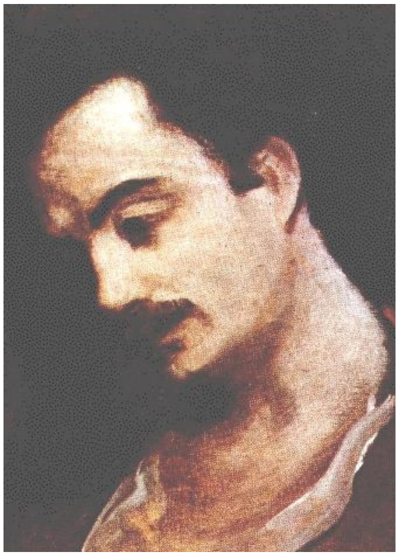
Knightsbridge Asset Management, LLC

July 28, 2010

Summer Quarterly Commentary



"March on. Do not tarry. To go forward is to move toward perfection. March on, and fear not the thorns, or the sharp stones on life's path."

Kahlil Gibran, 1883-1931
Lebanese-American Christian
Author and Poet

Most equity investors are finding acceptance of Mr. Gibran's advice difficult if not impossible, given the brutal and sudden 16% drop in the S&P 500 from April 26th to July 2nd. Memories of 2008 and early 2009 are just too fresh. Nor does scant economic progress seem to warrant anything resembling risk-taking in this environment. For most investors "march on" has been taken to mean "get out of all stocks, the sooner the better, and get into some safe havens where you can't lose money, irrespective of returns", and while you're at it, change "march on" to "run-like-a-scalded-dog-as-fast-as-you-can!"

The extremity of sentiment is perhaps best highlighted by the recent AAII (Amer. Assoc. of Individual Investors) survey which as of July 7th showed 57.1% bearish and only 20.9 % bullish, the remainder neutral. Also registering extremes was the Hulbert measurement of short-term stock-trading newsletters which showed a net negative reading (net sell short) on NASDAQ of 67.9% as of July 8th, the highest negative reading since the week ending March 9th, 2009. Small wonder that the snap-back rally of the past three weeks was such a powerful event.

The two thoughts at the forefront of investor thinking are:

1) Deflation or inflation
2) Sustainability, or lack thereof, of the economic recovery

Historically, the best predictor of inflation has been gold. In years up to the end of the 20th century, increasing gold prices predicted increases in inflation, leading by about six years. So what has happened? Since gold bottomed in 2001 at about $250/oz., and now, nine years later is five times higher at about $1250/oz., one might have anticipated a large increase in inflation. In fact, the polar opposite has occurred. How does one explain this 180 degree change in behavior? We would submit that observers feel the only governmental (Keynesian) response to deflation will be what is known as QE (quantitative easing), which is a fancy term for more stimulus in order to push more money into the system. Therefore, in a sort of inverted logic, the more signs that are seen of the deflationary threat, the more likely they will be battled by the government with QE, which hastens the day of monetary

Gold & Silver Prices in Real Terms (CPI based)

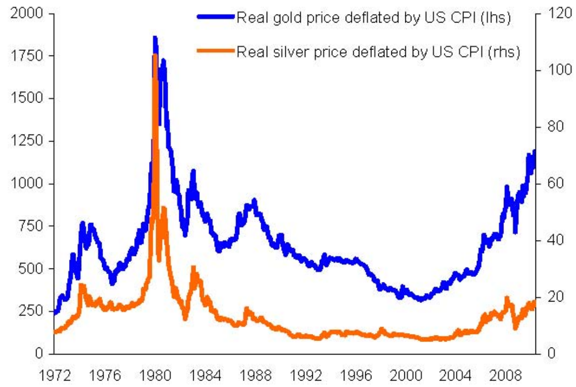


*Chart courtesy of Deutsche Bank

Gold Leads CPI Inflation by 6 Years

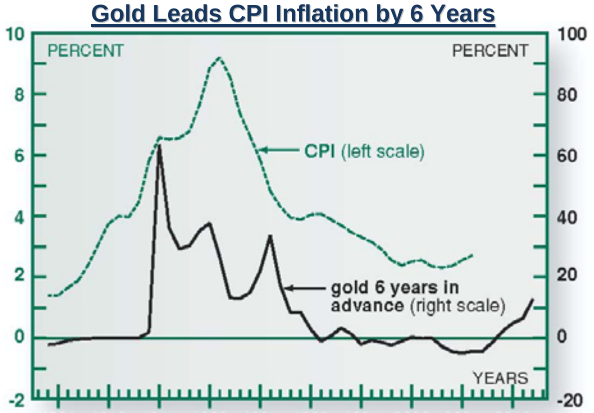


*Chart courtesy of Wainwright Economics

reckoning, the day where there is no hope of debts ever being serviced much less paid off. We would speculate that at some point gold will be drawn back into the monetary system in some way, as successive easing through stimulus programs bring us closer to the tipping point when people will have lost so much confidence in their fiat currency as to demand something new and less corruptible. This point most likely would arrive when the underground economy becomes so large as a percentage of the total economy as to render tax collections problematic causing a fiscal crisis (receipts vs. expenditures). We conclude, therefore, that further deflationary signs (need for more QE) would accompany higher gold prices. A corollary to that would be that lower ten-year treasury yields would also accompany higher gold prices. And by extension, higher ten-year treasury yields (economy strengthening and deflationary fears weakening) would accompany lower gold prices. As J.P. Morgan once famously said “gold and silver are money; everything else is credit.”

*Chart courtesy of Deutsche Bank

Some are concerned that gold has become too popular. There can be no question that the five-fold increase of the past nine years means we are well along the path, but it might be useful to look at gold’s price today compared to prior historical extremes to get some feel for how extended we could be. We conclude the primary direction is still up, even though the rise of the past two years is now in correction mode. Moreover, we also wonder if the appropriate comparative metric might not be worldwide governmental liabilities which have grown faster than the S&P 500 comparative shown in the above table, although we acknowledge these types of liabilities might be negotiated lower as the French government did recently during the euro crisis.

Reinforcing the deflationary idea are small negative numbers in the headline CPI (Consumer Price Index) for each of April, May

and June (-0.1%,-0.2% and -0.1% expected) with the CPI now lower than two years ago, a first since 1956 and 1951.

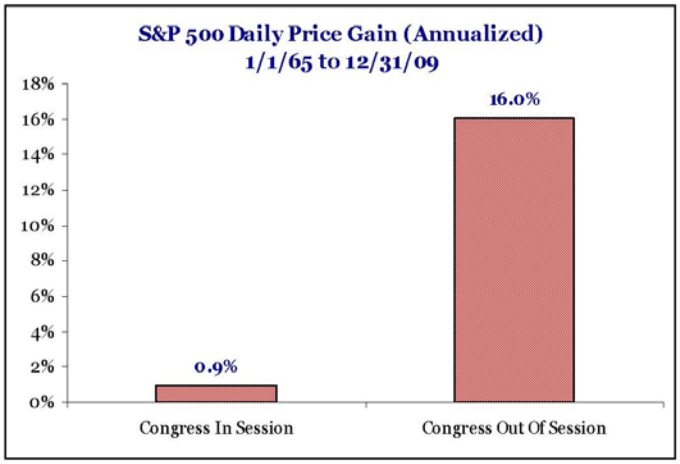


*Chart courtesy of Strategas Research Partners

Many view the government, particularly the federal government, as disingenuous at best, and Congressional approval ratings of 18% in the May Gallup poll are reflective of a loss of confidence in our institutions generally. It might be no surprise then that the above chart shows a 15% performance difference for the S&P 500 based on whether Congress is in session or not. Absolutely astounding! Clearly, investors have believed for some time that Congress is not even a neutral factor, but sadly, a strongly negative factor in the investing process.

Individual investors face some strong headwinds of their own making in the investment process. The chart at left demonstrates that equity mutual fund investors have the art of timing down to a fine science... buy "high" and sell "low". Over the past 40 years, in months where there were net inflows into equity mutual funds, those purchases occurred at an average P/E of 19.6X, whereas in months where there were net outflows, those sales occurred at a P/E of 15.7X. Ouch!

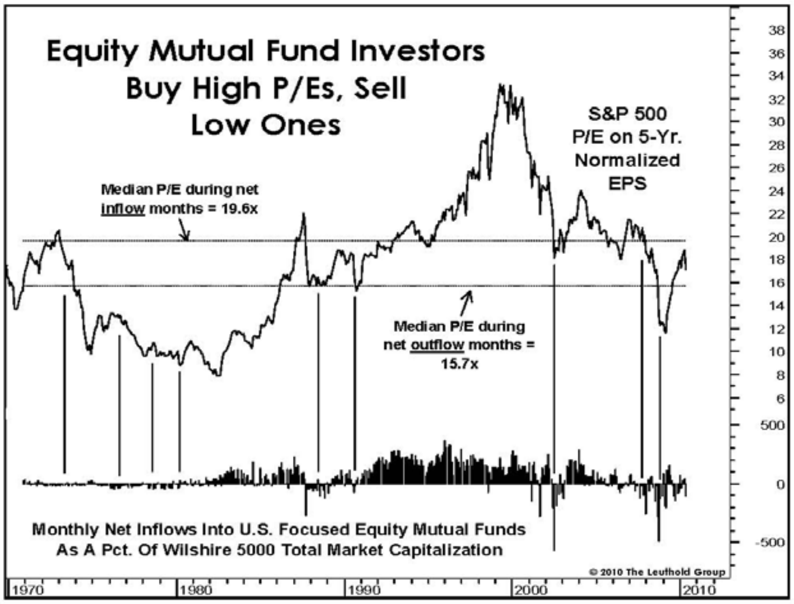


*Chart courtesy of The Leuthold Group

We continue to tilt toward believing there will not be a “double dip” recession in the second half of 2010 or in the early parts of 2011. A slowdown, yes, but not a “double dip” that would have the U. S. generating negative real GDP numbers. According to Chief Economist Joseph LaVorgna at Deutsche Bank, there have been 33 recessions since 1854 and only three instances of the economy relapsing into recession within twelve months of exiting the prior one. The “double dips” occurred in 1913, 1920 and 1981. The fact that there was only one “double dip” in the past sixty years does not make it impossible, just statistically unlikely. It does appear from many economic statistics that a broad slowdown could be in process, e.g., the Baltic Dry Freight index shown here supports such a conclusion. Yet others such as industrial metals prices are signaling the opposite. Since just June 8th, copper is up 17.5%, lead up 29.8%, tin up 26%, zinc up 20% and aluminum alloy up 16%.

The Baltic Dry Index

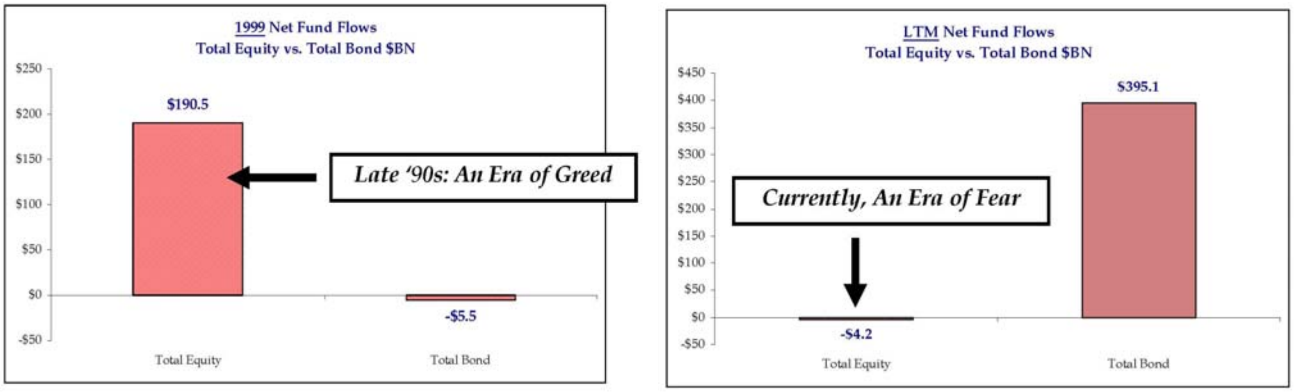
*Chart courtesy of Bloomberg L.P.

The past quarter provided no shortage of fodder for those inclined towards manic depression. The mystery sinking of a South Korean vessel raised the spectre of war. The “flash crash” left everyone shaking their heads in wonder as to what had really happened. These events transpired just as investors were about to tip-toe back to the equity market, shattering investor confidence anew.

Nevertheless, consumers have been deleveraging, and significant progress has been made with the financial obligations to income ratio, the best in a decade. This is particularly noteworthy as foreclosures may be lessening the “obligations”, but “income” is also depressed in this equation.

After the traumatizing events of 2008 and early 2009, and the backward-looking losses in equities over the past dozen years, investors are still licking their wounds. The uncertainty on the political landscape only adds to risk-averse attitudes, so it is not surprising that nearly all investable funds are pouring into the bond market. In fact, as seen below, the current scene is diametrically opposed to what was going on in 1999. This fact alone should draw investors to equities, but, as an old friend now deceased once told me, "This is the only business where when they have a sale, nobody comes." How true.

THE "BUBBLE" IS LIKELY IN BONDS, NOT STOCKS



*Charts courtesy of Strategas Research Partners

We thank our stalwart investors for "hanging tough" in an awful environment. The past three weeks may in fact be the beginning of a reprieve. To paraphrase the eloquence of Kahlil Gibran, march on we will, fearing not the thorns and sharp stones.

Very Truly Yours,

John

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