Angeles
INVESTMENT ADVISORS

Market Commentary
Fourth Quarter 2007

Despair

Northwest of Philadelphia runs the Schuylkill (pronounced "Scoo-kul") River. Before the Midwest was settled, before the San Joaquin Valley was irrigated, these rolling hills around this valley were among the most fertile ground in the world, the breadbasket of the nascent American colony. It is no coincidence that the largest city in British America was Philadelphia, proximate to the largest food source in all of the colonies.

Food, then, was the reason Washington chose Valley Forge as his winter camp in 1777. The war for American independence had not gone well those first 18 months. The British occupied both Philadelphia and New York, and with a few exceptions, had won every battle. The Continental Army had been reduced to barely a shell. Of the 12,000 troops encamped that winter, only about 4,000 were fit for duty. 2,000 had no clothes or shoes, 3,500 were "sick present," 2,500 were "sick absent" (meaning hospitalized). 2,000 died that winter from exposure, disease or starvation. One week after arriving at winter camp, Washington wrote to Congress: "I am now convinced beyond a doubt, that unless some great and capital change suddenly takes place…this Army must inevitably be reduced to one or the other of these three things: Starve - dissolve - or disperse."

A bitter irony in this bitter winter was that there was no food for the Army. Local farmers sold their stocks to the British in Philadelphia because they paid in sterling, not in the debased Continental dollar. Compounding the problem, at the start of winter the Quartermaster General of the Army, Thomas Mifflin, resigned, and the army's procurement and logistics organization collapsed into chaos.

The deprivations of the American army cannot be overstated; neither could its prospects have been bleaker. It was a bare skeleton of a force that encamped during one of the harshest winters that century, without sufficient food, shelter or clothing and with disease rampant among the troops. At that very moment, there was a movement in Congress to remove Washington as general of the army and replace him with Horatio Gates, hero of Saratoga (although Benedict Arnold, not Gates, was responsible for that victory). In the midst of these calamities, Washington was counseled that the American's fundamental assumptions—that this would be a short war, that an enthusiastic group of patriots could quickly defeat the world's dominant military power—were erroneous. Washington became convinced and wrote to Congress that winter, disabusing them of that earlier hope: "Men may speculate as they will—they may talk of patriotism—they may draw a few examples from ancient stories of great achievements performed by its influence; but, whoever builds upon it, as a sufficient basis, for conducting a long and bloody War, will find themselves deceived in the end."

In the darkness of that winter of 1777-78, there arose a voice that singularly perceived the nature of this battle, a man who would shape the strategy of the American struggle in the coming years, thereby changing the course of history. That voice belonged to the self-

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educated son of a Quaker farmer from Rhode Island who became, after Washington, the most important general in the war. His insights 230 winters ago hold lessons for us today.

Despondency descended on the equity markets at the close of 2007. Real estate, especially, was walloped, the dollar declined and credit spreads widened. The Irish ran out of luck, as that market fell 11% in the quarter and was off 20% for the year, the worst among world equity markets. As oil touched $100 per barrel, it was no surprise that the Middle East markets soared. Jordan and Egypt were both up 24% in the quarter, but the big star was Saudi Arabia, rising 46%. Despite a modest decline in the quarter, Peru held on to the top spot in the world for 2007, up 94%.

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But outside of the Middle East (and Peru) the mood turned gloomy with the onset of winter. The proximate cause of the markets' dislocations was the gradual awakening to the growing fractures in a precarious financial system.

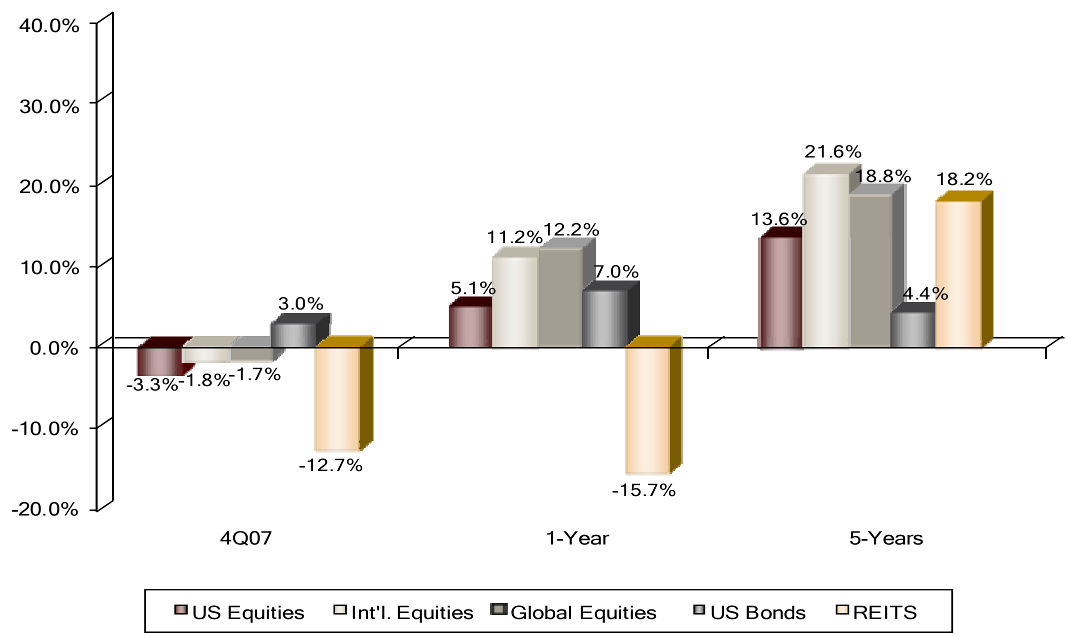
Fissures first appeared a year ago in the subprime mortgage market. At the time, it was understood that a certain percentage of loans would default, but the risks were widely spread and any threat to the financial system was remote.

Financial crises are always preceded by rationalizations: we believed that the highly flexible and mutually dependent global economy could sustain massive current account imbalances; it was argued that the burgeoning savings in Asia and the Middle East needed a safe home and so were naturally channeled into Western assets, sparking a permanent rise in property values, equities and bonds. But after rationalization comes reality, or rather, recognition of the reality that these growing imbalances were, after all, unsustainable, thus proving Herb Stein's dictum that trends that cannot continue won't.[1]

[1]Herbert Stein was chairman of the Council of Economic Advisors under Presidents Nixon and Ford. This comment was in the context of arguing for a hands-off approach to the balance of payments deficits of the 1970s.

1

CAPITAL MARKET PERFORMANCE



In the past thirty years, there have been eighteen bank-centered financial crises in developed countries.[2] All cases were preceded by rising asset prices, increasing debt accumulation and widening current account deficits. Most were preceded by financial liberalization. Today's crisis may be similarly characterized.

Carmen Reinhart of the University of Maryland and Kenneth Rogoff of Harvard point to a parallel between today's sub-prime mess and the 1980s debt crisis. Money-center banks were the conduits for the recycled petrodollars of the 1970s. Then, the banks lent those ever-growing deposits to emerging market (then known as Third World) governments who were ill-equipped to handle this new-found liquidity. A series of sovereign defaults in the 1980s placed significant strains on the financial system. Today, banks have recycled petrodollars and trade surpluses to another ill-prepared borrower, the sub-prime home owner, and rising defaults now are causing similar pains.

But sub-prime defaults alone would not have caused an implosion: there needed to be a catalyst. And that would be found in leverage.

Our economy is more levered than at any time in more than a century. With total debt close to 350% of GDP, we've shattered the previous record of 250% set back in the 1930s (see Graph 2). Of course, then the problem wasn't too much debt, it was too little income. Over the past two decades, the broad decline in interest rates (see Graph 3) has enabled the economy both to accumulate and service more and more debt (see Graph 4). It is reasonable to suspect that this rise in debt and decline in interest rates over the past 25 years has enabled the economy to grow faster than it otherwise would, which leads to reasonable questions as to whether the current debt burden may inhibit the sustainable growth rate of the economy in the future. Might we be in an epochal transition from an era of declining interest rates, declining inflation and strong growth to something else?

Complicating the analysis is the cyclical slowdown across the global economy. But it is a slowdown (it's too early to label this a recession, a distinction that is largely irrelevant) unlike we've seen in the post-war era. Recessions, in our lifetimes, have been caused by monetary tightening in the face of rising inflation pressures. Outside of some emerging

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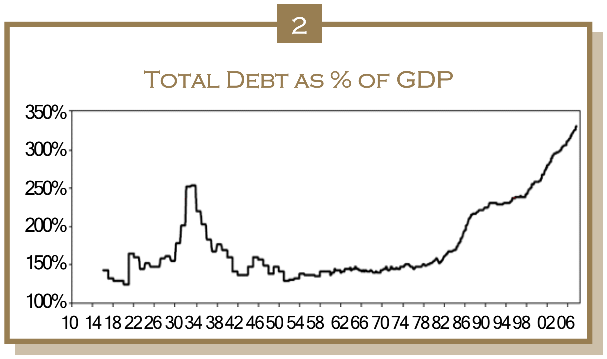

Graph Courtesy: Bridgewater Associates

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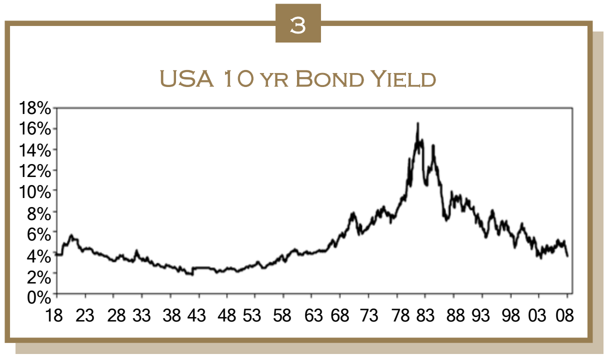

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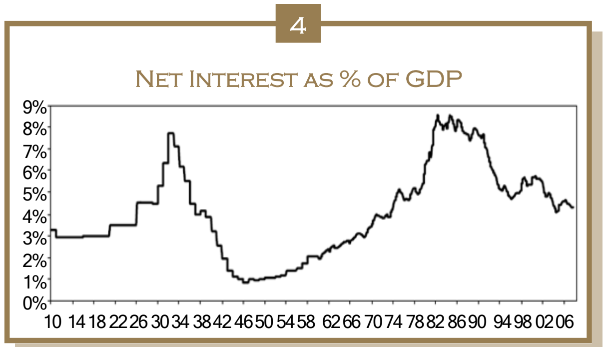

Graph Courtesy: Bridgewater Associates

[2] *Carmen M. Reinhart & Kenneth S. Rogoff, Is the 2007 Sub-Prime Crisis So Different? An International Historical Comparison.* These crisis episodes include: The Five Big Five Crises: Spain (1977), Norway (1987), Finland (1991), Sweden (1991) and Japan (1992), where the starting year is in parenthesis. Other Banking and Financial Crises: Australia (1989), Canada (1983), Denmark (1987), France (1994), Germany (1977), Greece (1991), Iceland (1985), Italy (1990), New Zealand (1987), United Kingdom (1974, 1991, 1995), and United States (1984).

economies, inflation has been well contained (so far), and central banks have been generally accommodative. Indeed, the "real" economy, excepting housing, has been fairly resilient, although the recent data have been weakening.

But the recent softness in economic data is not coming from tighter monetary policy; it is a symptom of the massive process of de-leveraging in the financial system. In a typical recession, causality flows from the economy to the financial sector. That is, monetary tightening slows economic activity. This leads to a rise in defaults, putting strains on lenders, and is eventually resolved with monetary easing ameliorating the financial pressures and re-stimulating economic activity.

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The de-leveraging dynamic flows the other way, from the financial system to the real economy. A small decline in asset values is magnified by leverage, requiring asset sales to cover margin calls. These sales push prices lower, necessitating further margin calls and further sales, and so on in a downward spiral. In this environment, monetary policy is generally ineffective because prices are falling faster than nominal interest rates, so real interest rates rise, further inhibiting economic activity. This dynamic characterizes Japan in the previous decade, and the world economy in the 1930s.

The de-leveraging process is reversed through a combination of reflation (think helicopters dropping money), currency devaluation and/or government nationalization (or guarantee) of financial institutions.

We may not be in such dire straits yet, but the signals are clear. The Federal Reserve is engaged in a massive liquidity drive that includes relaxing the capital requirements of banks, the dollar is under pressure, and Congress is about to direct the federal mortgage agencies to play a larger lending role in that market. It seems likely (inevitable?) that government will play a larger role in the financial system through greater regulation, but also through direct control of larger parts of the economy. This latter point has important implications, some benign, some negative and some uncertain.

Sovereign wealth funds have gained much notoriety in recent months, particularly as they have contributed $100 billion to the bailout (um, recapitalization) of Western banks. It is important to note that the drivers of their wealth come from the accumulation of savings generated by foreign reserves emanating from exports (oil and commodities in some cases, manufactured goods in others). This growing pool of savings has driven real long-term interest rates to generational lows. And there is no sign of this phenomenon abating; if anything, savings are increasing globally.

Graph 5 shows IMF data of the current account surpluses of countries outside the US as a percentage of the US current account deficit. Beginning in 2004, the rest of the world's surpluses were 100% of the US deficit. Last year, the world's current account surplus was estimated to exceed $1 trillion, or 135% of the US deficit, and that is expected to rise again this year.

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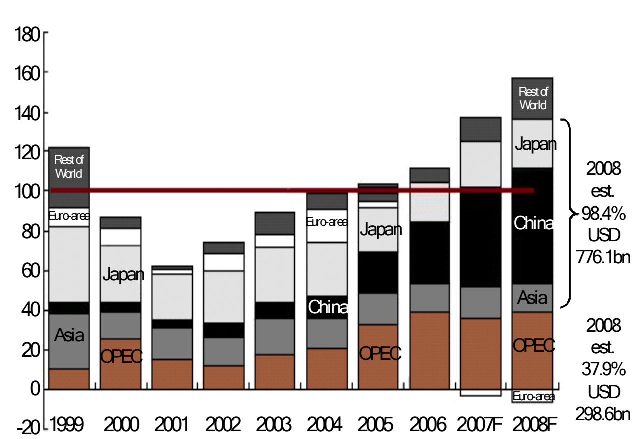
CURRENT ACCOUNT AS RELATIVE % OF US CURRENT ACCOUNT



Source: IMF World Economic Outlook, Morgan Stanley Research

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WEIGHTED AVERAGE G10 REAL 10Y INTEREST RATE

Source: Bloomberg, Morgan Stanley Research

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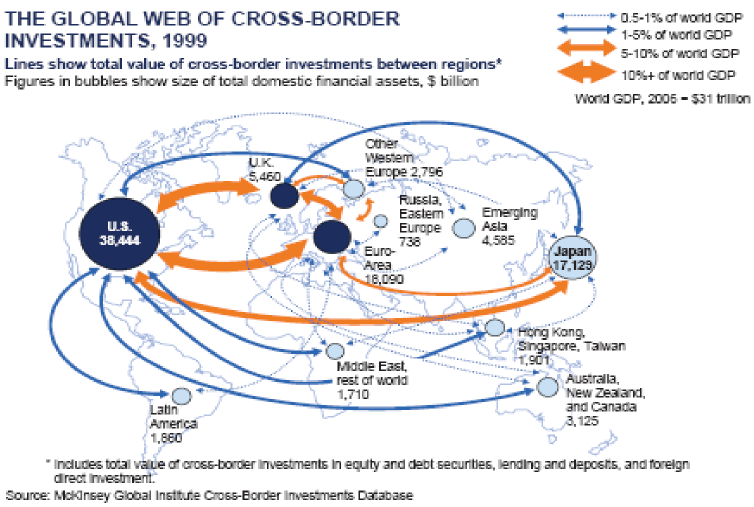
THE GLOBAL WEB OF CROSS-BORDER INVESTMENTS, 1999



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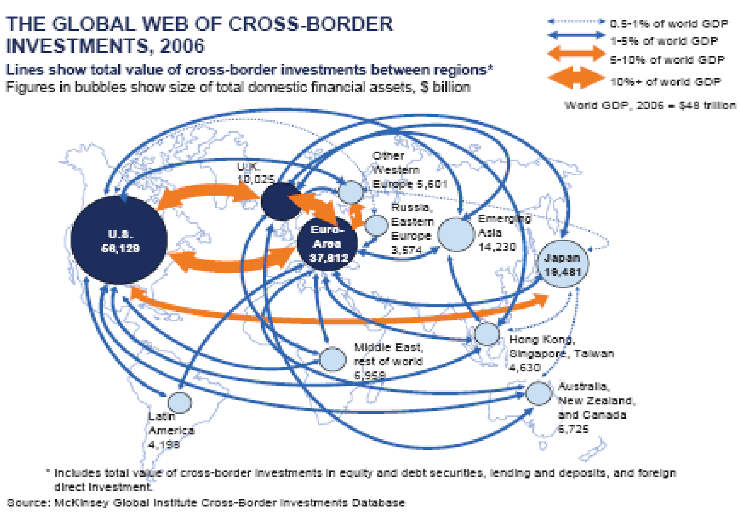
THE GLOBAL WEB OF CROSS-BORDER INVESTMENT, 2006



At the same time, the US current account deficit has been narrowing, from 6.7% of US GDP at the end of 2005 to 5.5% now, and is expected to improve to less than 4% by the end of next year. There is an abundant supply of excess savings in the world, arguing for low real yields to absorb all this. Indeed, global real interest rates have been in secular decline for over twenty years (see Graph 6, pg. 4).

Sovereign wealth funds will continue to accumulate massive amounts of reserves, thus expanding the pool of global savings. Consider one example, the Gulf Cooperation Council (GCC) countries (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and UAE). These six countries have nearly 500 billion barrels of proven oil reserves worth approximately $44 trillion. Include proven gas reserves, and the mineral wealth of these six countries exceeds $50 trillion, the same as the market capitalization of the entire world's equity markets. As these hard assets are converted to dollars, they will be further converted into the financial instruments of the developed markets: debt, real estate and equity. The balance of power, first economic, but eventually political, is shifting dramatically to these developing countries, and specifically, to the governments of these developing countries.

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It is important to appreciate the magnitude of this global interdependency. The two pretty graphs above come from McKinsey Global Institute's recently published report on cross-border capital flows, the first schematic from 1999, the second from 2006. One can quickly see the swelling of flows over these few years. Cross-border investments represented 150% of world GDP in 2006, and one-fifth of all corporate debt, nearly one-third of all government bonds and more than one-quarter of all equities are owned by foreigners, all triple the level of 1990 (see Graph 7).

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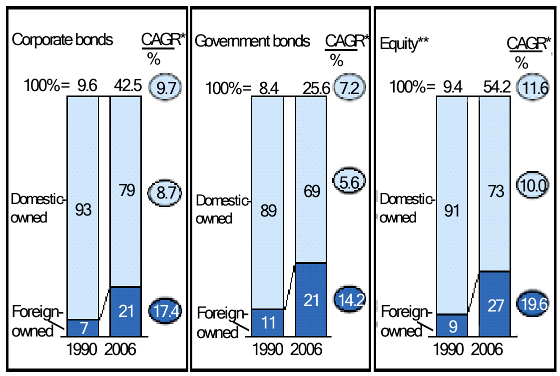
FOREIGN-OWNED BONDS AND EQUITIES



Graph Courtesy: Bridgewater Associates

> *"Nathanael Greene was a most unlikely military hero."*

Cross-border capital flows, greater securitization of assets, and advanced technology have all drawn markets closer. Interestingly, this hasn't necessarily tied economies closer, as financial flows have far exceeded trade flows. Emerging economies may (or may not) be able to de-couple from the slower-growth economies in the developed world, but our financial systems are ever more closely linked. There is a poor correlation between the sensitivity to US markets and sensitivity to US growth, as Stephen Jen of Morgan Stanley notes (see Graph 10).

Thus we can distinguish between economic coupling and financial coupling which may be complementary, but not necessarily so. This complicates matters for investors because market correlations are high, so diversifying portfolios with uncorrelated assets is harder to achieve. This is one reason why shorting strategies are attractive in portfolio construction, as a means to diversify risk.

Quartermaster General is a non-combat position, usually not the path to military greatness. But the logistics problems were so severe in 1777, there was an acute risk that there would be no path to military greatness for anyone because the Army would dissolve before winter end. Washington turned to his ablest general, with the understanding that once the procurement mess was solved, a combat role would be offered again.

Nathanael Greene was a most unlikely military hero. His father's Quaker sect not only opposed war, it discouraged all "literary accomplishments." Nonetheless, Greene taught himself law, mathematics and the history of military tactics and eventually acquired a large library on the subject. He would demonstrate superior battle tactics, especially in the future Southern campaign, but also a perceptive sense of the larger strategy. He was the only American general with Washington for the full eight-year duration of war, easily his most successful, and certainly his most trusted advisor.

As spring approached, Washington convened his advisors to determine strategy in the coming year. There were three choices: attack General Howe in Philadelphia, try to recapture New York, or stay on the defensive. All argued for striking a decisive blow. But Greene dissented: "The great difficulty the Enemy labour under is to continue and secure their conquests at the same time." Greene predicted that the British would launch a Southern strategy, hoping victories in the countryside would break the spirit of resistance.

But Cornwallis soon captured Savannah, then Charleston, and in August 1780, scatter Gates' army near Camden, South Carolina. Congress asked Washington to select a new leader in the South (the previous generals had all been appointed to Congress). Washington chose Greene.

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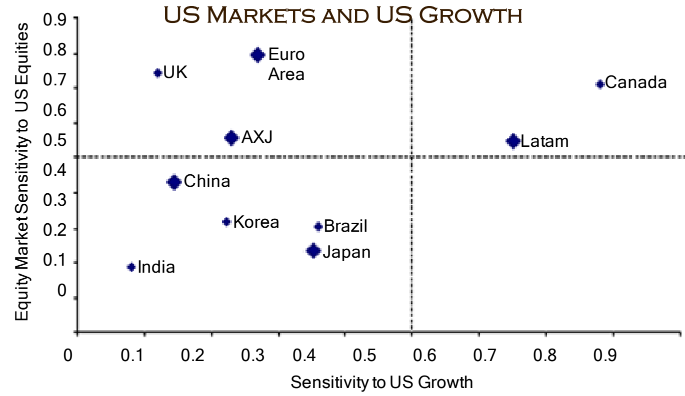
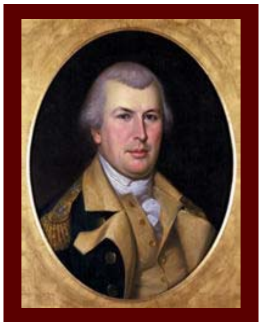
SELECTED COUNTRIES SENSITIVITIES TO US MARKETS AND US GROWTH



Source: Morgan Stanley



Leadership in the South had been dismal for the Americans. The first general, Robert Howe, lost Savannah. The next, Benjamin Lincoln, lost Charleston. In August 1780, Gates' army was attacked near Camden, South Carolina, and fled in wild confusion. All three generals had been chosen by Congress, but now, Congress asked Washington to choose the next general. He chose Greene.

Greene's strategy was remarkably effective. He was able to divide, harass, tire and elude Cornwallis with long marches and make the British pay dearly at any point of engagement. His retreat across the breadth of North Carolina and beyond the Dan River to Virginia sapped the resources of the British, and is considered one of the great military accomplishments in world history.

Valley Forge, in the winter of 1777-78, was the turning point in the war for American independence. It was at this darkest moment in early American history that the nature of the war changed and the character of the new nation was formed. The war changed from a clash between armies to a struggle for the countryside, as Nathanael Greene argued, from a war the Americans could not win, to one they were unlikely to lose.

As importantly, the political character of the Revolution changed also at Valley Forge. It was no coincidence that the most vocal leaders of the Federalist idea—Washington, Hamilton, Marshall—were together there. The seeds of a national vision were planted at Valley Forge, the link between independence and nationhood, as historian Joseph Ellis puts it.

We often take for granted the course of history as natural or obvious, but this is dangerous. In that winter 230 years ago, there was nothing obvious or natural about the outcome of the war, and the future of the American republic could have easily taken a different path. But Nathanael Greene understood the strengths and weaknesses of both the Americans and the British, he saw the flaws in the original strategic assumptions, and was able to convince Washington that a long, defensive war of attrition in the countryside would lead, indeed was the only path, to victory. Investors are not always rewarded for taking risks, and sometimes a defensive strategy is the expedient approach. We may hope for a quick, decisive resolution to the markets' gloom, but it is prudent to prepare for a protracted battle.

The American character was forged in that bitter, hopeless winter from a few individuals who were tested beyond human endurance, who were able to envision and then execute a difficult but clearer path to victory, and so inspired a new nation and a new ideal.

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Principal & Chief Investment Officer
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