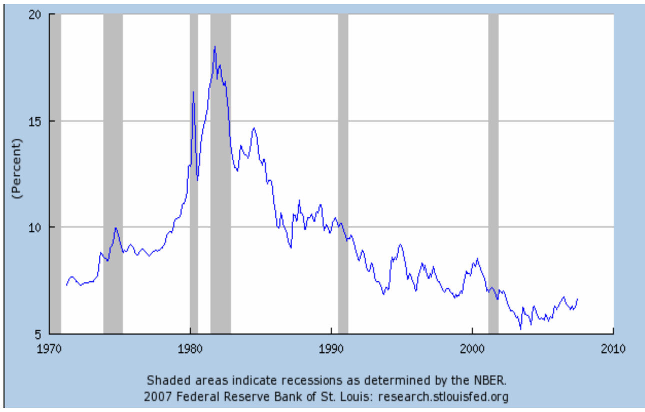
30-YEAR CONVENTIONAL MORTGAGE RATE (MORTG)



Source: Board of Governors of the Federal Reserve System

more stable in most countries for the past decade or more, and better monetary policies are the principal reason. However, there is evidence[1] that global factors of production have supplanted domestic measures as explanatory variables of inflation. Imports now account for more than 20% of all personal and business spending in the US, double the level at the beginning of the 1990s, and prices of imports have been deflating. Till now: for the first time last quarter we saw a rise in import prices from China. Global factors have helped to keep overall prices lower, but the winds may be changing.

Uncertainty, however, is on the rise, with credit spreads widening and equity volatility spiking higher. The precise reasons why volatility fluctuates are unclear, but it's logical to consider macroeconomic factors as explanatory variables, as Dominic Wilson of Goldman Sachs has suggested.

We are later in the economic cycle now (the US expansion is more than 5 ½ years along, a bit longer than the average period of growth), evident by the usual factors of capacity and leverage. Tighter capacity is evident in high utilization rates and an unemployment level that is both low and not falling further (meaning that additional workers are hard to find). Capacity constraints make companies (and economies) more vulnerable to supply shocks. Secondly, corporate leverage is rising, due partly to the surge in buyout activity. Leverage entails financial risk, and when this is coupled with greater vulnerability to supply shocks due to capacity constraints, it seems reasonable to expect volatility will rise.

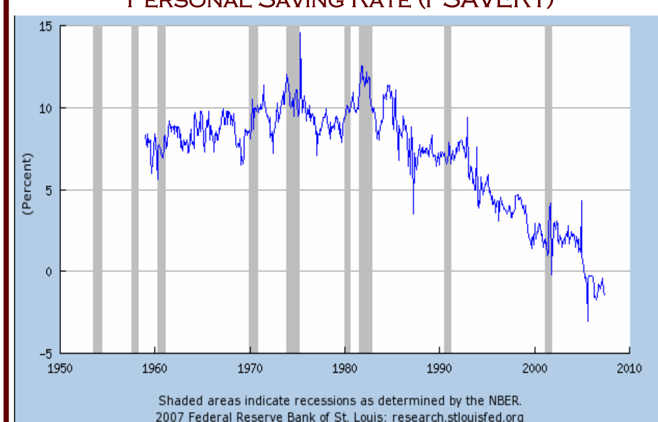
Rising volatility does not address prospective returns, however, as there is a near-zero correlation between equity volatility and equity returns. There is historically a modest positive relationship between rising equity volatility and widening credit spreads, perhaps reflecting the typically greater use of leverage. We may indeed be in such a period.

We've specified equity volatility because volatilities among the major asset classes do not follow a common pattern. Bond volatility is rising a bit, but currency volatility has barely budged. This is particularly surprising given the very large and growing trade and current account imbalances. These imbalances stem from the extreme levels of savings differentials around the globe.

The low savings rate in the US probably stems from an increase in wealth. Since 1990, the S&P 500 Index has risen 120% in real terms versus 60% for real GDP, and home prices have also surged. A low savings rate, both in absolute terms (see Graph 4) and relative to domestic investment, usually means that investment falls. By definition, foreign goods and capital are imported to cover the difference between domestic savings and domestic investment.

4

PERSONAL SAVING RATE (PSAVERT)



Source: U.S. Department of Commerce: Bureau of Economic Anaysis

The mystery is why domestic investment hasn't declined with the domestic savings rate, as it has in similar past periods. The answer lies in the enormous pool of available foreign capital from three principal sources: the rapidly growing export-led economies such as China, the oil exporters, and the Japanese via their prolonged zero-interest rate policy. These trillions of

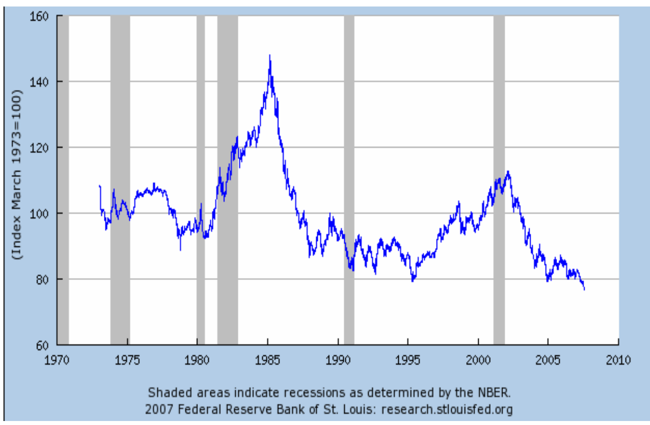
[1] *Globalization and inflation: New cross-country evidence on the global determinants of domestic inflation*, Claudio E. V. Borio and Andrew Filardo, BIS Working Papers No. 227, May 2007.

dollars have found a home in US (primarily) assets (principally debt), keeping a lid on interest rates and providing support for the dollar, thereby enabling consumption and investment to continue apace.

The massive interventions by central banks in the currency markets in recent years have also probably stabilized currency movements, so if we see central banks moving away from sterilization policies, even gradually, we could see a rise in currency volatility too. Such a scenario may not be favorable to the value of the dollar, which is currently at multi-decade lows versus the euro, pound and other currencies (see Graph 5).

5

TRADE WEIGHTED INDEX: MAJOR CURRENCIES (DTWEXM)



Source: Board of Governors of the Federal Reserve System

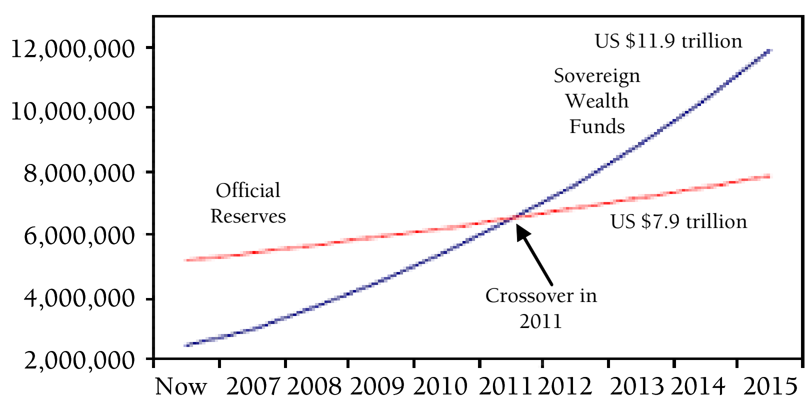
Sovereign wealth funds (SWFs) are one of the consequences of the enormous pools of capital accumulated by, and the sterilization policies of, the oil producers and Asian exporters. SWFs are separate legal entities owned and controlled by national governments, established for the purposes of investing the wealth of the state. Some, such as the Abu Dhabi Investment Authority (ADIA) and the Government of Singapore Investment Council (GIC), have been around for decades and are the largest investors in the world. The largest owner of European equities, for example, is the Government of Norway. Others, such as the Future Generations Fund (FGF) of Russia, are newly formed. The FGF is expected to grow at $40 billion per year, but get ready for the Huei Lian Company, the SWF that soon will be "seeded" by China with $300 billion and is expected to add $200 billion per year.

Stephen Jen of Morgan Stanley estimates that SWFs collectively hold around $2.5 trillion of assets today, about half of the total world reserves, and sees this growing more than five-fold in the next ten years (see Graph 6). Till now, most SWFs have operated quietly, mostly purchasing government bonds, occasionally in the news with an investment in or an acquisition of a western company (such as Blackstone, P&O, Barclays, Sainsbury).

Consider the implications of this extraordinary wealth accumulation. SWFs are instruments of the state and have, arguably, invested sub-optimally, as economic factors have been balanced with political objectives. But should SWFs be motivated to improve their investment returns, and turn from primarily creditors to become owners, the political ramifications could be significant. How will the UK government react if China decides to convert its passive stake in Barclays to a controlling interest, or how will the Australian government respond to a takeover of one of their large natural resources companies? We already know the US government blocked the acquisition of Unocal by the Chinese and of certain US ports by Dubai. The immediate consequences of obstructing capital flows for political purposes may have been minor, but it seems likely that SWFs will become more assertive as their wealth explodes, and the progression of economic integration, so essential to the material wealth of billions of people, could be retarded by ill-conceived political policies. We would do well to begin formulat-

6

NET US EQUITY SUPPLY BY COMPONENT



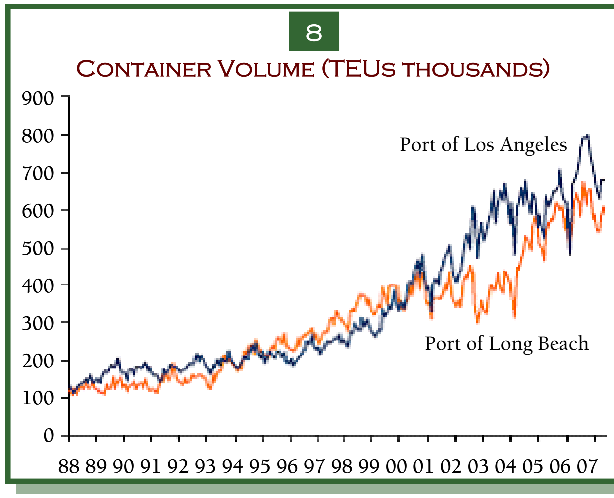
Source: Morgan Stanley Research estimates ing a framework for interacting with these new investor leviathans.

Globalization, the integration of economic activity across national borders, is perhaps the most profound secular theme of the coming decades. In a recent paper[2] we argued for a global allocation to equities, that is, to remove the "home bias" in investors' portfolios. Without repeating ourselves, we'll share some of the data that illustrate the impact globalization has already had on the world economy.

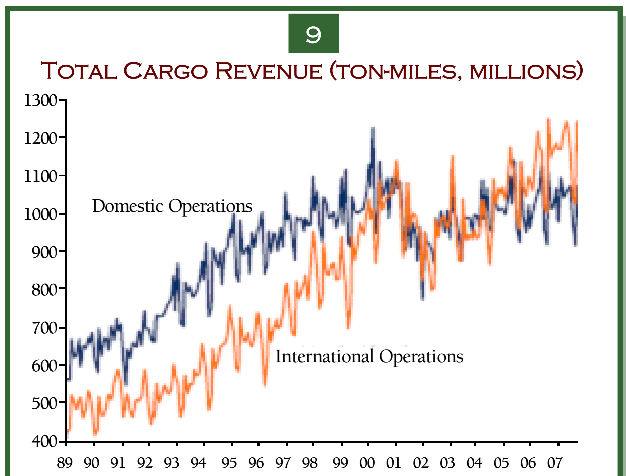
Trade has been growing faster than the world economy for the past two decades (see Graph 7). From our window, we often see the overflow of ships lined up to offload goods in the harbor. Now, our office doesn't overlook the harbor, which is on the other side of the Palos Verde peninsula, so the ships we see in our bay are waiting their turn 15 miles from port. The numbers confirm what we see: a 60% rise in container volume over the past five years at the port of Los Angeles/ Long Beach (see Graph 8). Similarly, and for the first time in history, international air freight volume exceeds domestic volume (see Graph 9).

Source: International Monetary Fund (IMF)

It is no coincidence that the rise in globalization corresponds with the entry of so many countries to the world economy. Less than a generation ago, the global economy consisted essentially of the United States, Western Europe and Japan. China, India, Southeast Asia, Eastern Europe, Russia, Latin America—the majority of the world's peoples—were effectively excluded (even if self-inflicted) from world trade. It was a very different world twenty years ago, and the forces of change will ensure that the world will look different



Source: Port of Los Angeles, Port of Long Beach; Graph Courtesy Merrill Lynch



Source: Air Transport Association; Graph Courtesy Merrill Lynch

twenty years from now. These rapid developments spark anxiety and concern among many in the developed world. The absolute wealth of the world is rising exponentially, but the relative positions of countries are shifting (for a 2,000 year perspective, see Graph 10).

What a life our precocious economist was to lead! Internationally acclaimed by 1909, he saw a stellar career interrupted by the Great War. In the aftermath of defeat, he was named Austrian minister of finance in 1919, but lacked political skills (for example, he favored selling state assets to foreigners as a way of attracting capital, not an especially popular idea). He lasted just six months. He made a fortune in the stock market of the booming 1920s, but in August 1925, his wife died in childbirth, along with the baby, and then his mother passed a few weeks later. He sank into a depression

[2] *Globalization of Equity Portfolios*, Angeles Investment Advisors, July 2007.

from which he would never fully recover. His wealth was no cushion, as he lost everything in the 1929 crash that left him deeply in debt. It was the promise of a $12,000/year salary that enticed him across the Atlantic to Harvard in 1932.

From his *Theory of Economic Development* in 1909 to his masterpiece *Capitalism, Socialism and Democracy* in 1942 umtil his death in 1950, Joseph Schumpeter saw capitalism, *in its natural state*, as a system in constant disequilibrium. No one before Schumpeter had had this insight, and even today, the notion of a disequilibrium model is anathema to most economists. Yet for Schumpeter, continual disruption was not only the natural condition of capitalism, it was the very basis for economic development of any kind. "Economic progress means turmoil," he wrote.

Innovation, driven by entrepreneurs, is "a feat not of intellect, but of will," he noted. As important as entrepreneurs are the providers of capital, investors. Schumpeter saw credit as wealth that had not yet been created, thus the mechanism by which future wealth is generated. "Innovation, being discontinuous and involving considerable change requires…large expenditures previous to the emergence of any revenue….Credit creation therefore becomes an essential part [of economic development]."

He famously began the second part of *Capitalism, Socialism and Democracy* with the line: "Can capitalism survive? No, I do not think that it can." Schumpeter is toying with us, but making a point. He goes on to write about "industrial mutation" that "incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one. This process of Creative Destruction is the essential fact about capitalism."

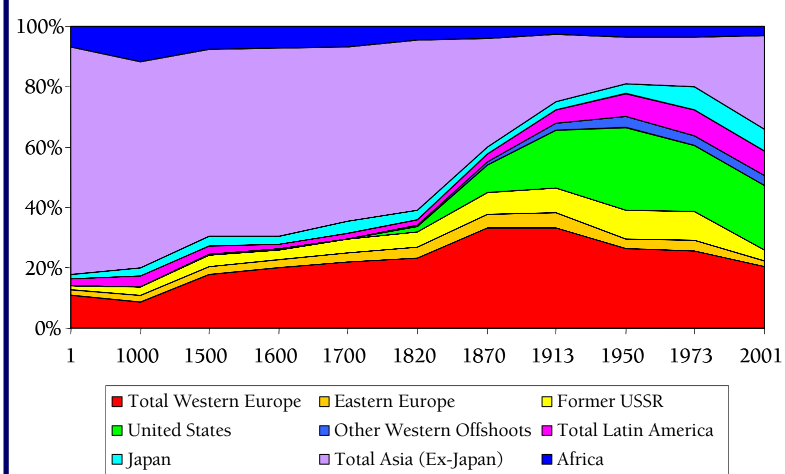
There you have one of the most famous phrases in all of economics, *creative destruction*. Investors enable entrepreneurs to innovate, that innovation creates new markets and then destroys existing structures. That is how all wealth is created. But the order is important, as we recall one of Mao's slogans during the Cultural Revolution was "Destroy first, and construction will look after itself." Millions of deaths followed. "We always plan too much and always think too little," was one of Schumpeter's widely applicable aphorisms.

Creation, innovation, drive all material progress, and all businesses, all economies eventually fail because they fail to innovate. Globalization has unleashed the entrepreneurial talents of hundreds of millions of people, capital flows across borders empowering those entrepreneurs, and future wealth is created lifting billions out of poverty. But that which creates also destroys, as it must.

Richard Nixon remarked in 1971 that "we're all Keynesians now." He was wrong. We are all—from Beijing to Bangalore to Budapest to Brooklyn—Schumpeterians.

10

WORLD GDP, YEAR 0-2001



Source: Angus Maddison, The World Economy, OECD, 2003.

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