Angeles
INVESTMENT ADVISORS

THIRD QUARTER 2007

Commedia

Easter Day in Florence, the year 1215: a woman flirted with a man, not her husband. He flirted back. The brothers of the offended husband declared a vendetta, thus beginning a nearly century-long feud. The Guelphs wore a red rose on the right side of their hats, and were backed by the Pope. The Ghibellines wore a white rose on the left side of their hats, and were backed by the Holy Roman Emperor (can you keep this straight?). In 1289, the Guelphs won a decisive battle, an apparent victory for the Pope, but the Guelphs soon split into two factions, White and Black. The White Guelphs were wary of Papal influence while the Black Guelphs fully supported the papacy. The Whites dominated initially, but in 1301, Pope Boniface VIII planned to take Florence for the Black Guelphs. The pope summoned a peace delegation of White Guelphs to Rome while simultaneously employing Charles de Valois, brother of Philip the Fair, King of France, to attack Florence. In six days, Charles managed to sack the city, and the peace ambassadors were told by Boniface that there was nothing more to discuss, their side had lost. They were sentenced to exile from Florence for two years and required to pay a large fine.

Among the peace delegates in Rome was a 36-year old apothecary from a prominent Florentine family, whose life as a part-time soldier and politician had been wholly undistinguished . His marriage was arranged for him when he was a child, but he secretly loved another woman. Like many of the educated class, he wrote poetry, but there was nothing noteworthy about him or his life, and certainly no indication of any latent talents in any endeavor.

Certain that he had done nothing wrong, he refused to admit his guilt, refused to pay a fine. His obstinance meant that his wife and three children would have to fend for themselves in Florence while he roamed the countryside as a beggar. He ventured as far north as Paris, and east to Venice, barely scraping by. For 20 years, he was a fugitive, till his death, never returning to his beloved Florence.

Improbably, really impossibly, during this exile he wrote 14,000 lines of verse that, collectively, became the greatest poem every written, profoundly influencing the leading writers, artists and musicians of the past 700 years, as breathtakingly beautiful and startling today as it was then. That this extraordinary work sprang from such a forgettable man, while impoverished and homeless, is nothing short of miraculous. A journey through this astonishing poem continues to inspire and instruct us today, as we shall see.

INSIDE GRAPHS:

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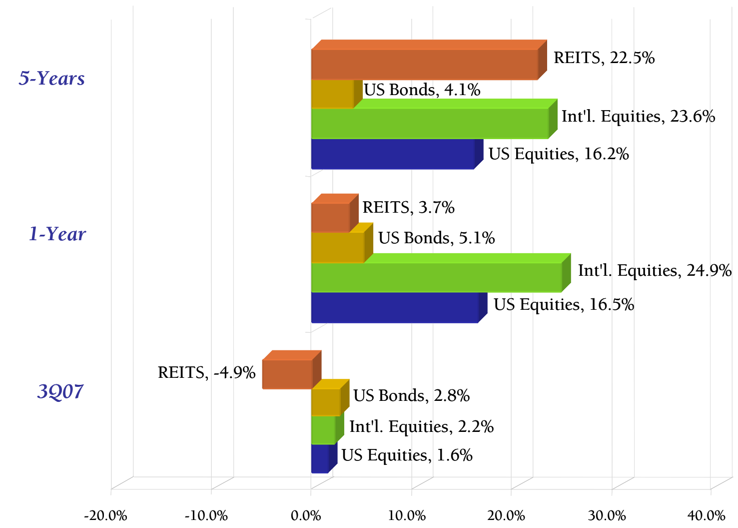
Turmoil rocked the markets in the third quarter, as mortgage losses, and attendant fears, choked the free flow of debt capital that has fueled this bull market in virtually all financial instruments. But when the books closed at the end of September, it was hard to spot the damage in the broad indices; equities and bonds posted moderate gains and are having decent years. Spectacular was China, with equities (Shenzhen) soaring 50% in the quarter and 185% year-to-date. Unfortunately, luck deserted the Irish (in South Bend as well as in Dublin), as Irish stocks fell 11% in the quarter. The big loser this year (so far) is Venezuela, off 29%, proving that even if your only export (oil) is up 50% this year, incompetent political leadership can cause far more damage.

1

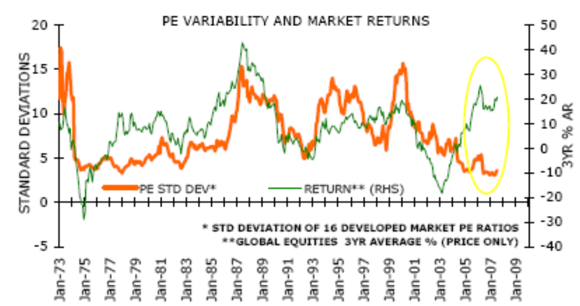
CAPITAL MARKET PERFORMANCE



The summer spike in volatility came as a shock, but only because we've been lulled by the blissful, but highly unusual, combination of high and stable financial returns. Historically, high returns have come with high volatility (more risk, more return), but Chart 2 shows the recent divergence in this pattern as global equities have soared even as valuation volatility (defined here as the standard deviation of P/E multiples) has continued to decline.

2

P/E VARIABILITY AND MARKET RETURNS



Source: DataStream; Morgan Stanley Research

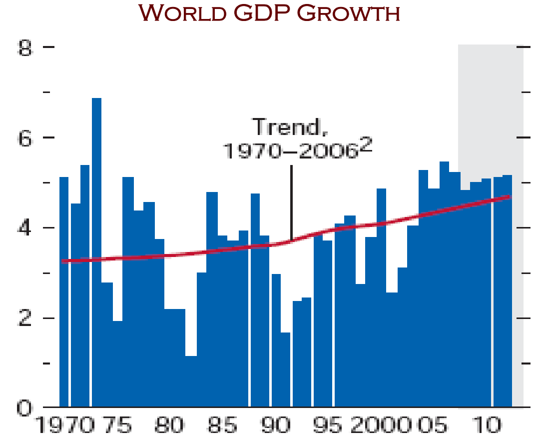
Courtesy: Morgan Stanley

Markets have been unusually favorable, with high returns and low volatility, but perhaps this only reflects the impressive global economy, which is enjoying an extraordinary era of strong growth and low inflation across all continents. Of the 130 economies tracked by the IMF, only two are contracting (Lebanon and Zimbabwe, if you must know), a level of collective growth not seen in four decades. From 2004 to 2009, real GDP growth will average more than 5% (see Chart 3), per the IMF, led by emerging economies growing at nearly 8% (see Chart 4).

The rapid growth of developing countries has precedents (see Chart 5), but not the magnitude of its impact. It's extraordinary to reflect that the world economy was driven almost exclusively by a dozen or so countries for most of the past fifty years, and that more than half the world's population did not participate at all in the global economy. The technology revolution has been deservedly lauded for advancing communications, transportation and logistics, a step-function in higher economic efficiency akin to the advances of late-19th and early 20th centuries that saw the development of the railroad, automobile and airplane,

3

WORLD GDP GROWTH

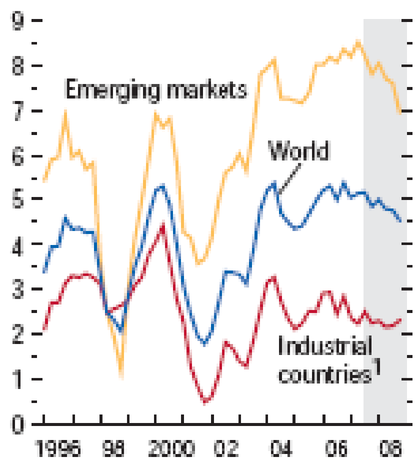


Source: IMF World Economic Outllok, October 2007 the telegraph and telephone, and the harnessing of electricity. The creation of the first truly global economy, that has lifted hundreds of millions out of poverty, is of a significance that cannot be overstated.

One implication of the rapid and widespread expansion of economic growth is the heightened dependence US companies have on these markets. Approximately 20% of the profits of *all* US corporations is derived from overseas, and for the largest companies (those in the S&P 500), over a third of total profits come from abroad (see Chart 6). As the developing world now accounts for more than half of world output and 75% of the growth (at PPP), it's reasonable to expect this dependency to grow.

4

REAL GDP GROWTH, 1996-2008



Source: IMF World Economic Outlook, October 2007

The rapid growth of developing countries comes at a price for the global economy, most notably manifested by the magnitude and direction of capital flows. This year, emerging economies will run a collective current account surplus of $690 billion and attract another $495 billion in net private capital (per IMF estimates). These flows will be offset by government outflows, as reinvestment of reserves. So, more than a trillion dollars will pass to developing countries, and more than a trillion dollars will flow back to the developed world in the form of bank deposits and loans (and the occasional equity investment). Thus the US runs a large current account deficit, enabled by the surpluses of the developing world (see Chart 7).

These large imbalances come directly from the key feature of this model of economic development, a systemic dependence on trade. Virtually all of the wealth creation in developing countries (including the oil producers) has been generated by exports to the developed world (especially the United States). And Western (primarily American) consumers have had to want to consume these goods. To facilitate consump-

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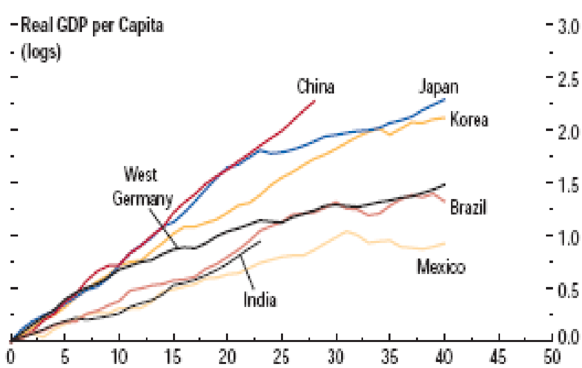
GROWTH PATH, SELECTED COUNTRIES 1950-PRESENT

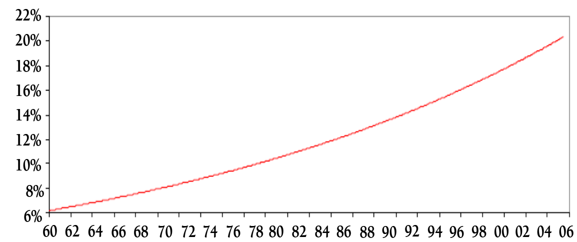


[1]Growth takeoff is dated as follows: 1950 for Brazil, 1979 for China, 1984 for India, 1950 for Japan, 1963 for Korea, 1950 for Mexico, and 1950 for West Germany. See Appendix 5.1

Source: IMF World Economic Outlook, October 2007

6

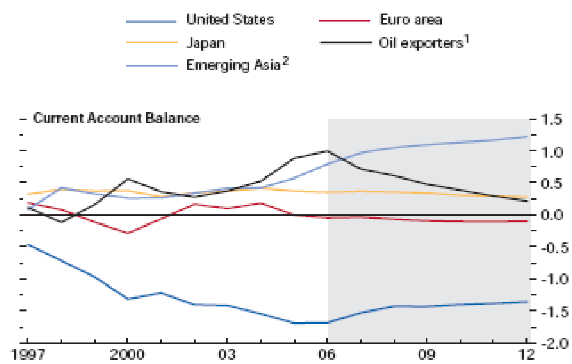
PERCENT OF US EARNINGS FROM ABROAD 1960-2006



Source: Bridgewater Associates

7

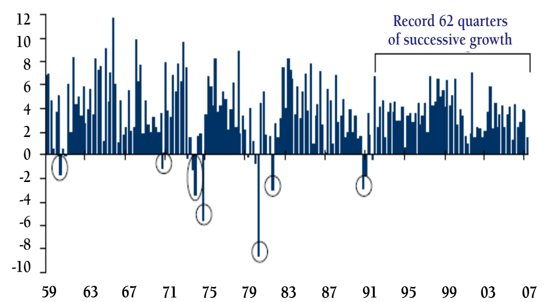
CURRENT ACCOUNT BALANCE AS A % OF WORLD GDP



Source: : IMF World Economic Outlook, October 2007

8

REAL CONSUMER SPENDING
Q\Q PERCENTAGE CHANGE, ANNUALIZED



Source: Bureau of Economic Analysis *Courtesy: Merrill Lynch*

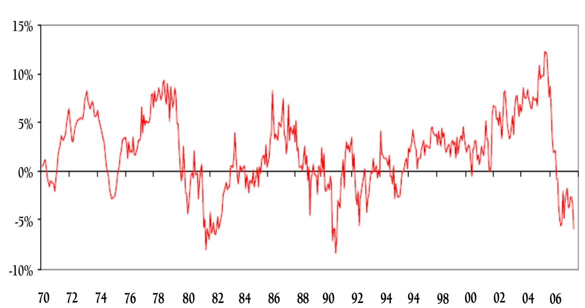
tion demand (not that we ever really needed help here, but the US is in the midst of the longest period of rising consumption on record—see Chart 8), export earnings were used to purchase US stocks and (primarily) bonds, thus helping to increase our (paper) wealth and lower interest rates.

Cracks are beginning to appear in the edifice, however. The mortgage mess that mauled the markets last quarter reflects the weakness in residential housing. Real home prices were advancing more than 10% p.a. two years ago (a record), but are now declining (see Chart 9).

The key to understanding housing is sales, not price. Ed Leamer of UCLA, one of the leading experts on housing markets in the US, presented data this summer showing that housing is best understood as a volume cycle rather than a price cycle. Chart 10 shows how volume leads price (in Los Angeles in this example). Nationwide, new and existing single-family home sales are currently off 40% and 30%, respectively, from their peaks.

9

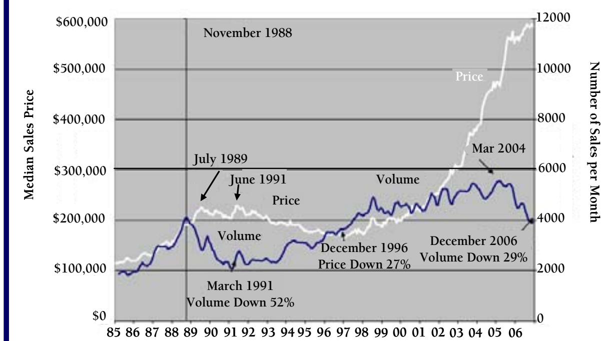
REAL HOME PRICES Y/Y



Courtesy: Bridgewater Associates

10

LOS ANGELES WHOLE PRICE & SALES VOLUME

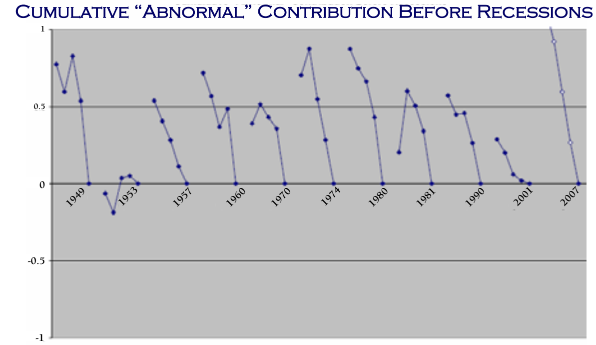


Source: Edward E. Leamer, Housing and the Business Cycle, August 2007

When the economy is growing, housing plays a very small part in that growth (just 4.6% of GDP). But when the economy contracts, 26% of the overall economic downturn is attributable to residential housing. Recessions are preceded by significant declines in housing, as seen in Chart 11 (housing declines as a contributor to growth in the year before a recession).

11

RESIDENTIAL INVESTMENT
CUMULATIVE "ABNORMAL" CONTRIBUTION BEFORE RECESSIONS

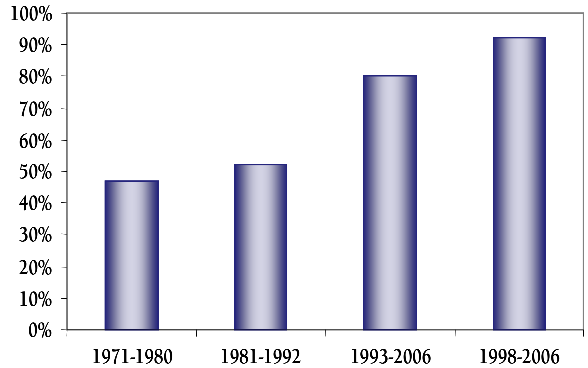


Source: Edward E. Leamer, Housing and the Business Cycle, August 2007

Housing is a local market, so national data are merely averages across multiple markets. Indeed, weakness on the coasts was preceded by booms, whereas much of the Midwest experienced neither the boom nor the bust. Similarly, there is no world housing market, although globally housing prices have both risen and become more closely correlated (see Chart 12). And the gains in the US have only been moderate, relatively. From 1990 to 2006, US prices rose 50% versus 70% for OECD (developed) countries. However, Germany and Japan have seen no real appreciation in nearly four decades (see Chart 13). Of course, all this pales to the Baltic nations: since 2000, real home prices in Latvia and

12

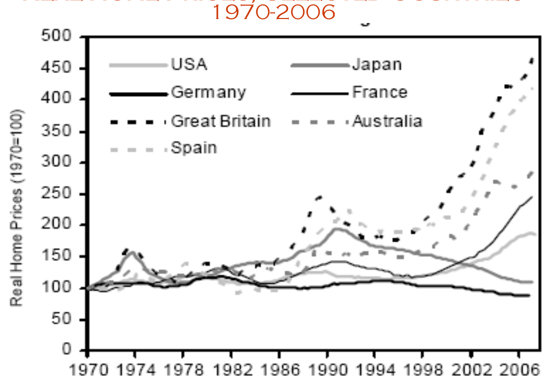
SHARE OF THE VARIANCE OF OECD HOME PRICES
EXPLAINED BY GLOBAL FACTOR



Source: OECD

13

REAL HOME PRICES, SELECTED COUNTRIES
1970-2006



Source: OECD, courtesy Goldman Sachs

Lithuania have more than trebled, and more than quadrupled in Estonia.

Despite the modest home price appreciation relative to most of the rest of the world, the US market looks most vulnerable, perhaps because our sophisticated financial innovations extended home ownership to more marginal borrowers. But the dramatic rise across so many markets suggests caution may be in order and raises fears of that dreadful "B" word.

Bubbles have a long history in markets that one could reasonably conclude that they are an integral part of investor behavior. Let's define a "bubble" as an asset price that has risen well above its value as justified by economic fundamentals. In the past ten years we have seen three such significant events, starting with the Asian crisis in 1997. At that time, a commercial real estate bubble unwound, currencies were devalued (some by more than 80%) and recession hit many countries. Capital flight from Asia found a home in technology companies, but in 2000, the tech bubble burst. The subsequent collapse in capital spending that followed in the wake of the previous boom led to a (mild) recession in the US and elsewhere. In response, the Fed eased monetary policy to stimulate consumer spending (overnight rates were dropped to 1%), and a bubble in US home prices ensued, with a concomitant construction and spending spree that is now unwinding.

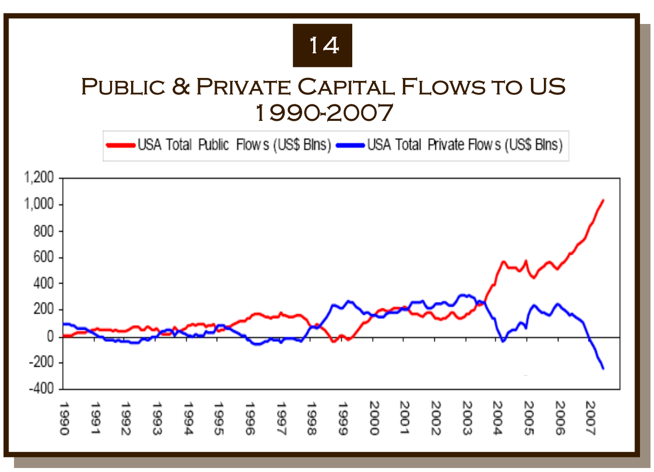
But bubbles, per se, don't concern us. There is a psychological aspect to mania that is difficult for us to analyze, and in some cases, have had only short-term ramifications confined to narrow markets. Of great interest to us are financial crises, events of broad and deep systemic dislocations, in which bubbles may appear as symptoms of an underlying cause.

The major financial crises of the past century have occurred against a backdrop of shifting economic power, where attempts to support a currency regime eventually became unsustainable in the face of growing pressures.

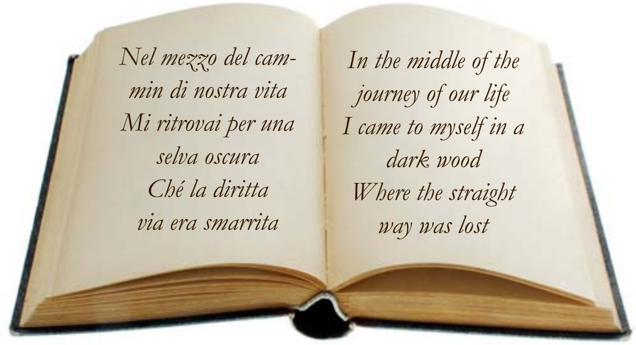
Following the First World War, Britain's hegemonic role in the global financial system, underpinned by the sterling peg to gold, waned as its political power diminished. Britain accepted a large trade deficit in favor of open trade, allowing the high-savings, protectionist United States to run a large trade surplus. To help support the pound's link to gold, the newly created US Federal Reserve kept interest rates low. By 1929, the imbalances had grown, and an attempt to prick the equity bubble led to the infamous Crash in October 1929, presaging the Great Depression of the next decade. Now, the events surrounding the Crash and the ensuing Depression are more complicated than described, but the pressures that grew in the 1920s made the currency regime, the gold standard, unsustainable. The 15 years following its collapse were the most horrific in human history.

An implicit gold standard was created at Bretton Woods in 1944, this time replacing the pound sterling as the centerpiece with the new hegemonic power, the US dollar. It was agreed by all that thirty-five dollars would buy one ounce of gold, and each country's currency was pegged to the dollar. In the 1960s, the US began printing many more dollars than it could have reasonably exchanged for gold, and in 1970-71 moved aggressively to lower interest rates in response to a slowing economy. The growing, export-led economies of Europe, especially France and Germany, which had accumulated vast reserves of dollar, began to worry about the value of their dollar holdings, and asked to exchange them for gold. As soon as this exchange mechanism was tested, its flaws became apparent, and in August 1971 President Nixon announced that the United States would no longer convert dollars for gold. Foreigners did the logical thing: they dumped their dollars. The plunge in the value of the dollars led to rising fears of inflation, Nixon imposed wage and price controls on the economy in response, and the result was the worst decade for the American economy since the 1930s. Again, this short sketch of events is necessarily incomplete, but in 1971, an unsustainable currency regime, Bretton Woods, eventually broke under pressure when fast-growing, export-led economies grew worried about the value of their large dollar reserve holdings.

Today, the macroeconomic environment is encouraging. Growth is strong, inflation is low, wealth is rising. But the engine of world growth has shifted to Asia through an export-led model that has generated enormous trade surpluses and reserves accumulation. Inflation is rising in Asia, and the normal policy response would be to raise interest rates. But higher interest rates would make the currencies more attractive. So interest rates have been held low in order to depress the value of the currencies, which has only stimulated faster growth and even more foreign reserves accumulation. Should export demand falter, or confidence in the value of reserve holdings wane, or domestic considerations gain primacy over foreign exchange manipulation, there could be a significant revaluation of these currencies. The lesson from the past is that governments can manipulate their currencies or their interest rates, but cannot manage both simultaneously over time. The private sector abroad has already abandoned the dollar; it is foreign central banks that are supporting these large imbalances (see Chart 14). For now.



Courtesy: Bridgewater Associates



So begins the greatest poem ever written, *La Commedia*. Written in the first person, it is the story of Dante Alighieri's quest to learn the ultimate truth. The great poet Virgil is his guide through *Inferno*, and as he begins his descent (Canto 3) he sees the inscription, *Lasciate ogni speranza, voi ch'entrate (Abandon hope, all ye who enter here)*. Each of the nine circles of *Inferno* is reserved for particular sinners suffering appropriate tortures for all eternity. The most vivid (and scary) is found in Canto 26, the circle reserved for liars and thieves (and consultants); the latter use superior wisdom to deceive, and thus are guilty of spiritual theft. Famous people from history are found throughout the book; in this Canto, we find Odysseus, condemned for the sin of trickery (remember the Trojan Horse).

Inferno is eternal, but the second book, *Purgatorio*, is transitory, where souls embrace their punishment as the way to learn about themselves. Change is not possible in *Inferno*, but it is in *Purgatorio*, in fact, it is the very principle of beauty. Dante discovers beauty as the key to understanding oneself. Beauty comes from seeing your life as larger than itself, as part of a larger whole. He recognizes three types of truth: self-evident, truth that comes from experience; reason, truth that we can't see; and beauty, the ultimate truth that comes from the vastness of the mind of God.

Before he enters *Paradiso*, Dante prepares to lose everything that is unessential, all his desires. He becomes a hero, not through great deeds, but by eliminating everything he has or wants so that he can transcend his sorrows.

In *Paradiso*, he is guided by his great unrequited love, Beatrice Portinari, who in life died in childbirth at the age of 23, never knowing of Dante's love for her. Dante begins his journey before *Inferno* wondering if he is worthy of love, and in *Paradiso* it is answered: open yourself to love and return it; he does. All souls have sinned, but those in *Paradiso* are the ones that have found love. In the ninth circle of *Paradiso*, Dante is blinded by a light, and sees God not as faith or hope but purely as love. With this revelation, his sight is restored, and he returns to earth so that he can write of his journey.

We read Shakespeare, the greatest of writers in the English language, but Dante reads us. As Cicero wrote, "knowledge is ultimately self-knowledge, and self-knowledge is the soul seen by itself." Dante knows of our fears and hopes, of our quest for truth and beauty. He captivates us with tales of peril and struggle and ultimate redemption. We may descend to *Inferno*, but if we remain true to the pursuit of beauty, we may hope to rise again. In fact, this is how it must be. As Dante shows us, the way up is the way down.

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