Angeles
INVESTMENT ADVISORS

Market Commentary
Second Quarter 2008

La Chute ("The Fall")

Louis-Joseph, Marquis de Montcalm, Baron de Gabriac, seigneur de Saint-Veran, Candiac, Tournemine, Vestric, Saint-Julien, and Arpaon, was old French aristocracy on both sides of his family. For centuries, the family ruled lands throughout the south of France. In the 17th century, the male heirs turned to military service as a means of distinction and glory. Louis-Joseph, born in 1712, followed this family tradition when his father purchased a captaincy for his son at the age of 17. Louis-Joseph took quickly to the military, a born leader. He fought bravely in the War of Polish Succession, and was promoted to Colonel, led a successful charge in the War of Austrian Succession, and was made Brigadier.

Seven years of peace interrupted his career, but in 1755, Baron de Dieskau, commander of the French army in North America, was captured by the British. Louis XV needed a replacement, and turned to the Marquis de Montcalm.

His trust was rewarded as Montcalm captured Fort Frontenac (Toronto) in August 1756, securing Lake Ontario for the French, thus opening a path to attack New York. The following year, Montcalm did just that, besieging Fort William Henry (on Lake George, NY), capturing 2,500 British troops, and causing panic in New York City that a French invasion was imminent.

To thwart Montcalm's threat, in 1758, General James Abercromby assembled 15,000 troops, the largest army ever massed on the continent, to capture Fort Carillon (Ticonderoga) from the French. Montcalm's 3,600 troops withstood the onslaught, inflicting nearly 2,000 casualties on the British. It was the greatest French victory since Charlemagne conquered most of Europe a thousand years before, and the Marquis de Montcalm was acclaimed a hero throughout the French Empire.

In the mid-18th century, most of North America was under French control, not British. The only two gateways into the heart of the continent, the Mississippi and the St. Lawrence, were French rivers. From Canada through the Ohio River Valley, and along the thousands of miles of the Mississippi River to New Orleans, French, not English, was the *lingua franca*. The political and cultural center of this vast empire was the walled fortress of Québec City.

Québec sits atop 180-foot bluffs on the north bank above the St. Lawrence River. Just downstream, to the east of the city, is the large Isle d'Orleans that splits the river into two narrow passages, making maritime navigation treacherous. The land east of the city is

"The political and cultural center of this vast empire was the walled fortress of Québec City."

buffered by two rivers and 300-foot gorges. Twice before, in 1690 and in 1711, the British attempted to take the city, only to fail both times. Québec, with its walled fortifications and natural barriers, was impregnable. Still, Montcalm knew the British would attempt to take it, since control of Québec meant control of the St. Lawrence, and with it most of North America. So Montcalm prepared his defenses, and waited for the British to come. The Battle of Québec in 1759 turned on the most improbable sequence of events, changing the course of world history, and offering us lessons for today.

"While stocks and bonds struggled in the quarter, commodities continued to soar."

Stocks, bonds, and real estate all declined in value in the quarter ending 30 June. The modest drop in equities masked the turmoil within the quarter, as April and May were strong, but June was awful. Stocks fell more than 8% in the last month, making it the worst June since 1930. Breadth turned down too in the past three months, as nearly half the stocks in the market declined more than 10%, and nearly a quarter were more than 40% off their 52-week peaks, the highest readings since the bear market of 2002. Analysts are scrambling to reduce their earnings estimates, now 13% below what they thought a year ago, with probably more to come (see Chart 2). Particularly singled out is the financial sector, as analysts have reduced this year's earnings estimates 43% from where they were at the start of the year. We're thankful other areas of the economy don't operate with the level of (im)precision of financial analysts (surgeons and pilots, especially, come to mind).

While stocks and bonds struggled in the quarter, commodities continued to soar (the Goldman Sachs Commodity Index rose 28% in the quarter). The confluence of supply and demand factors (not evil speculators, senators) is behind this surge. Years of underinvestment have constrained the supply side, while massive industrialization and growing wealth throughout the emerging world have pressured demand.

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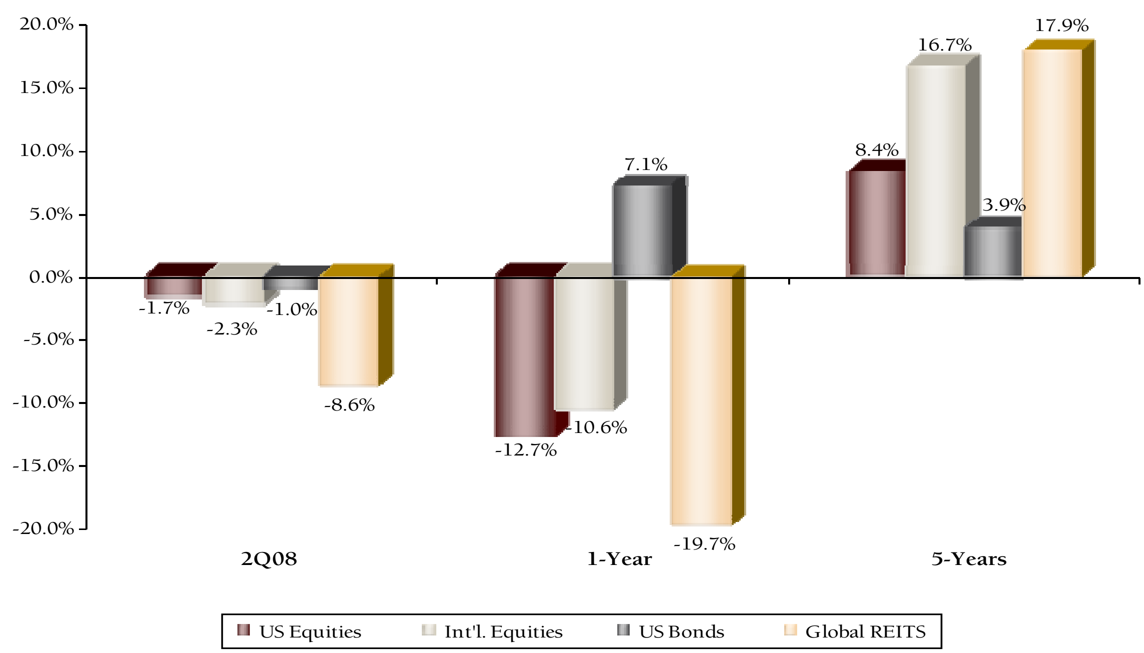
CAPITAL MARKET PERFORMANCE



From 1980-2000, US oil companies averaged less than $50 billion of capital expenditures per annum. This year they will spend over $150 billion, but this is catch-up from decades of underinvestment (see Chart 3).

Likewise, rapid industrialization has fueled demand for energy and materials. From 1Q07 to 1Q08, the price of oil rose 65%. Consumption fell in the US by 900,000 barrels/day, but rose by 1.6 million barrels/day in emerging countries. Worldwide, there was a 15% increase in demand for oil despite the 65% rise in its price. Among agricultural goods, global inventories of wheat and corn are at their lowest in over 50 years (approximately 70 days and 40 days, respectively).

The pricing mechanism works, as high prices draw more investment and limit demand. But unlike the graphs in our economic textbooks, there can be a considerable time lag in the shifting of the supply and demand curves.

Inflation is the scourge of financial assets, and inflation is rising everywhere. The inflation rate in the US over the past year reached 5%, the highest since 1990 (see Chart 4), and is at multi-year highs in most countries around the globe. Morgan Stanley counts over 50 countries with double-digit inflation rates (see Table—Zimbabwe's 165,000% inflation stands out; at that rate, prices are dou-

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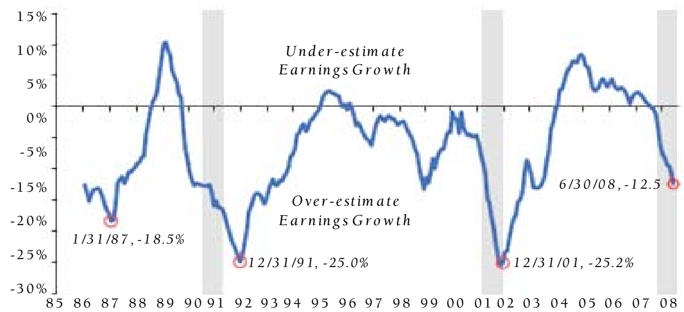
S&P 500 Rolling Earnings Surprise %
12mo Forward Estimates vs. Actual



Sources: FactSet, Thomson Financial. Courtesy: Morgan Stanley

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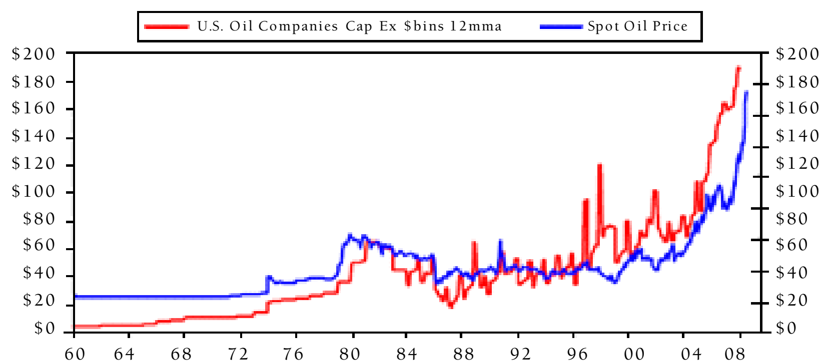
U.S. Oil Companies Cap EX & Spot Oil Price



Courtesy: Bridgewater Associates

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Consumer Price Index for All Urban Consumers: All Items
(CPIAUCNS)

Shaded areas indicate US recession as determined by the NBER
2008 Federal Reserve Bank of St. Louis: research.stlouisfed.org

Source: U.S. Department of Labor: Bureau of Labor Statistics

"Inflation is the scourge of financial assets, and inflation is rising everywhere."

Inflation Rate, Selected Countries

Country	Inflation(YoY)	Population (Mln)	% of World Population	Country	Inflation(YoY)	Population (Mln)	% of World Population
India	11.1% Jun 7 (WPI)	1,134.60	17.01%	Zambia	10.1% Apr	11.9	0.18%
Indonesia	10.4% May	231.60	3.47%	Serbia	15.7% May	9.9	0.15%
Pakistan	19.3% May	163.60	2.45%	Belarus	14.8% Apr	9.7	0.15%
Bangladesh	10.1% Mar	158.70	2.38%	Haiti	16.5% Apr	9.6	0.14%
Nigeria	9.7% (expect 10.3% Y by Jun-08)	148.10	2.22%	Bolivia	16.8% Apr	9.5	0.14%
Russia	15.1% May	141.90	2.13%	Azerbaijan	18.35% Mar	8.5	0.13%
Philippines	9.6% May	88.60	1.33%	Bulgaria	15.0% May	7.6	0.11%
Vietnam	25.2% May	87.40	1.31%	Honduras	11.2% May	7.1	0.11%
Ethopia	29.6% Mar	77.10	1.16%	Tajikistan	21.9% Apr	6.7	0.10%
Egypt	19.7% May	75.50	1.13%	Paraguay	11.3% May	6.1	0.09%
Turkey	10.7% May	70.60	1.06%	Sierra Leone	9.2% June 06	5.9	0.09%
Iran	20.2% Feb	70.50	1.06%	Nicaragua	21.8% May	5.6	0.08%
South Africa	10.4% Apr	47.90	0.72%	Nyrgyz Rep.	24.9% Mar	5.3	0.08%
Argentina	9.1% May (official but likely higher)	41.00	0.61%	Costa Rica	11.9% May	4.5	0.07%
Sudan	8.8% 4Q	38.60	0.58%	Georgia	12.2% Apr	4.4[1]	0.07%
Kenya	26.6% Apr	3.80	0.56%	UAE	11.5% Q1	4.4	0.07%
Iraq	15% Apr	29.00	0.43%	Moldova	15.6% Mar	3.8[2]	0.06%
Venezuela	30% Y May	27.90	0.42%	Lithuania	12.0% May	3.4	0.05%
Uzbekistan	11.0% Apr	27.40	0.41%	Jamaica	22.5% May	2.7	0.04%
Saudi	10.5% Apr	24.70	0.37%	Oman	12.4% Apr	2.6	0.04%
Ghana	16.9% May	23.50	0.35%	Latvia	17.9% May	2.3	0.03%
Mozambique	18% Feb 06	21.40	0.32%	Botswana	12.1% May	1.9	0.03%
Sri Lanka	26.2% May (Colombo)	19.30	0.29%	Estonia	11.3% May	1.3	0.02%
Angola	12.0% May	170.00	0.26%	Qatar	14.8% Q1	0.8[3]	0.01%
Kazakhstan	19.1% Apr	15.40	0.23%	Guyana	14% Dec	0.7	0.01%
Guatemala	12.2% May	13.40	0.20%	Iceland	12.3% May	0.3	0.01%
Zimbabwe	164.900% Feb	13.30	0.20%	**Total: 53**		**2939.2**	**42.00%**

[1]Figure includes the Republic of Abkhazia (216,000) and South Ossetia (70,000); [2] Includes Transnistria (555,347); [3] Figure for Catari residents only. Estimates for 2008 that include non-resident transient labourers indicate a population of 1,448,446. From Qatar General Secretarial for Development Planning

Source: UN, National Statistics Offices, Morgan Stanley Research

"Easy money is the source of inflation."

bling every few hours). Global inflation is expected to jump from 3.5% in 2007 to 5.8% this year, led by an 8.5% rate in emerging economies.

Easy money is the source of inflation. Many countries have set interest rates well below nominal growth rates. This is especially true in emerging economies, hence the high inflation rates found there. This policy has been pursued primarily for two reasons: either (in a misguided attempt) to stimulate their economies (as in Venezuela and Argentina, e.g.), or because they have chosen to link their currencies to the dollar, and hence have adopted US monetary policy as their own.

For the export-led economies, primarily of Asia and the Middle East, adopting the US monetary policy has (heretofore, anyway) been highly beneficial. As the dollar weakened, their currencies weakened, thus cheapening their exports. This accelerated export growth, generating ever higher levels of foreign reserves. But to maintain this virtuous cycle of cheap currencies and rising exports and growing piles of excess reserves, these economies had to keep domestic interest rates low, even in the face of higher inflation.

So now we have negative real interest rates (nominal rates below the rate of inflation), and negative real interest rates will not tame inflation, as we learned in the 1970s. In August 1971, President Nixon imposed wage and price controls as inflation passed 4%. The predictable shortages arose, and the controls were eventually abandoned. President Ford appeared on television in October 1974, declaring inflation "Public Enemy Number One," and wearing a WIN button (for "Whip Inflation Now"; some wore the pin upside down, for "No Immediate Miracles"). The buttons didn't work. Inflation peaked at 15% in 1980, and receded only because Paul Volker brought the Fed funds rate to more than 20%. To tame inflation today, we may need hundreds of basis points of monetary tightening.

Markets, however, don't seem especially concerned about inflation. Debt has outperformed equities this past year; indeed, US equities have provided no real return over the past decade (see Chart 5). Money supply growth has trailed off in the US, Europe and Japan, and the US current account deficit has diminished as exports have soared. Headline inflation may be moving higher, but ex-food and energy, the (core) rate has been steady.

Certainly, the economic data have been weak: employment is down, as is capacity utilization, and of course residential housing is in the midst of a depression: vacancy rates have risen to multi-generational highs (see Chart 6), and new construction has plummeted (see Chart 7).

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Source: Merrill Lynch Investment Strategy, Standard & Poor's

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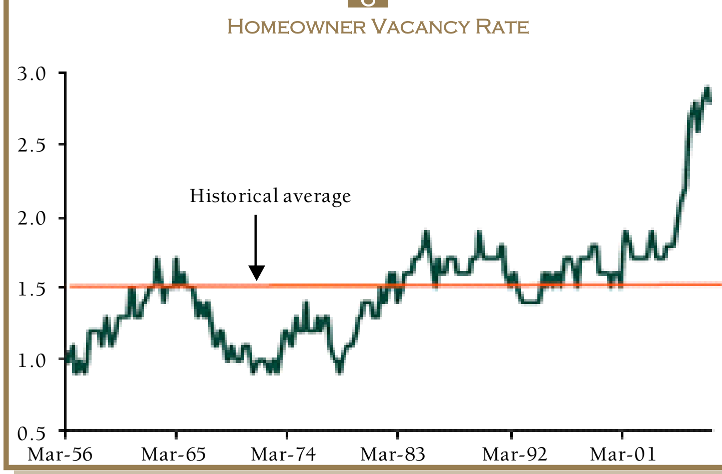

Source: Census Bureau, Courtesy: Lehman Brothers

"The buttons didn't work."

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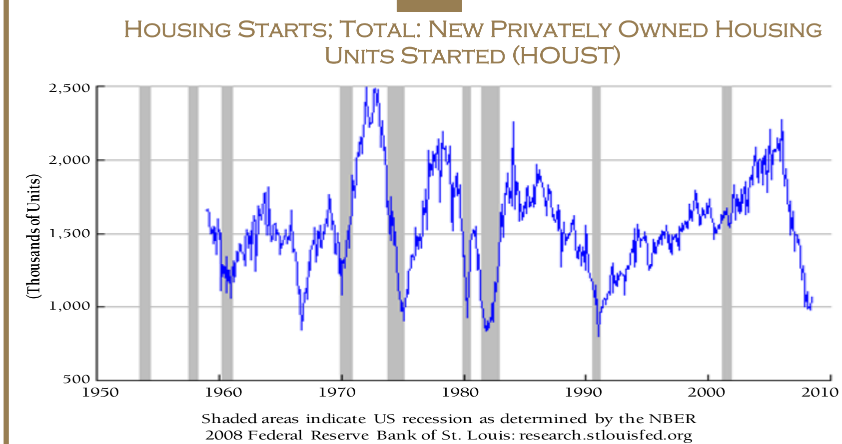

Source: U.S. Department of Commerce: Census Bureau

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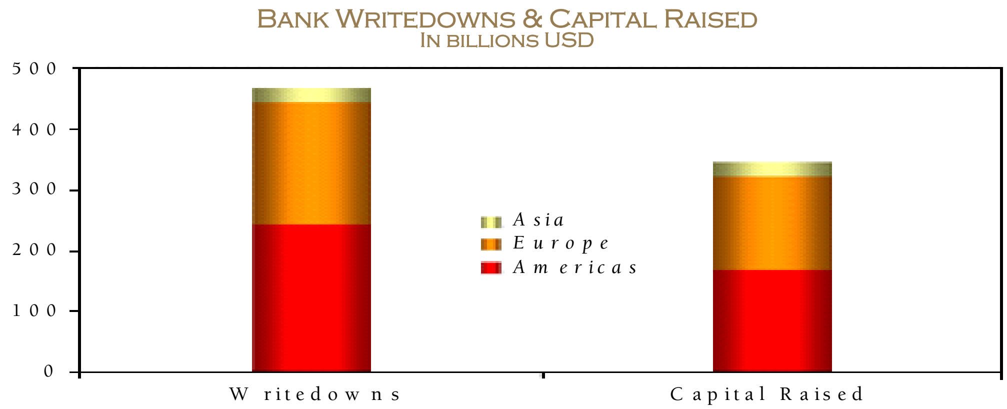

Courtesy: IMF

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Source: Bloomberg L.P.

> *"...the second largest bank failure in history ."*

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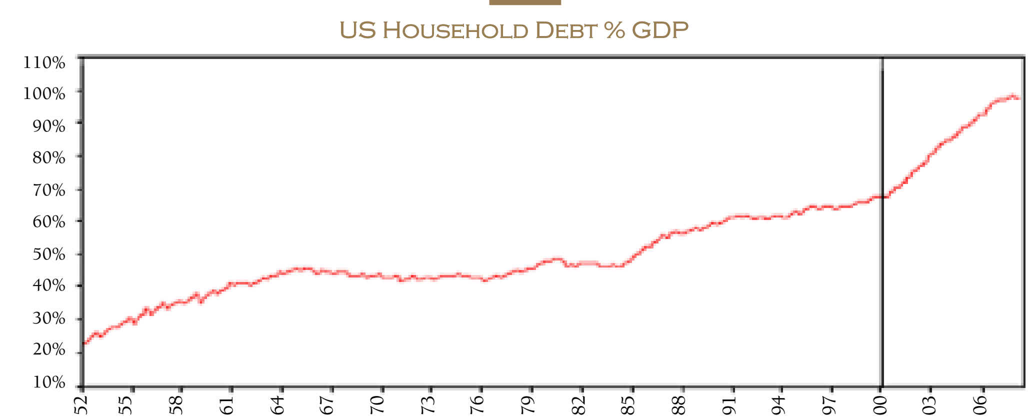
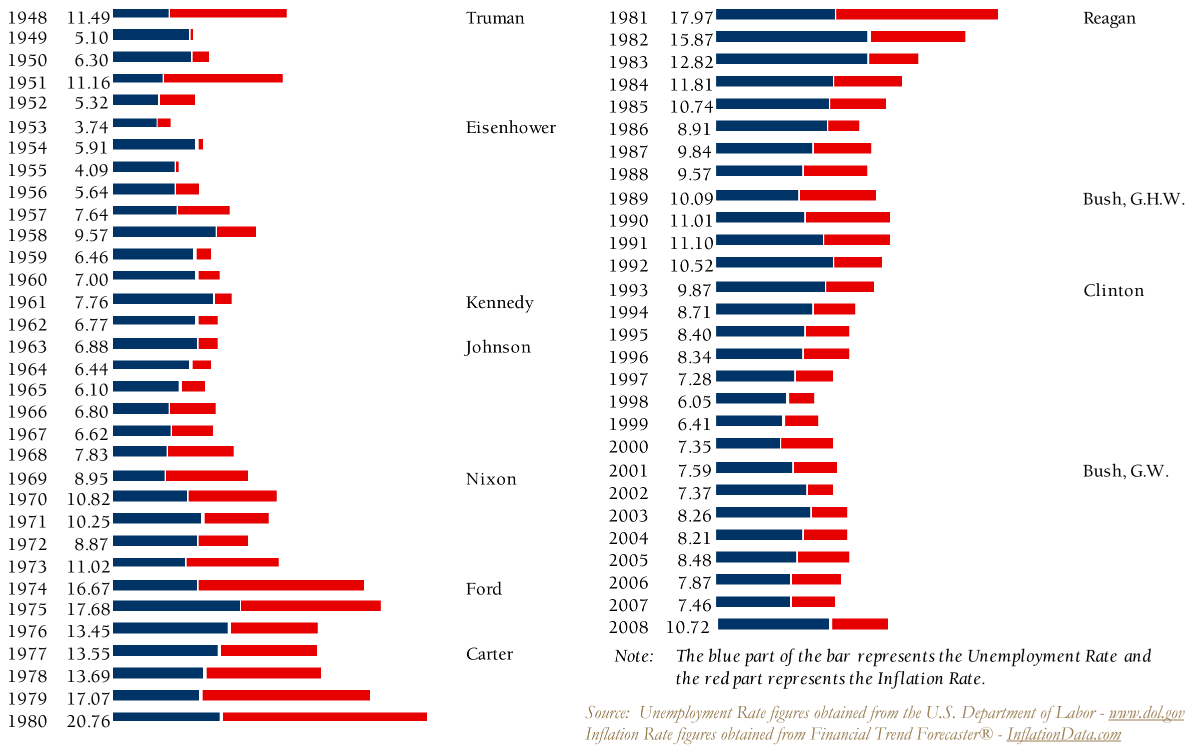


Courtesy: Bridgewater Associates

The US Misery Index – 1948 to 2007
Misery Index = Unemployment rate + Inflation rate



Note: *The blue part of the bar represents the Unemployment Rate and the red part represents the Inflation Rate.*

Source: Unemployment Rate figures obtained from the U.S. Department of Labor - www.dol.gov
Inflation Rate figures obtained from Financial Trend Forecaster® - InflationData.com

"We hope they succeed."

Perhaps the biggest economic headwind (more like a gale force) is the continuing financial crisis, now a year old. The collapse in early July of Indymac Bank, with $32 billion of assets, was the second largest bank failure in history (following Continental Illinois in 1984). Banks have written off nearly half a trillion dollars thus far, and experts expect another trillion or so of write-offs to come. Shareholders have been diluted as approximately $350 billion of new capital has been raised (see Chart 8 on page 6). No wonder bank stocks are off 33% this year, and have lost about half their equity capitalization over the past twelve months (see Chart 9 on page 6).

The combination of weak employment data, the persistent (even accelerating) housing slump and the severe dislocations in the financial system has led to a decline in inflation expectations. In a normal economic cycle, this might be reasonable but, of course, this is not a normal economic cycle. Tight monetary policy did not cause the economic contraction; the unwinding of excessive debt (see Chart 10 on page 6) and leverage did. Strong economic growth in emerging economies puts upward pressure on commodity prices and wages at the same time as the credit crisis contracts the US economy. This may not be the stagflation of the 1970s, but the misery index (the sum of the unemployment rate and the inflation rate, a term coined by economist Arthur Okun, advisor to President Johnson), is moving higher (10.7% today—see above). The Fed is targeting low (or negative) real interest rates, attempting to stimulate the economy, and hoping that inflation remains contained. We hope they succeed.

Canada was the prize, the key objective of British strategy during the Seven Years (French & Indian) War. Secretary of State William Pitt (the Elder) knew that the future of British North America lay in conquering Canada, and he ordered every available military asset to be placed at the disposal of General James Wolfe, commander of the British army.

"It was one of Britain's worst defeats ever."

In June 1759, Wolfe, age 32 at the time, ordered the Royal Navy to sail up the St. Lawrence just east of Québec, notwithstanding the extremely treacherous waters of this river. The Royal Navy came through, and on 28 June 1759, captured the uninhabited Isle d'Orleans, just east of Québec (see Map). Three days later, the army took Pointe Lévy, less than a mile across the river from Québec. Wolfe split his army in thirds—at Pointe Lévy, Isle d'Orleans and on the north bank east of Beaufort. But he was stymied: east of Québec was heavily fortified and despite his command of the south bank, the St. Lawrence was impassable for the Royal Navy.

Montcalm waited, and by the end of July, Wolfe began to panic. Winter comes early in Canada, and the river had, at most, two months before ice would halt all travel. On 31 July, Wolfe attacked at Montmorency Falls, east of Beaufort. He ordered his troops at Pointe Lévy to join him, but a summer squall closed the St. Lawrence, preventing this reinforcement. Wolfe suffered tremendous losses, 443 casualties to just 60 by the French, and was forced to withdraw. It was one of Britain's worst defeats ever.

Throughout August, Wolfe pillaged the countryside hoping to starve the French, but by the first week of September the weather turned ugly. Wolfe knew he was running out of time. Without consulting his staff, on 12 September Wolfe ordered all his troops to embark with the Royal Navy to cross the St. Lawrence west of Québec. At 2 a.m. on the 13th, ships passed below the French garrison, yelling out (in French, *bien sûr!*) that they had come to resupply the city. They were allowed to pass.

By 8 a.m., all 4,600 troops had managed to climb up the 180-foot cliffs at Le Foulon and re-assembled on the Plains of Abraham, just west of the walled city. Montcalm was in Beaufort that evening, expecting another attack from the east, and was shocked to hear of the British landing, disbelieving it until he saw for himself.

Wolfe took an extraordinary risk and, remarkably, it paid off. But he still had an enormous problem: his troops were trapped on the plains. They had insufficient firepower to take the stone ramparts of Québec, and had no means of escape. There were an equal number of French troops in the city, and a similar number a few hours away from the west heading toward Québec. Wolfe would soon be trapped by Montcalm to the east, General Bougainville from the west and the St. Lawrence to the south. All Montcalm had to do was wait.

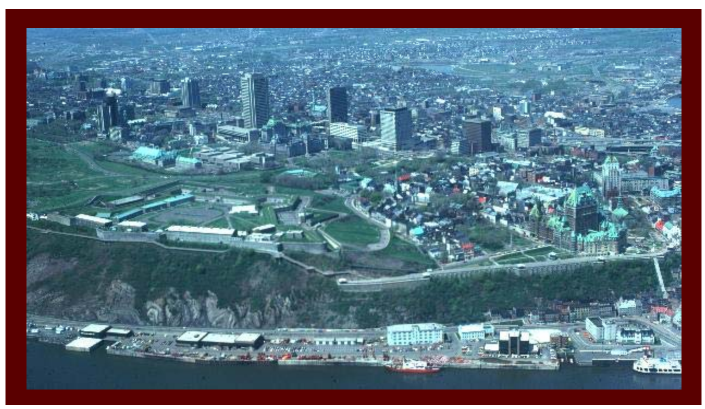
At 10 a.m., for reasons that will never be known, Montcalm ordered his troops out of the city to attack the British. Bougainville was no more than two hours away with reinforcements, but he would be too late. Wolfe was killed by a cannonball in the very first volley, but in ferocious fighting, with about 600 dead on each side, the British prevailed. Montcalm was struck by a mortal round and died the next day. The French abandoned Québec to the British, and with it, their claim to a North American empire.

Wolfe became a hero to generations of British schoolchildren, but his actions were indefensible and irresponsible. That he succeeded was due to an extraordinary sequence of errors by Montcalm: failing to defend the cliffs, where a few dozen troops could have picked off the entire British army; failing to wait for reinforcements that were only hours away; and engaging the British when waiting inside his fortifications would have led to victory.

It has been an extraordinary decade for investors: an equity bubble, then punctured, followed by a long and massive liquidity injection at the same time enormous pools of savings were amassed and redirected to debt instruments, spurring an unprecedented accumulation of debt and immense levels of leverage, now in the process of unwinding.

Delevering on this scale might be expected to be deflationary: as assets are liquidated, prices fall, jobs are lost, spending is cut and balance sheets may gradually be rebuilt. All that is happening. But, as we've seen, inflationary pressures are also rising due to the explosive growth and wealth creation in emerging economies and the loose monetary policy pursued by most central banks.

The investment waters are as treacherous as the St. Lawrence. Just as Montcalm erred in defending only from the east, investors cannot choose between economic contraction and inflation, we must guard against both. The lessons from the Battle of Québec are not that risk is always rewarded or that outcome always justifies the risks taken. James Wolfe is not our model. Rather, look to the Marquis de Montcalm for our lessons: some victories are won by action, and some by inaction. The same is true in defeats.



Founded in 2001, Angeles Investment Advisors LLC provides investment advice to select institutions and high net worth families and individuals.

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