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Eye on the Market, October 18, 2010

Topics: Portfolios, QE2 and the elections; growth stocks; consequences of the \$ decline; the Truman Show; Saudi Arabia

How we are positioned heading into the U.S. Big Bang on November 3rd

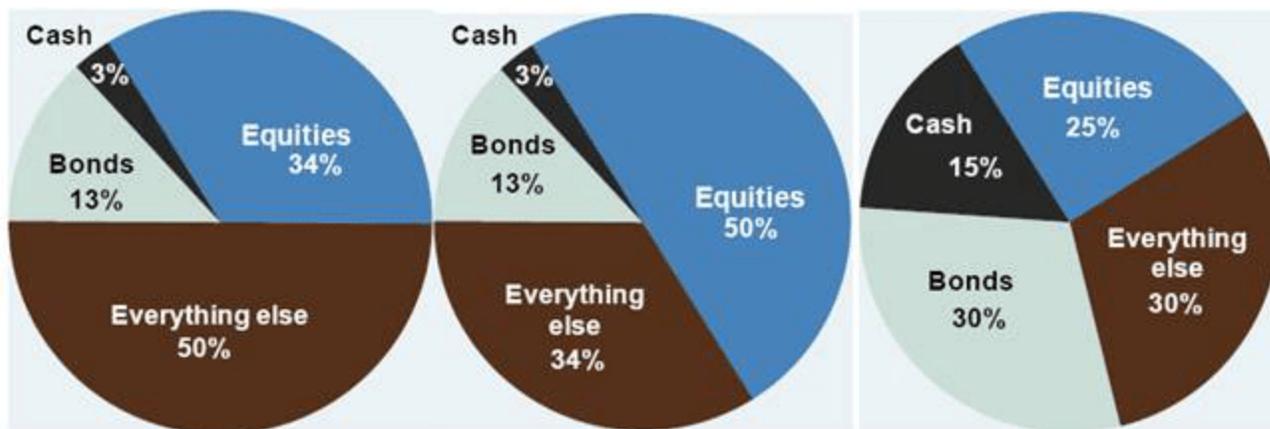
Despite modestly better retail sales and manufacturing data, both inflation (too low) and unemployment (too high) are outside the Fed's statutory mandate to influence them. US GDP growth in Q3 is headed for 1.5%, half the consensus level projected in June of this year. So, as we head into the Big Bang on November 3rd (Fed meeting, expected announcement of additional monetary stimulus [a] and likely U.S. electoral shift to the right), here's a visual on where we are, and where we might have been.

How we are positioned now,

considering the Fed's intention to expand the monetary base (again) and weaken the dollar with the goal of reflating financial assets, and possibly creating downstream benefits for employment growth, although the Fed has not described exactly how

How we *would* be positioned if we were basing portfolio construction mostly on current conditions in the corporate sector: strong cash flow and profits, low P/E multiples and a likely rebound in capital spending (esp. equipment and software)

How we *would* be positioned if we thought that there would be a double-dip recession in 2011, and that reflation efforts would certainly fail



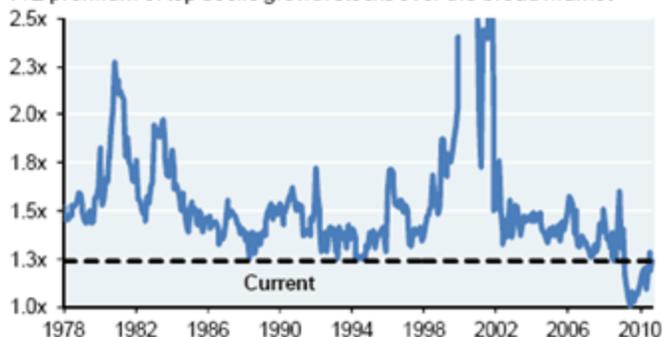
Equities: a barbell primarily composed of large cap US and Asian stocks

Everything else: commodities (e.g., oil, copper and gold); high yield bonds [b] and leveraged loans; private mezzanine lending; commercial real estate, and hedge funds (long-short, macro and funds focused on merger arbitrage).

In these notes, we grapple with the risk of unintended consequences resulting from unorthodox policy experiments. **But keep in mind that equity markets are already assuming negative outcomes.** One example of this: the low premium paid for the “growthiest” growth stocks, compared to the overall U.S. equity market (see chart below). **The relative premium paid for growth has rarely been lower.** This reflects elevated caution on the part of equity investors regarding future economic and corporate profit prospects. A healthy recovery looks remote to us, but anything resembling normal would likely exceed current market expectations. **This is part of the reason why we retain a 35% foothold in equities, and additional market exposure through the “Everything Else” bucket.**

Growth stocks price in a lot of pessimism

P/E premium of top decile growth stocks over the broad market



Source: Corporate reports, Empirical Research Partners.

Government Balance % GDP	2007	2009	2011E
Advanced G-20	-1.7%	-9.4%	-7.1%
Emerging G-20	0.3%	-4.8%	-2.9%
Government Gross Debt % GDP			
Advanced G-20	78%	97%	109%
Emerging G-20	37%	37%	36%

Source: International Monetary Fund.

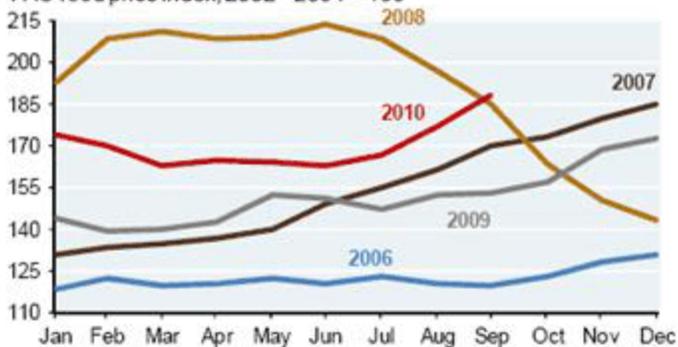
Cheapness of growth stocks notwithstanding, **our overall portfolio risk is below normal for a recovery**, given tough choices facing developed economies (see table, above), and the stresses resulting from the Currency Wars. I don't put much weight on *Plaza 2.0*, a rumor suggesting the Fed would agree to not print more money in exchange for a substantial Chinese revaluation. The payoffs for both sides are too uncertain, and the foundation of trust does not appear to be in place for such an accord. This is rough economic math, but estimates I have seen suggest that a real devaluation in the dollar of 10%-12% would be needed to dissuade the Fed from further asset purchases. Given the 18% weight of the Chinese RMB in the dollar's trade basket, this would be close to impossible to achieve via such a bilateral accord.

Casualties of the Currency Wars (other than Southern Europe)

The first one is us. We did not anticipate the recent strength of the Euro vs the US dollar; since the summer, the Fed and the ECB have adopted opposing positions on further stimulus, and it appears the dollar has more room to fall. As the Fed throws the dollar on the pyre, it will need to monitor the **regressive consequences of higher food and energy prices** that may result. As shown below, food prices are rising again, as are commodity prices, driven by recent increases in commodity ETF flows. The second chart shows the **elevated percentage of after-tax income spent on food and energy** by the lowest 2 income quintiles. Expect plenty of debate about the consequences of QE2, even if *core* inflation hovers at a 50-year low due to weak imputed housing costs which are 40% of Core CPI. [Note: we benefitted from agriculture investments this year, and are considering potential re-entry points of the ones that matured.]

Food prices rising again...

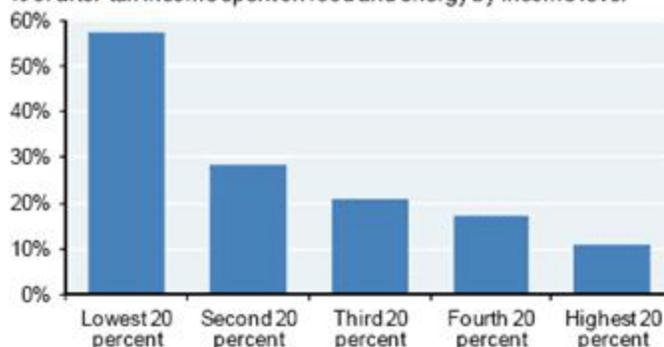
FAO food price index, 2002 - 2004 = 100



Source: Food and Agriculture Organization of the United Nations.

... which disproportionately affects low income families

% of after-tax income spent on food and energy by income level



Source: Bureau of Labor Statistics.

Beneficiaries of the Currency Wars

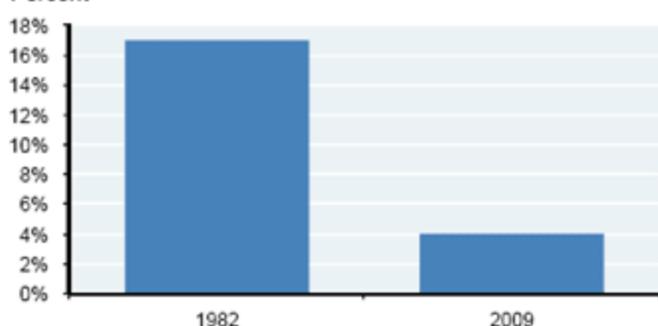
We hold gold in portfolios, and believe it will continue to rise, until the debasing of money has run its course. I interviewed Ray Dalio from Bridgewater at a conference we had last week in Paris [c], and among other things, he talked about investor biases reflecting the recent past (the last 20-30 years). One of these biases is the low ownership of gold; he asked an audience of 200 how many owned gold at 10% or more in their portfolios, and there was only one hand raised.

This brought to mind the chart (below) that we showed earlier in the year on the low gold ownership rate compared to prior periods. Ray agreed that for generations until the Volcker disinflation which began in the 1980s, investors generally held more investments that functioned as a “store of value”. Many investors are scrambling to catch up by buying store-of-value assets for the first time since then. That includes Indian, Russian, Chinese, Japanese and Taiwanese Central Banks whose gold investments are well below 10% of total FX reserves. **Gold is demonstrating some characteristics of a bubble, and exiting at the right time will be important. But we do not think that day is today.**

Former Assistant Secretary for International Affairs Ted Truman recommended that the U.S. sell all of its gold with the goal of reducing US debt/GDP by a modest 2%. His timing is better than Gordon Brown’s decision to sell half of the UK’s gold at \$250 back in 1999. But it is also an expression of utmost confidence that the US will not need this gold for a future monetary regime, and could create even more concerns about the world’s reserve currency. I would be surprised if the U.S. Treasury were to go down this road.

Value of investible gold relative to global financial assets

Percent



Source: J.P. Morgan PB calculations, World Gold Council, GFMS, U.S. Geological Survey, IMF, Bloomberg, MSCI, BIS, Merrill Lynch.

Saudi Arabia food price inflation

% change - YoY



Source: Saudi Arabian Monetary Agency.

Saudi Arabia: pressures from a weaker dollar, and how its investment parapets limit foreign investment

Asia is not the only place where a weak dollar might cause problems. Gulf currencies are pegged to the dollar as well. Food and beverages are the largest component of the Saudi Cost of Living Index, and tend to lead other Saudi inflation components. **In 2007-2008, when the dollar weakened, Saudi inflation peaked at 11% despite higher bank reserve requirements and increased Central Bank bill issuance;** food prices played a major role in this increase. Saudi Arabia is a large wheat importer, and has begun to phase out domestic subsidies given scarce water concerns. Global wheat stocks are not as tight as they were 2 years ago [d], but are still at the scarcer end of the historical spectrum. Saudi inflation is now around 6%, with food inflation at 7.5%, the highest rates in the Gulf.

Should the dollar continue to weaken in line with Fed money-printing, it may accelerate pressure on the GCC nations. The Saudi Riyal is already at its highest level since 1986. Saudi Arabia, the United Arab Emirates, Qatar, Oman, Bahrain and Kuwait are scheduled discuss revaluation at a summit in Qatar this week. Ideas under debate include a new peg of which the dollar would only account for 60%.

As for investing in Saudi Arabia, it's a struggle for outsiders. Based on its GDP, per capita income and improved competitiveness (#13 globally as per the World Bank), Saudi Arabia should in principle account for a greater share of global portfolios. Its GDP is greater than Malaysia, Ireland, Denmark or Hungary. But the following constraints are part of the investing landscape:

Public equities: Saudi Arabia is 50% of Gulf region market cap and its equity markets are more diversified than other Gulf countries. However, most international fund managers are underinvested, since its equity markets are closed to non-residents (non-Arab investors account for less than 1% of the trading volume on the Tadawul). Our managers do have some exposure, but take on counterparty risk through local banks issuing equity-linked certificates or total return swaps (there has been a recent increase in local issuers, reducing counterparty concentration risk). Noted index manager MSCI dropped Saudi Arabia from its Arabian Markets Index last week after the Tadawul reportedly insisted on veto power over the composition the index; it had not been included in their broader Emerging Markets Index.

Private equity: Gulf private equity transactions rose from \$148 mm in 2004 to \$3.8 bn in 2007, but fell to \$520 mm in 2009. In a 2010 survey of private equity investors [e], respondents ranked the Middle East next to last, ahead of only Russia and former Soviet Republics. Possible reasons? Local economies are dominated by family-owned businesses that often do not cede control, and state-sponsored enterprises and sovereign wealth funds (Mubadala, Emirates Investment Authority) that do not seek outside investment partners. Another reason: a slow pace of privatization, and the fact that Saudi IPOs are restricted to local investors, resulting in very thin trading. As a result, more than half the Gulf region private equity raised since 2001 remains uninvested. We're watching for opportunities in transportation, infrastructure and consumer goods in case the landscape changes.

Michael Cembalest

Chief Investment Officer

[a] Bernanke wrote in 1999 about the “**self-induced paralysis**” of the Japanese, and how Roosevelt’s best contributions in the 1930’s were the “willingness to be aggressive and to experiment”, and “for having the courage to abandon failed paradigms and to do what needed to be done.” I do not think the Fed is bluffing here. Whether the initial announcement is big or small, they mean business over the long run.

[b] U.S. high yield issuers refinanced 40% of their maturities from 2010 until 2013; JPMSI has reduced its 2011 default forecast to below 2%.

[c] The best French movie I saw this year was “*Le Grand Voyage*”, about a French-Moroccan family making a pilgrimage to Mecca.

[d] In 2008, wheat stocks-to-use declined to the lowest levels since 1980. Stocks have since risen, particularly in China and India. However, less of this is available for export, which leaves the wheat market vulnerable to supply disruptions. In effect, supply is tighter than it seems.

[e] Conducted by the Emerging Markets Private Equity Association, as reported by Bain & Company in “*Private Equity in the Middle East*”.

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