Knightsbridge Asset Management, LLC

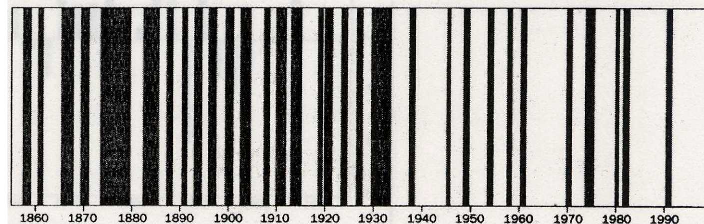
July 23, 1999

SECOND QUARTER COMMENTARY

" The fate of the world economy is now totally dependent on the growth of the U.S. economy, which is dependent on the stock market, whose growth is dependent on about 50 stocks, half of which have never reported earnings."

Paul A. Volcker, 1927-
American Economist
Former Federal Reserve
Chairman, 1979-1987

Although the above statement was reportedly uttered by former Fed Chairman Paul Volcker (AKA the Jolly Green Giant), he has been loath to claim authorship publicly. No wonder. It's truth is all too startling! But each excess sows the seeds of countervailing forces, which ultimately defeat the very excesses that gave birth. The policies pursued by current FED Chairman Greenspan have been most successful in stimulating the U.S. economy. So much so that the domestic economy's demand has almost single handedly pulled the rest of the world's economies up, out, and along with our own. But this success has bred forces which could threaten the undoing of what is soon destined to be the longest running U.S. economic expansion in 150 years.



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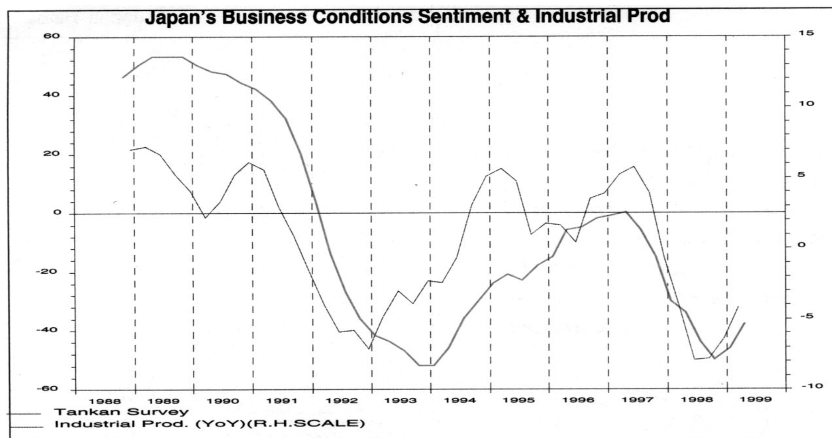
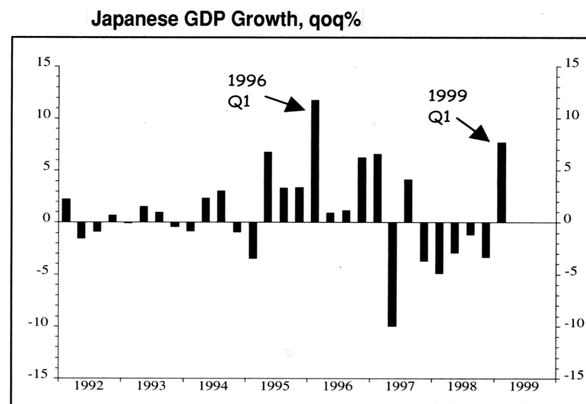
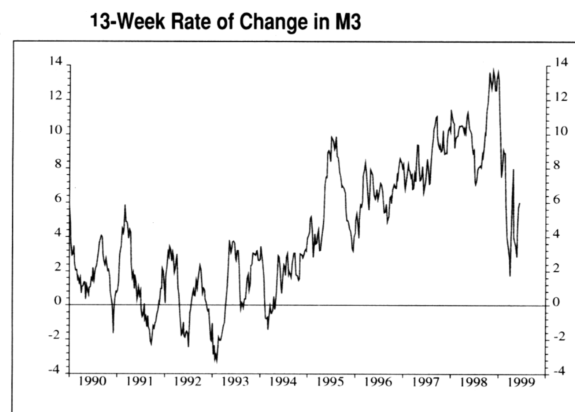
The threat comes from an extended buildup of excess liquidity, which is and has been spilling over into financial markets, bidding up stock and bond prices alike. Real estate prices are not far behind. If stock and bond prices are bid up, we do not call it "inflation". If real property prices are bid up, we start to call it "inflation". If wages and commodity prices are bid up, we definitely call it "inflation". Semantics aside, the dilemma faced by Alan Greenspan is how to throttle back the excess liquidity of the last few years without also forcing the domestic economy into recession. Left unchecked, accumulating liquidities would almost certainly lead the way to higher inflation. This would be coming when the rest of the world economy is recovering.



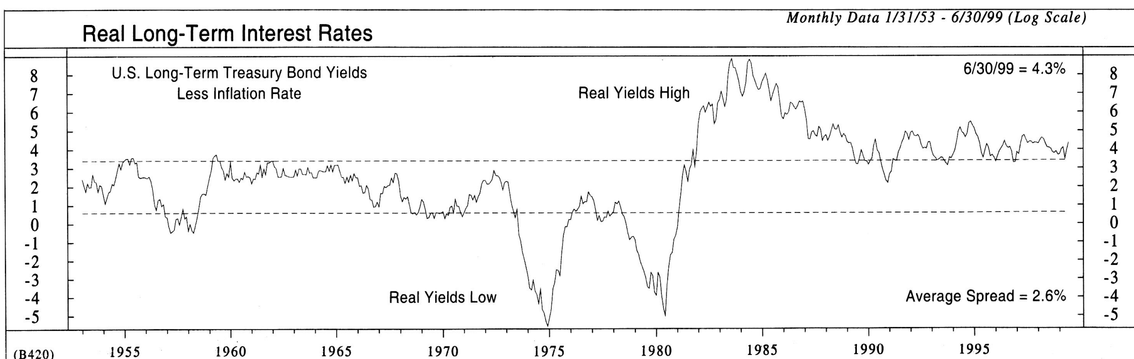
Clearly Asia has turned the corner, and first quarter Japanese GDP growth stunned pessimistic observers with an upside surprise. If that wasn't enough, Germany also surprised with stronger than expected numbers.



Now that world economic growth is not wholly dependent upon the U.S., the Fed may have the breathing room it needs to apply the brakes a bit. This brings with it new interest rate dangers to the U.S. stock market. Last October, ten year treasuries reached a low yield of 4.2%. Today, nine months later, they are at a 6.0% yield. This comes at a time when worldwide loan demand is increasing to accommodate concomitant economic growth. Clearly Greenspan is trying to reign in the excess money supply growth of the last several years as can be seen by the dramatic slowing of M3 money growth the first half of 1999.



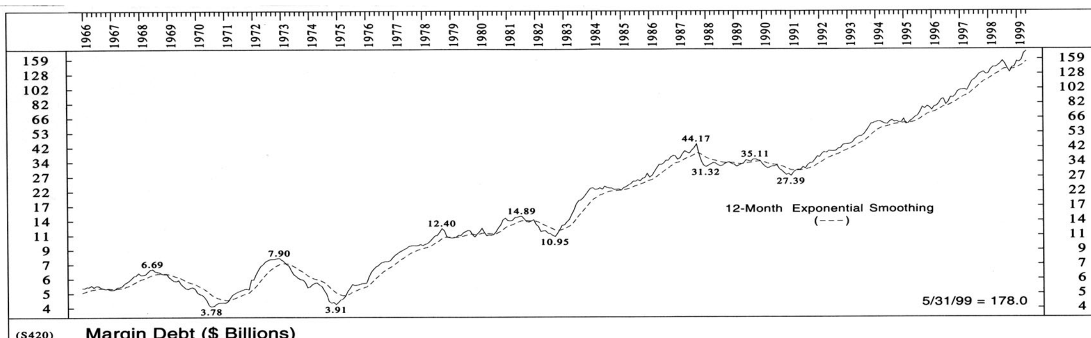
Nevertheless, we would not expect rates to be moving too much higher in the near term. The economic shock from a doubling of oil prices has been mostly anticipated. secondly, "real" long term interest rates remain at an historically high 4% or so (6.0% long term treasury yields minus inflation of 2.0% equals 4.0% real returns). This high real return, in and of itself, remains a deflationary force. Thirdly, the market had already anticipated Fed action to raise short-term rates, and the event itself was largely a non-event.



President Clinton "found" one trillion dollars. And didn't even have to buy a Lotto ticket! Through the miracle of changing the per annum GDP growth rate assumption from 2.0% to 3.2% over the next 15 years the economy would produce an extra trillion dollars in tax revenue we are told. In an apparent political gambit to stamp his imprimatur on an otherwise questionable eight years, the temptations of the ballooning budget surplus were just too much. The proposed drug prescription reimbursement program, if enacted, promises to be the biggest government spending program initiated since Lyndon Baines Johnson's "guns and butter" policy thirty years ago during the Vietnam War. Although Republicans will hold out for some tax cuts, Clinton most likely will accommodate them making his program even more costly. This campaign by the beltway spin-meisters is ultimately but another nail in the coffin of disinflation. No one dares ask the question… what if GDP growth is not 3.2% per annum? Even Washington has embraced the "new economics", which in many respects appears to be a reenactment of "voodoo economics".

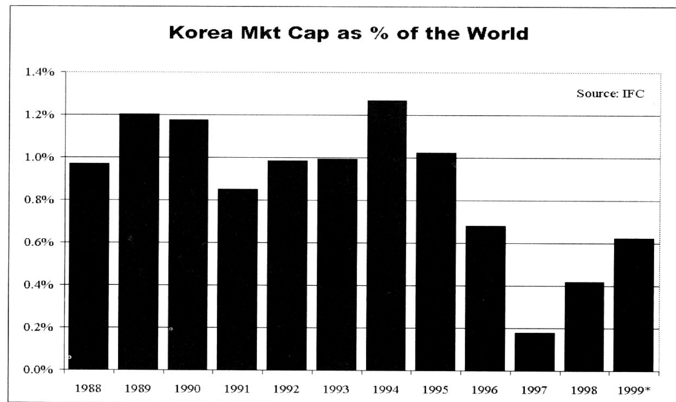
It could be a mistake to conclude that a renewal of inflation was around the corner. Inflation will simply take a longer period to establish it's roots. Too many factors still conspire to restrain the price level. In the near term, fear of Y2K if nothing else, may tend to subdue and restrain the overall economy. Irrespective of the reality of Y2K, the fear of the unknown is a powerful factor. Virgin Atlantic Airways just announced they would not fly on December 31st. Although hoarding would be a one-time economic stimulus, the postponement of computer related hardware and software purchases is pulling the opposite direction, and uncertainty tends to breed inaction.

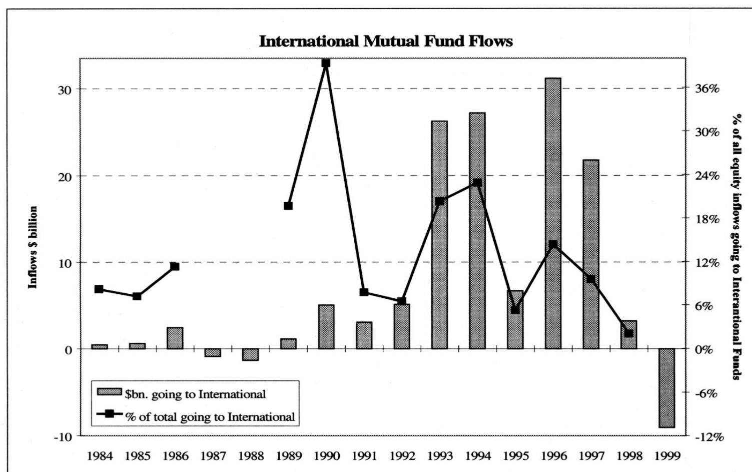
Through the end of 1998, the U.S. stock market experienced the highest four-year returns in history. Surveys indicate investors expect 18% returns. Get rich quickly has replaced get rich slowly. Margin debt rose by



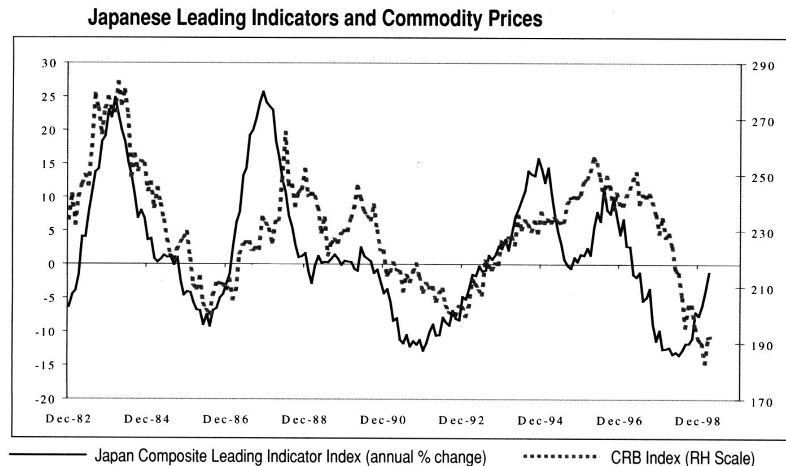
an astounding $40 billion to a total of $178 billion in the November-May time frame. We observe that as recently as 1991, *total* margin debt was only $30 billion. This "inflation" in margin debt has compounded at 23% per annum since 1991. We are thankful that "margin debt" is not a component of the Consumer Price Index!

The U.S. stock market is now worth $11 trillion, which is an astonishing 53% of the global total, up from 28% of the global market total ten years ago. This is interesting because the U.S. share of global output is only 28%. In stark contrast, Japan is 10% of global market values, down from 40% a decade ago and 17% of global output. Korea's position is similar to Japan, but even more extreme. We believe the U.S. market is too highly valued for a host of reasons upon which we've elaborated in past commentaries, and that Asia is too cheap in comparison. Furthermore, we believe the Asian recovery story "has legs". Consider that mutual fund inflows are still negative for international funds (largely Asia and Europe) and that these flows likely will turn positive as more are converted to believing that Asia is recovering.





Moreover, leading indicators of the Japanese economy show recovery at a very early stage. In fact, it is not accidental that, as can be seen in this chart, the Commodity Research Bureau (CRB) Index lags the Japanese leading indicators by about a year. The Japanese economy imports virtually all of their oil, coal, metal, etc… making their economy a huge swing factor in the world commodity markets. Appropriately, one can conclude that the recent 20 year lows on the CRB Index are probably over, and that commodity prices in general will be moving up. Our portfolios continue to own Asia, namely Korea Electric Power and MSDW Asia Pacific.



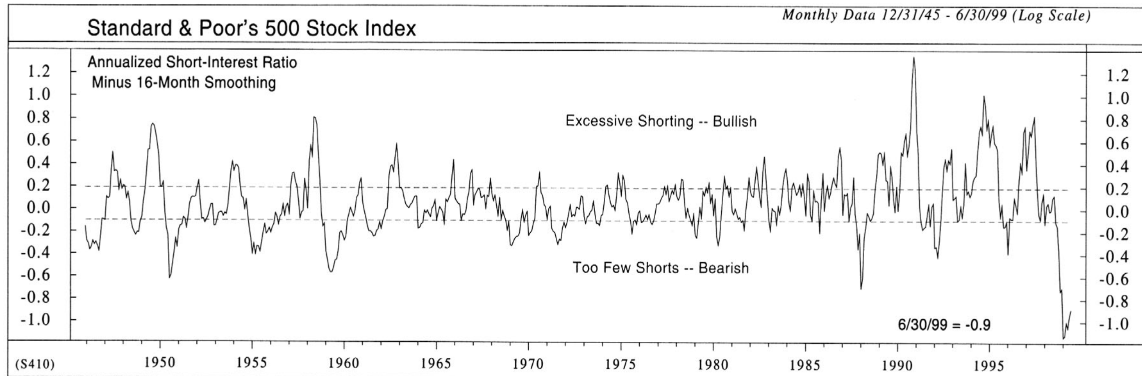
They say gold is dead. Supposedly it no longer has a role in monetary affairs. We are told that governments should earn interest rather than sit on the barbarous metal, and that investment returns will be much improved. But of course that statement is highly dependent upon the time period selected for measurement. In the past 70 years, gold returns are almost identical to treasury bill returns, with both in the 3-4% per annum range. However, the disinflation of the 80's and 90's has made gold a relatively poor investment indeed, and sentiment toward gold as a commodity is now 13% bullish and 87% bearish or neutral. Those are extreme sentiment statistics, generated most recently by the Bank of England announcement that they would sell 300 of their 715 metric tons, presumably as a preamble to their entry into the Euro. There has been an approximate annual 600 metric ton shortfall in supply for some time (jewelry, dental, electronics and coin consumption less mine production and scrap melt). This shortfall has been filled through central bank selling. We believe gold prices, currently $255 per ounce, will work higher once sentiment becomes less extreme. We think the Asian economic recovery will eventually stimulate more than just oil prices in the commodity markets.

Improving economics in Asia may drain away money being used to finance our trade deficit, causing the dollar to now fall against the yen and euro, causing the Fed to react by raising interest rates again to protect the dollar. This scenario is not assured, but could easily happen. We think gold is cheap at this point. With the aforementioned problems combined with Y2K uncertainties, and investor sentiment in the cellar, now is a good time to own gold equities. Gold is at 20 year lows and 30 year lows adjusted for inflation. Therefore, we purchased Newmont Mining, the largest North American gold producer and institutional favorite. Newmont produces four million ounces of gold per year at a cash cost of $190 to $200 per ounce. Historically, Newmont will advance 3.7% in price for each 1% increase in the price of gold. Purchased at $20 per share, it is now slightly lower at $18 per share with gold at $255/oz. To get to $40 per share would require gold to get to $348/oz. Newmont also has a huge copper and gold mining project under development in Indonesia where the up-front infrastructure costs have been made without offsetting revenue, and the rewards of this investment should become apparent in 2000 and beyond helped by an Asian economic recovery.

Furthermore, the U.S. has a record $300 billion trade deficit, financed largely by foreigners, content to hold "strong" dollars. Domestic capital investment is no longer being financed by savings, since savings are now running below zero (personal spending is exceeding personal income) for the first time in the post-war period.

Although the Fed announced a "neutral bias" after their recent quarter point increase in the fed funds rate, this should not be misinterpreted. Further hikes are probable in our opinion, as "neutral bias" announcements following past hikes were only precursors to more hikes. Clearly the U.S. stock market has yet to feel any pain from the heightened bond market competition.

With valuations not ever seen in U.S. stock market history and speculation continuing unabated, we remain cautious. The Fed's U.S. market valuation model shows a 30% overvaluation, P/E's are 34X earnings, dividend yields are 1.3% on the S&P 500, and short selling in the S&P 500 stocks is at a 55 year low by a generous amount.



Many have been lulled into complacency because they have heard the overvaluation story so many times before…basically every year since 1994. The U.S. market is in fine shape says Abby Joseph Cohen of Goldman Sachs. Corporate profits will be up 11% we are reassured. There are supposedly no visible clouds on the horizon. Our concern is that by the time they are visible, the financial penalty for reacting will be severe. We are in the camp that says the U.S. market is substantially overvalued…we will let others say "bubble" or "mania".

We believe Paul Volcker summed it up very well.

We thank you for your support, sponsorship, patience and understanding.

Very truly yours,

Alan T. Beimfohr John G. Prichard, CFA