Knightsbridge Asset Management, LLC

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FIRST QUARTER COMMENTARY

"Only when we know little do we know anything; doubt grows with knowledge."

- Johann Wolfgang von Goethe, 1749-1832
- German Author, Lawyer, Scientist, Philosopher
- Author of dramatic poem "Faust"

We view retired Fed Chairman Greenspan as the quintessential believer in the Goethe maxim, continually challenging members of Congress in testimony on Capital (or Capitol) Hill as to their cherished notions of how the economic world works. It would seem that investment markets of all descriptions are unusually focused on the Federal Reserve, and specifically upon every utterance of its new Chairman Mr. Bernanke, looking for clues as to whether one should be zigging or zagging. If in fact "doubt grows with knowledge" as alleged by Goethe, then Mr. Bernanke and associates must take yet another chapter from the Greenspan book and avoid making declarative statements about future economic conditions that must exist before a particular course of action takes new direction.

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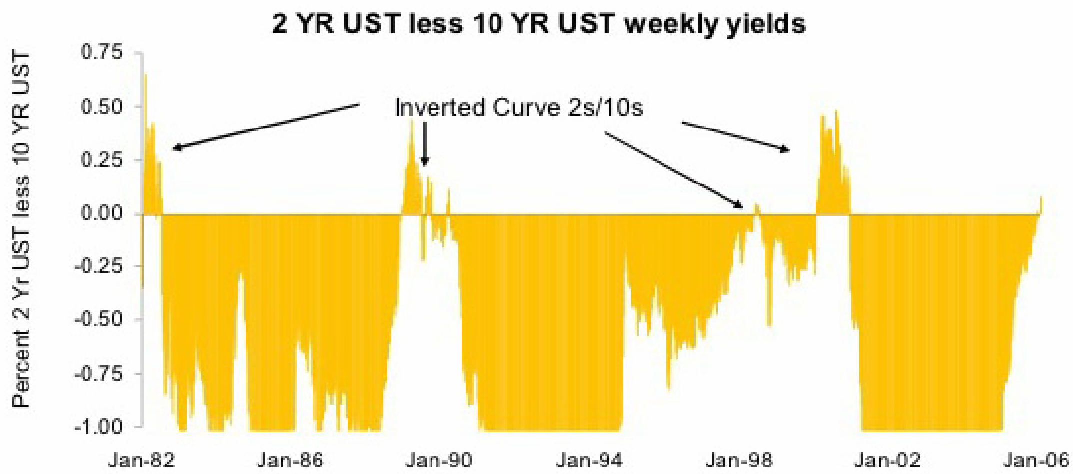
To speak plainly, we believe Mr. Bernanke in pursuit of clarity has made statements such as wishing to see "core" inflation be 1.5% to 2.0% which will come back to haunt him. Although Mr. Greenspan was accused of doublespeak and was famous for his abilities to question conclusions based on shaky assumptions, we wonder if Mr. Bernanke has yet mastered this high art form.

The most notable event of the past quarter was the February arrival of an inverted yield curve (two-year treasuries yielding more than ten-year treasuries), an event occurring now for the fifth time in twenty-five years as seen below in the chart from Stone & Youngberg. Such inversions have lasted on average about seven months which would portend a September 2006 end to the inversion. But is this primitive analysis reliable?



Recent comments emanating from Fed meetings note that "core" inflation (inflation less the food and energy components) is persisting at levels higher than Mr. Bernanke and others wish to see. Core inflation just reported for March was 0.3%, annualizing at 3.6%, and that, of course, excludes energy. That is at substantial odds with his declared wishes to see 1.5% to 2.0%, especially in light of precious little evidence that fifteen raisings of the Federal Funds Rate have done anything to dampen economic activity, either in the U.S. or worldwide. Having painted himself into this corner, it may be difficult if not impossible to deliver on his goals without slamming the U.S. economy into recession with even higher short term interest rates. And it may be that incremental Chinese demand for materials and resources has become the primary determinant of U.S. inflation alongside a globally synchronous economic expansion wherein real global GDP is running 4%.

The following chart from Goldman Sachs shows the "tipping point" for recession to be when 3-month T-Bill rates (currently 4.6%) exceed 10-year T-Bond rates (currently 5.0%) by 100 basis points (1%). We are not there yet.

Federal Reserve Study of
Inverted Curves and Recessions

Estimated probability of a Recession (%)	Spread: 10 Year less 3 Mon Treasury (%)
5	1.21
10	0.76
15	0.46
20	0.22
25	0.02
30	(0.17)
40	(0.50)
50	(0.82)
60	(1.13)
70	(1.46)
80	(1.85)
90	(2.40)

Study based on data from 1960 to 1995

Therefore, in the current environment, a 3-month T-Bill yield of 6.0% might be briefly tolerated should the Fed feel compelled to play brinksmanship with recession. We are skeptical that even this action would accomplish bringing "core" inflation into the desired 1.5% to 2.0% range. We believe the Fed will need to ultimately abandon this desire and face fresh realities. But we could be wrong.

Recently we have read two pieces on the topic of inflation which, although somewhat alarming in conclusion, serve to illustrate the difficulty in getting a handle on inflation. We are going to devote some space here to this discussion simply because the topic is so important to the valuation of investment assets.

We are indebted to Walter J.(John) Williams for the first analysis of the "true" rate of inflation. Mr. Williams has been a practicing economist for 25 years and an advisor to a number of Fortune 500 companies, specializing in economic forecasting and analysis of governmental statistics, particularly as it relates to interest rates. For brevity, we will summarize his statements and conclusions, most of which show that the stats are and have been influenced by

politicians to paint a rosy picture with a positive bias. Hold on to your hat.

1) **Unemployment is running 12% (not 5%) if calculated the way it was during The Great Depression. During the Kennedy Administration they redefined "unemployment" to exclude a category of worker called a "discouraged worker", one who had given up looking for work because there was no work to be had. "Discouraged workers" were taken out of the unemployment count, but still counted in a special category. Then in the Clinton Administration, anyone who was a "discouraged worker" was removed from the discouraged category if in that category for more than a year. This lopped off about 5 million people. Additionally, during the Clinton Administration the polling sample for the unemployment database was altered to reduce the number of people being counted in inner cities in favor of the suburbs, further lowering the unemployed headcount.**

2) **Trade data was manipulated upward during the Reagan Administration following the Crash of 1987 in a massive intervention to get the value of the dollar headed up after a steep decline, and to get the stock market moving north.**

3) **CPI inflation is running 8% (not 2% or 3%). The CPI (Consumer Price Index) in the Bush I Administration was deemed to be in need of "fixing", since it was believed by some to be overstating inflation. The idea was that if you eat steak and the price of steak goes up, you might substitute hamburger (or eventually, dog food), and that the CPI should somehow reflect that devolvement opportunity. The only problem is that the CPI was supposed to reflect a fixed basket of goods. It is always possible to substitute water for milk, etc. But the government wanted a way to suppress the growth of Social Security and other entitlement programs that were being increased annually with CPI adjustments. The resultant political furor killed that idea for the time being. But then in the Clinton Administration, the Bureau of Labor Statistics substituted geometric weightings for arithmetic weightings which has the "benefit" that if something goes up in price it gets a lower weight and if it goes down in price it gets a higher weight. Mr. Williams estimates that the Clinton Administration changes are causing the CPI to be 2.7% below where it would be otherwise, and that if one were to go back to the Carter Administration, the**

CPI understatement is running 3.5% to 4.0%. Social Security checks would be now be 70% higher if the methodologies used in the Nixon years were still used. It's almost magic!

4) **Hedonic pricing understates inflation. Hedonic pricing can be explained as follows: let us say the government mandates all autos to have airbags. Since the new airbags are supposed to represent a "quality" improvement, then the cost of the airbags is deducted from the cost of this year's model auto. In other words, if last year's $50,000 new car now costs $52,000, a 4% increase, and airbags in the new car cost $500, 1%, or a quarter of the 4%, then the CPI calculates the car to have gone up only 3% in price, not 4%. Long story short, hedonic pricing deflates anything subjectively determined to have been improved, which of course includes just about everything!**

5) **Real GDP is overstated by 3%. Nominal GDP growth is expressed in today's dollars. In order to get to "real" GDP growth (growth without inflation), the nominal number is reduced by the inflation estimate for the prior period. If the prior period inflation is *understated* for the reasons mentioned in 3) above, then GDP growth will be similarly *overstated*. For example, the 2005 Q4 real GDP growth reported at 1.1% was really a contraction of about 2%. Ouch!**

For those whose appetites have only been whetted by this discussion, we refer you to www.shadowstats.com. For those of you who have fallen asleep, try not to wrinkle the paper.

We are similarly indebted to R. David Ranson, PhD., of H. C. Wainwright & Co. Economics Inc. Mr. Ranson has deconstructed the CPI and reconstituted it as the CMPI or Consumer Market Proxy Index. To cut to the chase, his conclusion is that inflation was 8.4% in 2005 (not 3.4% as reported by the Bureau of Labor Statistics). To get a handle on how these calculations could be so divergent, one need only to consider how "shelter" is handled in the CPI. Houses went up 13% in value in 2005 across the U.S. we are told by the realtors. Since this component is almost a third of the entire CPI, one has to wonder what is going on here. Well, the government assumes that a homeowner is renting his home from himself to himself in what is known officially as "imputed rent on owner-occupied homes". Each family is considered to be renting

its home at a fictitious monthly fee to itself, which has nothing to do with the prices at which other comparable homes are transacting. The Wainwright Proxy Index is shown below.

Wainwrights's Proxy Index of Market-Clearing Consumer Prices

Sector	*Sector weight in the official CPI*	*Market-price data employed*	*2005 price change*
Shelter (excl. fuel)	37.440%	Price index for single-family homes	13.0%
Food and beverages	15.051	CPI component price indi-ces for food at home and alcoholic beverages	2.3
Energy	8.685	CPI component price index for energy commodities	16.7
Apparel	3.786	CPI component price index for apparel	-1.1
Transportation (excluding fuel)	13.224	CPI component price indi-ces for new & used motor vehicles	
Sum of weights	78.632%		
Weighted average			8.4%

Data: Shelter - Office of Housing Enterprise Oversight; Other sectors - Bureau of Labor Statistics.

So, in conclusion, we have two respected economists claiming that CPI inflation in 2005 was 8% or so rather than the reported 3.4%.

We are inclined to believe the important lesson here is not to get too wedded to a particular line of thinking, but to be aware of what alternative views on important subjects are, and not rule them out as being heresies. We are in absolute agreement with Goethe……………doubt grows with knowledge.

Very truly yours,

Alan T. Beimfohr **John G. Prichard, CFA**